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# Repatriating Low-Tax Earnings From a CFC

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Bloomberg BNA – New York City
U.S. Tax Planning for CFCs Under Subpart F
2 December 2013

# Agenda

- **Repatriation backdrop**
  - Genesis
  - Government approaches
- **Where we're going, where we've been**
  - Various § 956 arrangements
  - Operational pre-funding
  - Killer Bs
  - § 304 and Cash Ds
  - Deadly Ds
- **Legislative proposals**
  - A Republican's approach
  - A Democrat's approach

# Repatriation Overview

**Origins in 1962 legislation**

- WW system of taxation, but jurisdictional problems with foreign subs
- Kennedy compromise
- Globalization and chasing growth abroad
  - Foreign tax regimes – foreign MNE treasury advantage?
  - APB 23 – reporting pressures?

*Photo via U.S. Dept. of Treasury*

*Photo via Wikimedia Commons*

***Key rationales for [Subpart F's] enactment included…promoting economic efficiency, and avoiding undue harm to the competitiveness of U.S. multinationals. … Congress was concerned that ending deferral completely would place U.S. companies at a competitive disadvantage in their foreign operations.***

**– Mark Mazur, Asst. Sec. for Tax Policy, U.S. Dept. of Treasury**
**Testimony before U.S. Senate PSI (21 May 2013)**

# Government's Approach

**Some help provided to U.S. MNEs**

- American Jobs Creation Act 2004 – enacted § 965
  - U.S. corporations enjoyed 85% DRD on CFC repatriations
- Some tax-efficient repatriation was generally permitted
  - 88-108s (including relaxation of rules following 2007 economic crisis)
  - Government historically agnostic re affirmative use of § 956

*Photo via Office of Senator Levin*

**But general tact has been to *not* throw a lifeline**

- Congressional activity
  - New legislation – e.g., §§ 901(m) and 960(c)
  - U.S. Senate PSI hearings
- Administrative activity
  - Treasury / IRS have spent considerable time attacking repatriation transactions through guidance
  - IRS litigation positions – e.g., *BMC Software*

**SIDE NOTE: despite suggestions to the contrary, the mere presence of a CFC's property in the U.S. (e.g., on account at a U.S. bank) is *not* a repatriation of funds**

# Road Ahead, Road Behind

# Affirmative § 956 – Basic

**Historic § 956 treatment**

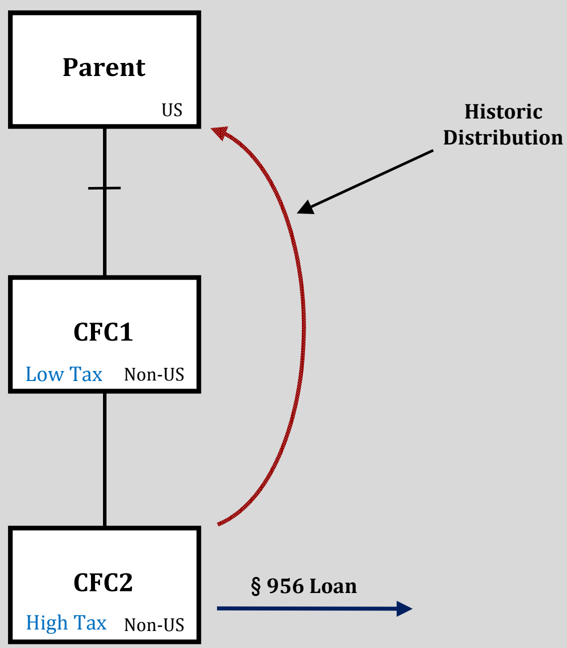
- If a CFC makes an investment in "U.S. property", the U.S. shareholders are required to include in GI their pro-rata share of the § 956 amount
  - Inclusion would "hopscotch" over any upper-tier CFCs in the chain of ownership
- U.S. corporate shareholders in CFC could claim a deemed paid FTC under § 960
  - No dilution through tiers – deemed paid dividend pulls FTCs from CFC holding "U.S. property"
  - Contrast with situation where *actual* dividend paid (potential dilution through CFC tiers)

