CODE §245A – SOMETIMES, THINGS ARE MORE THAN THEY APPEAR

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INTRODUCTION

Section 245A of the Internal Revenue Code of 1986 (the "Code") effectively exempts U.S. corporations from U.S. Federal income tax on dividends received from certain foreign subsidiaries. It allows a deduction equal to the amount of the dividend received. Code §245A applies only where certain conditions are met and only with respect to dividends received "by a domestic corporation which is a United States shareholder."

Nevertheless, Code §245A can also apply to dividends received by a controlled foreign corporation from a qualifying participation in a lower-tier foreign corporation. The question presented in that fact pattern is how Code §245A is applied.

- Is the controlled foreign corporation entitled to claim the deduction as dividends are received?
- Or is a U.S. corporation that is a U.S. Shareholder with regard to both the distributing and the recipient foreign corporations entitled to claim the deduction at the time Subpart F income is reported in its U.S. tax return?

Significantly different results may apply depending on the answer. Interestingly, the differences affect U.S. taxpayers other than the corporation that is a U.S. Shareholder.

CODE §245A: THE U.S. PARTICIPATION EXEMPTION REGIME FOR FOREIGN DIVIDENDS

Code §245A was added to the Code as part of the Tax Cuts and Jobs Act of 2017 (the "T.C.J.A.").[1] It is effective for distributions made after December 31, 2017.

Prior to the T.C.J.A., the U.S. international tax system was largely a worldwide system of taxation. Except as provided under Subpart F, active business income of foreign subsidiaries was taxed only upon repatriation, *i.e.*, when distributed to the U.S. corporate shareholder.[2]

The imposition of U.S. tax on repatriated income of foreign subsidiaries placed U.S. multinational corporations at a disadvantage compared with foreign corporations

[1] Pub. L. No. 115-97, §14101(a).

[2] In contrast to active business income, passive income of foreign subsidiaries has been taxed by the U.S. shareholder on an annual basis under the Subpart F regime or the P.F.I.C. regime where the foreign corporation is treated as a Qualified Electing Fund. Both sets of rules are beyond the scope of this article.

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based in countries that employed a territorial system of taxation dividend income received from foreign subsidiaries.[3] Examples include the U.K. and other G-7 countries. This was especially true because the nominal U.S. corporate tax rate was very high relative to the corporate tax rates in other countries, reaching 35% at the time.[4]

In 2017, Congress decided to eliminate the taxation of repatriated income of foreign subsidiaries and to reduce the corporate income tax rate to 21%. The main purpose was to allow U.S. multinationals to better compete against foreign multinationals.[5] This is when Code §245A came into play, effective in 2018.

CODE §245A - HOW DOES IT WORK?

Code §245A provides that, in the case of any dividend received from a 10%-owned foreign corporation by a U.S. corporation that is a U.S. Shareholder, the U.S. corporation is allowed a deduction in an amount equal to the foreign-source portion of the dividend (also known as a dividend-received deduction or a "D.R.D."). As a result of the D.R.D., the dividend income is fully offset, resulting in a nil rate of U.S. Federal corporate income tax.

An important point to bear in mind is that, where the distributing corporation is a controlled foreign corporation ("C.F.C.") as defined in Code §957(a), some of its income might already have been taxed in the U.S. under the U.S. anti-deferral regimes in advance of any distribution ("Previously Taxed Income").[6] To prevent the same income from being taxed a second time, the Code provides that Previously Taxed Income is not to be taken into account for U.S. Federal tax purposes when actually distributed to the U.S. Shareholder.[7] Accordingly, ordering rules published by the I.R.S. provide that any amount distributed by a C.F.C. will first be considered as being made out of Previously Taxed Income.[8] Only the remainder of the dividend amount, if any, will be potentially subject to Code §245A D.R.D.

For the D.R.D. to apply, the following five conditions must be met:

- The dividend must be received from a "specified 10-percent owned foreign corporation" (a "Specified Foreign Corporation" or "S.F.C."). An S.F.C. is a foreign corporation if at least one of its shareholders is a corporation that is "U.S. Shareholder."[9] A corporation is "U.S. Shareholder" if it was formed in the U.S. and it owns, either directly or indirectly, or is considered as owning under special attribution rules, shares representing 10% or more of the voting power or value of the distributing corporation.[10]

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[3] S. Comm. on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. No. 115-20, at 358 (Comm. Print 2017).

