

## TAXATION OF FOREIGN INCOME

### ¶705 Participation Exemption Deduction for Foreign-Source Portion of Dividends

#### **NEW LAW EXPLAINED**

##### **100-percent participation exemption deduction allowed for foreign-source portion of dividends.—**

A 100-percent deduction is allowed for the foreign-source portion of dividends received from a specified 10-percent owned foreign corporation by a domestic corporation that is a U.S. shareholder of the foreign corporation (a participation dividends-received deduction (DRD)) (Code Sec. 245A(a), as added by the Tax Cuts and Jobs Act).

#### **COMMENT**

The new law generally establishes a participation exemption (territorial) system for the taxation of foreign income that replaces the prior-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. The exemption, which is provided in the form of a participation DRD, is intended to encourage U.S. companies to repatriate their accumulated foreign earnings and invest them in the United States.

#### **CAUTION**

Dividends from foreign companies that are less than 10 percent owned by domestic corporations are not eligible for the participation DRD and will continue to be treated the same as under prior law (i.e., such dividends generally will be taxed when distributed, subject to any applicable anti-deferral rules). Also, dividends received by non-corporate U.S. shareholders are not eligible for the participation DRD.

#### **COMMENT**

According to the Conference Committee Report, it is intended that the term “dividend received” be interpreted broadly, consistently with the meaning of “amount received as dividends” and “dividends received” used in Code Sec. 243 and 245, respectively. Thus, for example, gain included in gross income as a dividend under Code Sec. 1248(a) or 964(e) would constitute a dividend for which the participation DRD may be available. Regulations or other guidance issued pursuant to the regulatory authority granted under Code Sec. 245A(g) (discussed below) may clarify the intended broad scope of the term “dividend received.” For example, if a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned the stock directly, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership’s dividend from the foreign corporation (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder (Code Sec. 245A(b), as added by the 2017 Tax Cuts Act).

#### **COMMENT**

The subpart F definitions of a U.S. shareholder and CFC are expanded so that they are used for purposes of Title 26 (including the participation DRD), and not just the subpart F provisions (Code Secs. 951(b) and 957(a), as amended by the 2017 Tax Cuts Act). The

U.S. shareholder definition is further expanded so that a U.S. shareholder includes a U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock entitled to vote or at least 10 percent of the total value of all classes of stock of the foreign corporation (Act Sec. 14214(a) of the 2017 Tax Cuts Act, amending Code Sec. 951(b); see ¶745).

#### COMMENT

Taxation of income earned by PFICs remains subject to the anti-deferral PFIC regime and dividends received from non-CFC PFICs are ineligible for the participation DRD.

#### COMMENT

A domestic corporation includes a CFC treated as a domestic corporation for purposes of computing its taxable income (Reg. §1.952-2(b)(1)). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to that income. In addition, the participation DRD is available only to C corporations that are not RICs or REITs (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

**Foreign-source portion of a dividend.** The foreign-source portion of any dividend from a specified 10-percent owned foreign corporation is the amount that bears the same ratio to the dividend as (1) the undistributed foreign earnings of the specified 10-percent owned foreign corporation, bears to (2) the total undistributed earnings of that corporation (Code Sec. 245A(c)(1), as added by the 2017 Tax Cuts Act).

Undistributed earnings are the earnings and profits of a specified 10-percent owned foreign corporation (computed in accordance with Code Secs. 964(a) and 986) as of the close of the tax year of the specified 10-percent owned foreign corporation in which the dividend is distributed that are not reduced by dividends distributed during that tax year (Code Sec. 245A(c)(2), as added by the 2017 Tax Cuts Act).

#### COMMENT

Under Code Sec. 959(d), a distribution of previously taxed income does not constitute a dividend, even if it reduces earnings and profits.

Undistributed foreign earnings of a specified 10-percent owned foreign corporation are the portion of the undistributed earnings of that corporation that is not attributable to (1) the corporation's income that is effectively connected with the conduct of a trade or business within the United States, and subject to tax under Chapter 1 of the Code, or (2) any dividend received (directly or through a wholly owned foreign corporation) from an 80-percent owned (by vote or value) domestic corporation (Code Sec. 245A(c)(3), as added by the 2017 Tax Cuts Act).