**Modern § 956 treatment – "anti-hopscotch" / chain pooling**

- New § 960(c) enacted – August 2010
  - One-way street – limits (will not increase) the amount of FTCs available due to § 956 inclusion
  - To compute FTC available – treat amount of § 956 inclusion as if paid up chain as cash distribution
    - It is a *deemed* payment – no local WHT attaches; normal U.S. tax rules continue to apply to hypo distribution (subpart F, PTI, etc.); FTC amount disallowed remains in CFC's tax pools

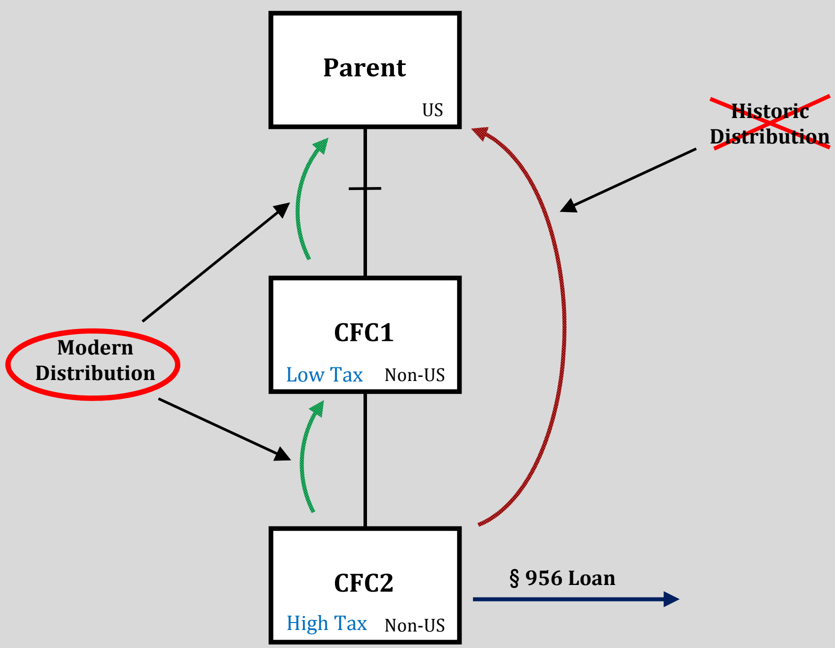
# Affirmative § 956 – Basic (Cont.)

## Historic Treatment




- *As a result of § 956 investment, <u>only</u> the FTC pool of CFC2 is relevant in determining FTCs available to Parent under § 960*

## Modern Treatment

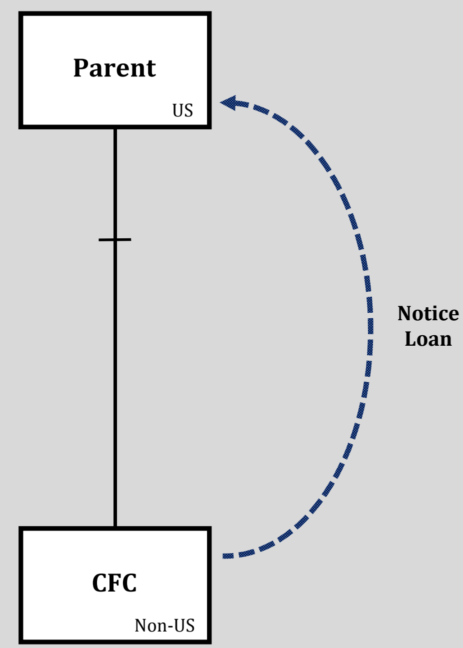



- *As a result of 956 investment, the FTC pools of CFC2 <u>and</u> CFC1 will be relevant in determining FTCs available to parent under § 960*
  - Interesting issues may arise depending on specific facts (e.g., due to PTI, deficits)