[4] Of course, corporations with sophisticated tax departments were tasked to manage the effective rate.

[5] S. Comm. on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. No. 115-20, at 358 (Comm. Print 2017).

[6] Mainly, the Subpart F regime governed by Code §§951 to 965 and the G.I.L.T.I. regime under Code §951A. The G.I.L.T.I. regime became effective as of 2018.

[7] Code §959(a).

[8] I.R.S. Notice 2019-01.

[9] Code §245A(b).

[10] Code §951(b).

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- The dividend must be received by a domestic corporation that is a "U.S. Shareholder" with respect to the distributing corporation.
- The U.S. Shareholder must meet a minimum holding-period requirement of more than 365 days during a two-year period beginning one year before the ex-dividend date.[11]
- The dividend must be a foreign source dividend, determined by reference to the undistributed foreign earnings of the Specified Corporation.[12]
- The dividend must not be any of the following: (i) a hybrid dividend,[13] (ii) a purging distribution by a passive foreign investment company ("P.F.I.C.") generally made as a condition of becoming a "pedigreed Q.E.F.,[14] (iii) any other distribution from a P.F.I.C."[15] that is not a C.F.C.,[16] and (iv) an extraordinary disposition amount during the taxable year preceding application of the D.R.D.[17]

In this article, we focus on the second requirement listed above, according to which the dividend must be received by a domestic corporation.

As explained below, the D.R.D. should also apply if the dividend is received by a C.F.C. owned by a domestic corporation, provided the domestic corporation is U.S. Shareholder with respect to the distributing corporation and all other requirements listed above are met.

"... the D.R.D. should also apply if the dividend is received by a C.F.C. owned by a domestic corporation, provided the domestic corporation is U.S. Shareholder with respect to the distributing corporation and all other requirements listed above are met."

DIVIDEND RECEIVED BY A CONTROLLED FOREIGN CORPORATION – WHAT IS THE PROBLEM?

The plain language of Code §245A provides that a D.R.D. may apply where a dividend is received by a domestic corporation which is a U.S. Shareholder. Allowing for a D.R.D. to apply only with respect to dividends received by domestic corporations makes sense – Code §245A was enacted to incentivize U.S. corporations and to remove fiscal barriers imposed on U.S. multinational corporations, not on foreign corporations.

However, multinational U.S. corporations typically own several tiers of foreign corporations. Therefore, a dividend distributed by an S.F.C. might be received by an upper-tier foreign corporation rather than directly by the U.S. parent corporation. Then what? Should Code §245A apply in such a case? Three scenarios are relevant to our discussion. The third scenario would be at the focus of this article.

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[11] Code §246(c)(5).

[12] As defined in Code §245A(c). A deduction for the U.S. portion of the dividend, if any, is available under Code §245, in full or in part, depending on the circumstances and provided certain conditions are met.

[13] Code §245A(e).

[14] Code §245A(f).

[15] Defined in Code §1297.

[16] Defined in Code §957(a).

[17] Treas. Regs. §1.245A-5.

