¶707 Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations

NEW LAW EXPLAINED

Special rules provided for sales or transfers involving specified 10-percent owned foreign corporations.— Sale of stock by U.S. persons. If a domestic corporation sells or exchanges stock in a foreign corporation held for one year or more, any amount received by the domestic corporation that is treated as a dividend under Code Sec. 1248 is treated as a dividend for purposes of the 100-percent participation exemption deduction for the foreign-source portion of dividends under new Code Sec. 245A (the participation dividends-received deduction (DRD)) (Code Sec. 1248(j), as added by the Tax Cuts and Jobs Act).

COMMENT

This rule allows gain on the disposition of the foreign corporation stock to be reduced or eliminated as a result of the recharacterization of the gain as a dividend for which a 100-percent participation DRD is allowed.

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. See ¶705 for a discussion of the participation DRD.

Reduction in the basis of certain foreign stock. If a domestic corporation receives a dividend from a specified 10-percent owned foreign corporation in any tax year, solely for the purpose of determining a loss on the disposition of the stock of that foreign corporation in that tax year or any subsequent tax year, the domestic corporation's basis in that stock is reduced (but not below zero) by the amount of the participation DRD allowable to the domestic corporation with respect to that stock. The basis in the specified 10-percent owned foreign corporation stock is not reduced under this rule to the extent the basis was reduced under Code Sec. 1059 by reason of a dividend for which the participation DRD was allowable (Code Sec. 961(d), as added by the 2017 Tax Cuts Act).

COMPLIANCE TIP

Thus, the reduction in basis is for the portion of the dividend received from the foreign corporation that was exempt from tax by reason of the participation DRD in any tax year of the domestic corporation.

COMMENT

The reduction in basis addresses the concern that taxpayers may obtain inappropriate double benefit that would otherwise be created as a result of the participation DRD. In particular, a distribution from a foreign corporation that is eligible for a participation DRD would reduce the value of the foreign corporation, thus reducing any built-in gain or increasing any built-in loss in the shareholder’s stock of the foreign corporation. While reducing gain in this way is consistent with the application of Code Sec. 1248 to recharacterize such gain as a dividend for which a participation DRD is allowed (see above), increasing any loss in the stock will create an inappropriate double U.S. tax benefit - first, a tax-free distribution from the foreign corporation and second, a tax loss on the disposition of the foreign corporation’s stock.

A specified 10-percent owned foreign corporation is any foreign corporation (other than a passive foreign investment company (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; see ¶705).

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 (Act Sec. 14101(e)(1) and (2) of the 2017 Tax Cuts Act, amending Code Secs. 951(b) and 957(a), respectively; see ¶705). 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).

Sale by a CFC of a lower-tier CFC. If for any tax year of a CFC beginning after December 31, 2017, an amount is treated as a dividend under Code Sec. 964(e)(1) because of a sale or exchange by the CFC of stock in another foreign corporation held for one year or more, then:

1) the foreign-source portion of the dividend is treated as subpart F income of the selling CFC for that tax year for purposes of the subpart F income inclusion rules;
2) a U.S. shareholder with respect to the selling CFC includes in income for the tax year of the shareholder with or within which the tax year of the CFC ends, an amount equal to the shareholder's pro rata share of the amount treated as subpart F income under item (1), above; and
3) a participation DRD is allowable to the U.S. shareholder with respect to the included subpart F income under item (2), above, in the same manner as if the subpart F income were a dividend received by the shareholder from the selling CFC (Code Sec. 964(e)(4)(A), as added by the 2017 Tax Cuts Act).

PRACTICE NOTE

The foreign-source portion of any amount treated as a dividend under this rule is determined in the same manner as the foreign-source portion of a dividend eligible for the participation DRD (see ¶705) (Code Sec. 964(e)(4)(C), as added by the 2017 Tax Cuts Act).

If a CFC sells or exchanges stock in another foreign corporation in a tax year of the selling CFC beginning after December 31, 2017, stock basis adjustment rules similar to the rules of Code Sec. 961(d) apply (Code Sec. 964(e)(4)(B), as added by the 2017 Tax Cuts Act).

Treatment of foreign branch losses transferred to specified 10-percent owned foreign corporations. If a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of Code Sec. 367(a)(3)(C), as in effect before December 22, 2017, the date of the enactment of the 2017 Tax Cuts Act) to a specified 10-percent owned foreign corporation with respect to which it is a U.S. shareholder after the transfer, the domestic corporation includes in income, for the tax year of the transfer, an amount equal to the transferred loss amount, subject to certain limitations (Code Sec. 91(a), as added by the 2017 Tax Cuts Act).