# "Notice" Loans

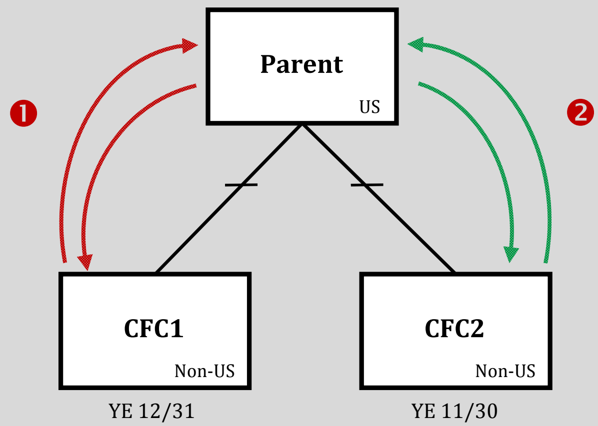
**Notice 88-108**

- Permits CFC to loan money back to U.S. parent, originally to temporarily clear off CP from books
  - Will not constitute § 956 "obligation" so long as (a) collected within 30 days from time it is incurred, and (b) CFC does not hold "obligations" for 60 or more calendar days during its year
- Can be dangerous – need guidelines if implement
  - Amounts at issue typically are substantial when used to clear off CP of parent at quarter-end; big miss (potential to blow-up deferral) if done wrong
  - Hair-triggers, be aware of potential traps
    - Transfer pricing
    - Funding
    - Insufficient waiting period
    - Guarantees




**NO INCLUSION**
**(if done correctly)**

# Dueling § 956 Loans




**Hypothetical Loan Matrix**

| Period | CFC1 | CFC2 |
|---|---|---|
| Jan 19 – Mar 4 | X | |
| Mar 5 – Apr 21 | | X |
| Apr 22 – June 8 | X | |
| June 9 – July 26 | | X |
| July 27 – Sept 10 | X | |
| Sept 11 – Oct 25 | | X |
| Oct 26 – Dec 7 | X | |
| Dec 8 – Jan 18 | | X |

## Alternating § 956 loan patterns

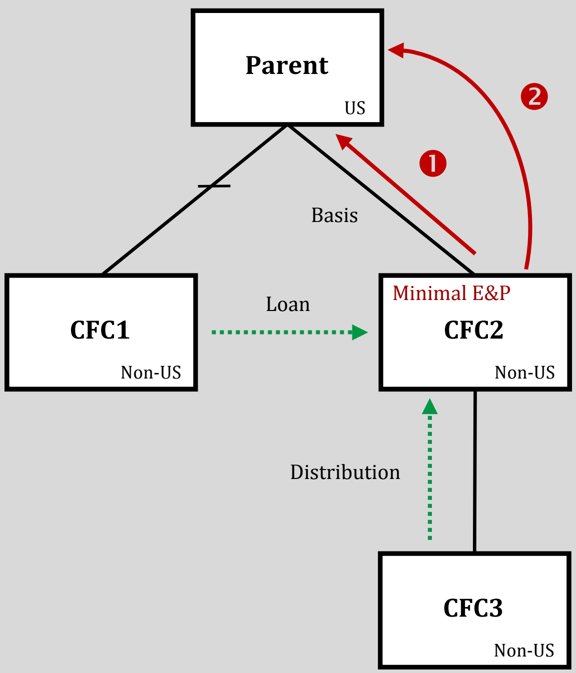
- CFC1 and CFC2 switch off lending
- AM 2009-013 suggests that each obligation is treated as distinct so long as (a) each CFC independently funds the loan, and (b) the U.S. person executes/repays each loan as separate, independent transaction

**Caution! This hypo is merely illustrative, need careful planning if were to pursue (and synchronization may be problematic)**

## Potential risks:

- Debt vs. equity
- Step-transaction – *Jacobs Engineering* and Rev. Rul. 89-73
- Substance over form
- "Funding" issues – Reg. § 1.956-1T(b)(4)
- § 269, conduit, economic substance and APB 23 issues
- Others?