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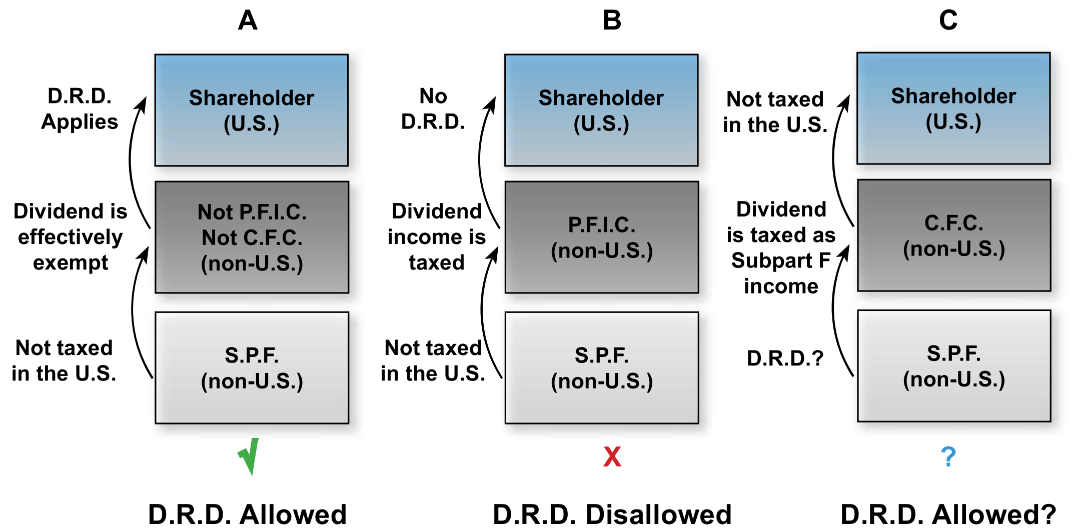
First, if the upper-tier foreign corporation is neither a P.F.I.C.[18] nor a C.F.C., the dividend income received will not be subject to U.S. Federal income tax when and as received by an S.F.C. When the proceeds of the dividend are distributed to a U.S. corporation that is a U.S. Shareholder, a 100% D.R.D. may apply under Code §245A. All in all, no U.S. Federal income tax would apply on the dividend amount.

Second, if the upper-tier foreign corporation is a P.F.I.C.[19] that is not a Q.E.F.[20] and not a C.F.C., the dividend income will be taken into account for U.S. Federal tax purposes when and as distributed to a corporation that is a U.S. Shareholder. Code §245A explicitly disallows the D.R.D on distributions from a P.F.I.C.[21] Therefore, U.S. Federal tax will be imposed when the dividend is distributed to the U.S. Shareholder, typically under the excess distribution regime applicable to P.F.I.C. distributions.

Third, if the upper-tier foreign corporation is a C.F.C., the dividend received will be considered Subpart F income,[22] if no exception applies,[23] and the U.S. Shareholder will be required to include in its gross income its *pro-rata* share of the C.F.C.'s dividend income.[24] In other words, the corporate U.S. Shareholder will be subject to U.S. tax on the dividend income distributed by an S.F.C. to a C.F.C. When a distribution is further made to the U.S. corporate shareholder by the C.F.C, no additional U.S. tax will be imposed and thus the D.R.D. will be technically irrelevant at that point.[25] However, U.S. tax would have already been imposed at the C.F.C. level, effectively subjecting the dividend income to U.S. Federal tax.

The different scenarios are demonstrated through the following diagram:



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[18] Defined in Code §1297.

[19] Whether the upper-tier foreign corporation is a "passive foreign investment company" and how to avoid such status, is beyond the scope of this article.

[20] Within its meaning in Code §1295.

[21] Code §245A(b)(2).

[22] Code §§ 952(a)(2), 954(a) & 954(c)(1)(A).

[23] See mainly Code §§954(c)(3) & (6).

[24] Code §951(a).

[25] Code §959(a).

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Scenario C illustrates that, if Code §245A would not apply to a dividend received by a C.F.C from an S.F.C., the dividend will be subject to U.S. Federal tax under the Subpart F regime. In this case, no participation exemption would apply and the intended purpose of the D.R.D. would be frustrated.

Since many U.S. multinational groups own S.F.C.'s through tiered C.F.C.'s, a narrow reading of Code §245A could impose a real obstacle in accomplishing the purpose of the U.S. participation exemption regime. A more liberal interpretation of Code §245A is therefore required, and it can be achieved through either of the following two theories:

- The C.F.C. will compute its income as if it were a domestic corporation, which includes Code §245A. Therefore, any dividend received by the C.F.C. will be regarded as being received by a domestic corporation.
- The C.F.C.'s Subpart F income resulting from the dividend and included in the U.S. Shareholder's gross income, will be treated as a dividend received by the U.S. Shareholder for purposes of Code §245A.

Interestingly enough, each of these theories can be supported by one or more related Code provisions as well as legislative history.

RELATED CODE PROVISIONS

Each of the Code provisions described below can support the notion that Code §245A was intended to apply on any dividend received by a C.F.C. from an S.F.C.