**Foreign tax credit disallowance.** No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the participation DRD (Code Sec. 245A(d), as added by the 2017 Tax Cuts Act).

For purposes of computing the Code Sec. 904(a) foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income by disregarding (1) the foreign-source portion of any dividend received from that foreign corporation for which a participation DRD is allowed, and (2) any deductions properly allocable or apportioned to that foreign source portion or the stock with respect to which it is paid. For this purpose, any term that is used in this rule and in Code Sec. 245A has the meaning used in Code Sec. 245A (Code Sec. 904(b)(5), as added by the 2017 Tax Cuts Act).

**Hybrid dividends.** The participation DRD is not available for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend (Code Sec. 245A(e)(1), as added by the 2017 Tax Cuts Act).

A hybrid dividend is an amount received from a CFC for which a participation DRD would otherwise be allowed and for which the CFC received a deduction (or other tax benefit) with respect to any income, war

profits, or excess profits taxes imposed by any foreign country or U.S. possession (Code Sec. 245A(e)(4), as added by the 2017 Tax Cuts Act).

If a CFC with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other CFC with respect to which the domestic corporation is also a U.S. shareholder, then:

- 1) the hybrid dividend is treated as subpart F income of the recipient CFC for the tax year of the CFC in which the dividend was received, and
- 2) the U.S. shareholder must include an amount equal to the shareholder's pro rata share of such subpart F income in gross income (Code Sec. 245A(e)(2), as added by the 2017 Tax Cuts Act).

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any hybrid dividend received by a U.S. shareholder or included in the U.S. shareholder's income under the rules, discussed above (Code Sec. 245A(e)(3), as added by the 2017 Tax Cuts Act).

**Special rule for purging distributions of PFICs.** Any amount that is treated as a dividend pursuant to the deemed dividend election under Code Sec. 1291(d)(2)(B) is not treated as a dividend for purposes of the participation DRD (Code Sec. 245A(f), as added by the 2017 Tax Cuts Act).

**Regulatory authority.** The Secretary of the Treasury is authorized to issue regulations or other guidance that is necessary or appropriate to carry out these provisions, including regulations for the treatment of U.S. shareholders owning stock of a specified 10-percent owned foreign corporation through a partnership (Code Sec. 245A(g), as added by the 2017 Tax Cuts Act).

**One-year holding period requirement.** A domestic corporation is not permitted a participation DRD for any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend (Code Sec. 246(c)(5)(A), as added by the 2017 Tax Cuts Act).

#### COMMENT

The special holding period rule for preference dividends in Code Sec. 246(c)(2) does not apply in this case.

The holding period requirement is treated as met only if the foreign corporation is a specified 10-percent owned foreign corporation and the taxpayer is a U.S. shareholder with respect to that specified 10-percent owned foreign corporation at *all* times during the required period (Code Sec. 246(c)(5)(B), as added by the 2017 Tax Cuts Act).

#### COMMENT

Under Code Sec. 246, the participation DRD is not permitted for any dividend on any share of stock to the extent the domestic corporation that owns the share is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. In addition, the required holding periods must be reduced for any period during which the domestic corporation has diminished its risk of loss in respect of stock on which a dividend is paid.

**Application of other rules.** The participation DRD does not apply to dividends received from Code Sec. 501 tax-exempt organizations and farmers' cooperative associations exempt from tax under Code Sec. 521 (Code Sec. 246(a)(1), as amended by the 2017 Tax Cuts Act).

In addition, the participation DRD reduces the amount of the dividend includible in gross income for purposes of computing the nontaxed portion of an extraordinary dividend (Code Sec. 1059(b)(2)(B), as amended by the 2017 Tax Cuts Act).

**Effective date.** The amendments made by this section apply to distributions made (and for purposes of determining a taxpayer's foreign tax credit limitation under Code Sec. 904, deductions with respect to tax years ending) after December 31, 2017 (Act Sec. 14101(f) of the Tax Cuts and Jobs Act).