The transferred loss amount, with respect to any transfer of substantially all of the assets of a foreign branch, is the excess (if any) of:

1) the losses incurred by the foreign branch after December 31, 2017, and before the transfer, for which a deduction was allowed to the domestic corporation, over

2) the sum of (i) any taxable income earned by the foreign branch in tax years after the tax year in which the loss is incurred and through the close of the tax year of the transfer, and (ii) gain recognized by reason of a Code Sec. 904(f)(3) overall foreign loss recapture arising out of disposition of assets on account of the underlying transfer (Code Sec. 91(b), as added by the 2017 Tax Cuts Act).

COMMENT

According to the Conference Committee Report, this loss recapture rule addresses the concern that taxpayers may wish to arbitrarily apply the participation exemption system to foreign subsidiaries but not foreign branches. Specifically, a taxpayer may deduct losses from a foreign branch operation against U.S. taxable income and then incorporate that branch once it becomes profitable. Even though there are other loss recapture rules, such as Code Sec. 367(a)(3)(C), these rules generally rely on the worldwide system of taxation to recapture losses in excess of built-in gains by taxing future earnings when the earnings are repatriated to the United States. Instead of only recapturing such losses upon later repatriation of earnings, the new law intends to recapture the U.S. tax benefits of these losses immediately upon the incorporation of a foreign branch that has generated losses. This way, the repatriation of foreign earnings will not carry negative tax consequences, thus discouraging repatriation, which is one of the reasons to transition to a participation exemption system of taxation (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

The transferred loss amount is reduced (but not below zero) by the amount of gain recognized by the taxpayer (other than gain recognized by reason of an overall foreign loss recapture) on account of the transfer (Code Sec. 91(c), as added by the 2017 Tax Cuts Act).

Amounts included in gross income under the above foreign branch loss recapture rules are treated as derived from sources within the United States (Code Sec. 91(d), as added by the 2017 Tax Cuts Act).

Consistent with regulations or other guidance as the Secretary of the Treasury may prescribe, proper adjustments are made in the adjusted basis of the taxpayer's stock in the specified 10-percent owned foreign corporation to which the transfer is made, and in the transferee's adjusted basis in the property transferred, to reflect amounts included in gross income under the foreign branch loss recapture rules, discussed above (Code Sec. 91(e), as added by the 2017 Tax Cuts Act).

Under a transition rule, the amount of gain taken into account under Code Sec. 91(c) is reduced by the amount of gain that would be recognized under Code Sec. 367(a)(3)(C) (determined without regard to the repeal of the Code Sec. 367(a)(3) active trade or business requirement by the 2017 Tax Cuts Act, discussed below) with respect to losses incurred before January 1, 2018 (Act Sec. 14102(d)(4) of the 2017 Tax Cuts Act).

Repeal of the active trade or business exception under Code Sec. 367. The active trade or business exception to the Code Sec. 367(a) rule requiring recognition of gain on the outbound transfer of property by a U.S. transferor to a foreign corporation is repealed (Act Sec. 14102(e)(1) of the 2017 Tax Cuts Act, striking Code Sec. 367(a)(3)).

COMMENT

As a result of the repeal, transfers of property used in the active conduct of a trade or business from a U.S. corporation to a foreign corporation in an otherwise tax-free transaction will be treated as taxable exchanges since the foreign corporation will not be considered a corporation.

Effective date. The amendments made by this section relating to sales or exchanges of foreign corporation stock by a domestic corporation and sales or exchanges of a lower-tier CFC stock by a CFC apply to sales or exchanges after December 31, 2017 (Act Secs. 14102(a)(2) and (c)(2) of Tax Cuts and Jobs Act). The amendment relating to the reduction of basis in stock of a specified 10-percent owned foreign corporation for purposes of determining loss applies to distributions made after December 31, 2017 (Act Sec. 14102(b)(2) of the 2017 Tax Cuts Act). The amendments relating to the transfer of loss amounts from foreign branches to certain foreign corporations and to the repeal of the active trade or business exception under Code Sec. 367 apply to transfers after December 31, 2017 (Act Secs. 14102(d)(3) and (e)(3) of the 2017 Tax Cuts Act). No specific effective dates are provided for the other provisions; therefore, such provisions are considered effective on December 22, 2017, the date of enactment.