Code §964(a) and I.R.S. Regulations Treat a Foreign Corporation as a Domestic Corporation for Purposes of Computing Income

Code §964(a) and I.R.S. regulations promulgated thereunder,[26] provide that the taxable income of a C.F.C. will be determined by treating such corporation as a domestic corporation.[27] This provision is a key feature of the Subpart F regime because it allows a U.S. Shareholder to determine the C.F.C.'s income under U.S. Federal tax principles.

In applying Code §964(a) to Code §245A, a dividend received by a C.F.C. should be treated as having been received by a domestic corporation.

Under Code §951(b), a U.S. Shareholder Includes an Indirect Shareholder

As mentioned above, Code §245A requires that a dividend distributed by the foreign corporation will be received by a domestic corporation that is a "U.S. Shareholder with respect to such foreign corporation."

The term "U.S. Shareholder" is defined in Code §951(b). Under that provision, a domestic corporation can be considered a U.S. Shareholder of a foreign corporation whether it owns shares in the foreign corporation directly or indirectly through an upper-tier foreign corporation.[28] It follows that Code §245A allows for an indirect ownership of the S.F.C. by the U.S. Shareholder.

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[26] Tres. Reg. §1.952-2(b).

[27] Certain exceptions apply but none of them relate to Code §245A.

[28] Code §958(a)(2).

Where the U.S. Shareholder indirectly owns the S.F.C. through an upper-tier foreign corporation, it can be expected that any dividend distributed by the S.F.C. will be received through such upper-tier foreign corporation. Since Code §245A allows for an indirect ownership of the S.F.C. through an upper-tier foreign corporation, it can be inferred that it also allows for an indirect receipt of the dividend through the upper-tier foreign corporation.

Under Code §245A(e)(2), an Exception Applies to Dividends Received by a C.F.C. Evidencing That Absent any Exception, a D.R.D. Applies to C.F.C.'s

As an exception to the general rule regarding the D.R.D., Code §245A(e)(1) provides that the D.R.D. will not apply with respect to a hybrid dividend received by a U.S. Shareholder from an S.F.C. that is a C.F.C. Code §245A(e)(2) further provides that the D.R.D. will not apply with respect to a hybrid dividend received by a C.F.C. from an S.F.C. that is a C.F.C.

The exception under Code §245A(e)(2) would not have been required had the D.R.D. not applied to dividends received by C.F.C.'s. The fact that Congress enacted this exception can be read to confirm that D.R.D. may apply to dividends received by a C.F.C. under the general rule and absent any exception.

Under Code §964(e)(4), the D.R.D. Applies on a Dividend That is Deemed Received by a C.F.C., Implying That a D.R.D. Applies to a Dividend That is Actually Received by a C.F.C.

Code §964(e)(4) provides that if a C.F.C. is treated as receiving a dividend under circumstances set forth in Code §964(e)(1),[29] a D.R.D may apply to that deemed dividend pursuant to the following mechanism:

- The deemed dividend is treated as Subpart F income.
- The U.S. Shareholder includes in its gross income its *pro-rata* share of the Subpart F income.
- The D.R.D. under Code §245A is allowable as if the Subpart F income were a dividend received by the U.S. Shareholder.

Under this view, if a D.R.D. may apply to a dividend deemed received by a C.F.C., it may also apply to a dividend actually received by a C.F.C.

I.R.S. Regulations Under Code §956 Allow for a D.R.D. on a Hypothetical Distribution From a Lower-Tier C.F.C.

At a high level, Code §956 requires any U.S. Shareholder of a C.F.C. to include in gross income the C.F.C's investments in U.S. property (the "Code §956 Amount"). Final regulations corrected in 2019 reduce the Code §956 Amount by amounts that the U.S. Shareholder could have deducted as a D.R.D. under Code §245A had the Code §956 Amount been distributed to it (a "hypothetical distribution").

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[29] Under Code §964(e)(1), if a C.F.C. sells stock in a lower-tier C.F.C. in which it owned 10% or more of the voting power at any time during the 5 years preceding the sale, part of the gain will be treated as a dividend, to the extent of the lower-tier C.F.C.'s accumulated earnings and profits attributable to the sold stock.

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These regulations, that allow for a D.R.D. to apply to a hypothetical distribution, also allow for a D.R.D. to apply on a hypothetical distribution from a lower-tier C.F.C. that is indirectly held by a U.S. Shareholder through another foreign entity, as if the distribution were made directly to the U.S. Shareholder.[30]

Allowing the D.R.D. to apply on a hypothetical distribution from a lower-tier C.F.C. confirms that the Treasury's view is that a D.R.D. can generally apply to dividends distributed by lower-tier foreign corporations.

THE LEGISLATIVE HISTORY

In addition to the Code provisions mentioned above, the legislative history also supports the notion that Code §245A was intended to apply on any dividend received by a C.F.C. from an S.F.C. Once again, two different interpretative theories may apply.

The C.F.C. may be Treated as a Domestic Corporation

Code §245A was described in the Congress' Committee of Conference Report published in regard to the T.C.J.A.[31] In that report, immediately after the words "domestic corporation," there appears a footnote that reads as follows:

> * * * including a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See Treas. Reg. Sec. 1.952-2(b). Therefore, a C.F.C. receiving a dividend from a 10-percent owned foreign corporation that constitutes Subpart F income may be eligible for the D.R.D. with respect to such income.

"Allowing the D.R.D. to apply on a hypothetical distribution from a lower-tier C.F.C. confirms that the Treasury's view is that a D.R.D. can generally apply to dividends distributed by lower-tier foreign corporations."

Based on the Committee's approach, Congress intended that the C.F.C. will be treated as a domestic corporation for purposes of the D.R.D. and, accordingly, the C.F.C. itself may claim the dividend-received deduction under §245A. As a result, the C.F.C.'s Subpart F income will not include the dividend income received from the S.F.C.

The C.F.C.'s Subpart F Income May be Treated as a Dividend Received by the U.S. Shareholder

A somewhat different approach was expressed in the Joint Committee on Taxation report (the "Bluebook").[32] According to the Bluebook:

> A corporate U.S. Shareholder of a C.F.C. receiving a dividend from a 10-percent owned foreign corporation shall be allowed a deduction with respect to the subpart F inclusion attributable to such dividend in the same manner as a dividend would be allowable under §245A."

According to this approach, it is the U.S. corporate shareholder who will be eligible for the D.R.D. with respect to the Subpart F inclusion, not the C.F.C. receiving the dividend. The D.R.D. would apply to the Subpart F inclusion in the same manner as a dividend would be allowable under Code §245A.

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[30] Treas. Reg. §1.956-1(a)(2)(ii).

[31] H.R. Rep. No. 115-466, at 599, n.1486 (2017) (Conf. Rep.).

[32] Joint Comm. on Tax'n, General Explanation of Public Law 115-97 (JCS-1-18), at 348 (Dec. 20, 2018).

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The Bluebook's approach essentially achieves the same result of reducing the U.S. Shareholder's Subpart F liability by the dividend amount in a three-step process: First, the dividend received by the C.F.C. will be treated as Subpart F income. Second, the U.S. Shareholder's *pro rata* share in that Subpart F income will be included in the U.S. Shareholder's gross income. Lastly, the U.S. Shareholder would claim a D.R.D. under Code §245A to offset its Subpart F inclusion.

WHICH APPROACH SHOULD BE ADOPTED?

In the previous sections we established that a D.R.D. may apply under Code §245A with respect to a dividend received by a C.F.C., not only with respect to a dividend received by a domestic corporation.

However, in absence of clear guidance on point, it remains unclear what interpretative approach should be adopted – should it be the Committee's approach, treating the C.F.C. as a domestic corporation and allowing the C.F.C. itself to claim the D.R.D.? Or should it be the Bluebook approach, treating the Subpart F inclusion attributed to the dividend as a dividend and allowing the U.S. Shareholder to utilize the D.R.D. to offset such Subpart F inclusion?

While both interpretations have supporting arguments, we are inclined to believe that the Bluebook's approach, which allows for the D.R.D. to apply at the level of the corporate U.S. Shareholder, is the better of the two approaches.

- The Bluebook approach goes hand-in-hand with the participation exemption regime which Congress sought to implement through Code §245A. Under the Bluebook approach, a D.R.D. will be allowable only "in the same manner as a dividend would be allowable under §245A." Therefore, the D.R.D. will be allowed only for a U.S. Shareholder that is a corporation, rather than an individual, that owns, directly or indirectly, 10% of the voting power or the value of the foreign corporation. In that way, a participation exemption will be granted only and exactly in the special circumstances articulated by Congress. Of course, if the individual were to make an election under Code §962 to compute tax under Subpart F as if a corporation, the D.R.D. would be available until an actual dividend is received.[33] In comparison, if the D.R.D. is allowable at the C.F.C. level, as suggested under the Committee's approach, a participation exemption will be available even where the C.F.C. is owned by an individual shareholder. This benefit goes beyond the purpose of Code §245A and is not the goal that Congress wished to achieve.

- The Bluebook approach is harmonized with Code §964(e)(4). As explained above, in certain circumstances a C.F.C. is treated as receiving a deemed dividend under Code §964(e)(1). Code §964(e)(4) provides that Code §245A may apply to such deemed dividend and, to that end, it is the U.S. Shareholder, not the C.F.C., that would be eligible for a D.R.D., subject to a 3-step process. The Bluebook approach follows the exact same path as Code §964(e)(4) and, by that, it creates a coherent and harmonized statutory scheme.

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[33] Code §962(d).

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- The Bluebook approach is not in conflict with the provisions of Subpart F. Subpart F requires any U.S. Shareholder in a C.F.C. to include in her gross income her *pro-rata* share in the C.F.C.'s Subpart F income. The term "Subpart F" income is defined to include certain types of income, including dividends received by the C.F.C.[34] (subject to certain exceptions).[35]

  Under the Bluebook approach, dividend received from the S.F.C. is expected to be treated as Subpart F income of the C.F.C. under the ordinary rules of the Subpart F regime. Similarly, the U.S. Shareholder is expected to include in its gross income its *pro-rata* share of Subpart F income. It is only at that point that the U.S. Shareholder may claim a D.R.D., and then, only to the extent it is eligible under the requirements of Code §245A. This way, the Bluebook approach allows the Subpart F regime and the participation exemption regime to co-exist side by side. As illustrated above, the Committee's approach is in conflict with the provisions of Subpart F as explained above. It would effectively allow an individual U.S. Shareholder to avoid income as dividends would flow up a chain of S.F.C.'s ultimately to the individual. That would not occur were all corporations U.S. domestic corporations.

- While the D.R.D. under Code §245A is fundamentally different from the indirect foreign tax credit that existed under prior law,[36] nothing in the legislative history suggests that the class of persons benefitting under the D.R.D. should be broader than the class of persons that previously benefitted from indirect foreign tax credit. The indirect foreign tax credit could be claimed only by domestic corporations owning 10% or more of the voting stock of the foreign corporation paying the dividend. If the D.R.D. is applied at the level of the C.F.C., effectively all U.S. persons who are shareholders of an S.F.C. could benefit by the deduction because the D.R.D. would reduce earnings and profits thereby reducing the portion of all distributions treated as dividend income.[37]

CONCLUSION

The legislative history and the related provisions of the Code, read as a whole, confirm that Congress intended for the D.R.D. under Code §245A to apply with regard to dividends received by C.F.C.'s.

While some portions of the legislative history suggest that the D.R.D. may be claimed at the level of a C.F.C., other parts of the legislative history support the approach that a dividend received by a C.F.C. from 10% owned foreign corporation should first be treated as the C.F.C.'s Subpart F income and included in the U.S.

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[34] See Code §§952(a) and 954(c)(1)(A).

[35] See, mainly, Code §§954(c)(3) & (6).

[36] Code §902 as in effect up to 2018.

[37] Under Code §316(a), the term "dividend" means any distribution of property, including money, out of earnings and profits after February 28, 2013 or out of earnings and profits of the taxable year in which the distribution is made, without regard to the earnings and profits at the time of the distribution. Amounts distributed in excess of earnings and profits are treated as a reduction in the shareholder's basis in the shares. When basis is reduced to zero, amounts distributed are treated as capital gains. See Code §301(c).

Shareholder's gross income. Only at the shareholder level may a D.R.D. be claimed by the U.S. Shareholder, and only by a corporation, provided all the requirements of Code §245A are met.

Such interpretative approach to Code §245A results in eliminating the taxable income arising from a Subpart F inclusion when a corporation is the U.S. Shareholder, thereby effectively achieving the purpose of the participation exemption regime that was introduced into the U.S. international tax system effective in 2018.

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