# ROC Distributions




Contrast situation #1 from situation #2

## Scenarios

(A) CFC2 has own cash

(B) CFC2 has little/no E&P and little cash

## Reg. § 1.956-1T(b)(4)(i)

CFC is considered to hold…investments in US property acquired by any other foreign corporation that is controlled by the CFC *if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of 956 w/ re the CFC.*

## Obama FY 2014 budget proposal

To the extent a FC funds a second FC with "a principal purpose" of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder's basis in the stock of the distributing corporation will not be taken into account for the purpose of determining the treatment of the distribution under section 301. Funding transactions to which the proposal would apply include capital contributions, loans, or distributions to the foreign distributing corporation (whether occurring before/after)

See Treasury Green Book (April 2013)

# Zero Basis § 956 Plays

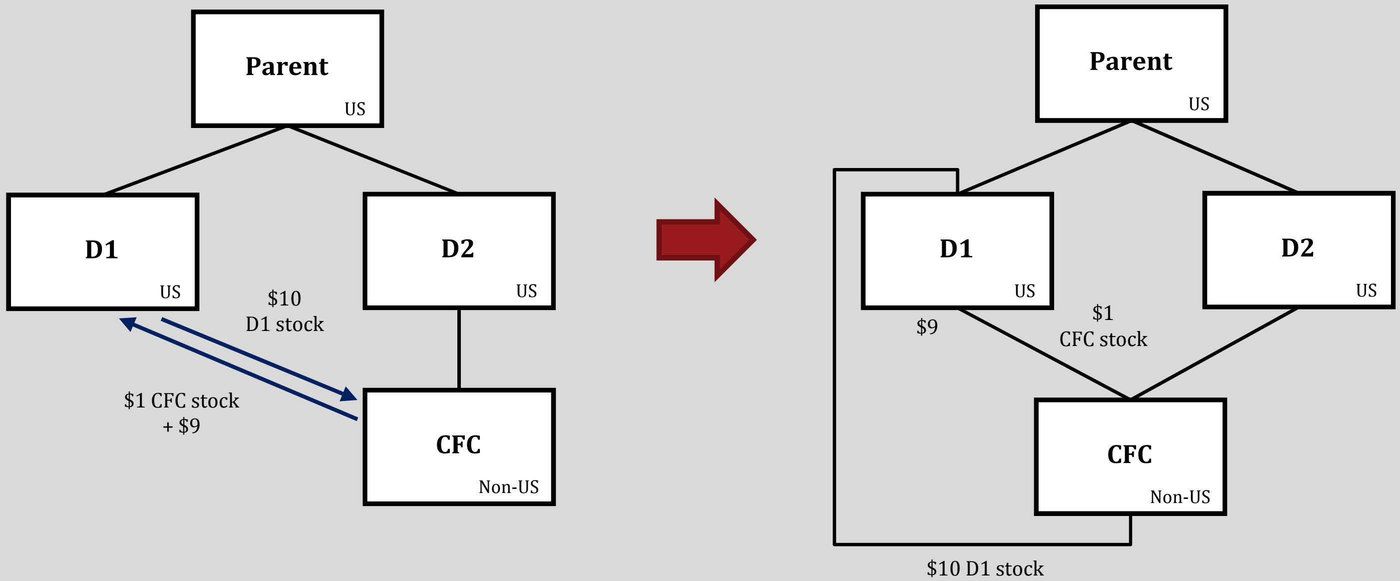
**§ 956 Zero Basis Transactions**

- Pre-regulations
  - Repatriating funds from CFCs using § 351 and § 1032 for protection
  - As a result of § 362, position was that CFC held $0 basis stock of US affiliate
    - § 362(a) provides that a transferee corp (TC) takes a transferred basis in property contributed, increased by any gain. Rev. Rul. 74-503 stood for the general proposition that a corporate transferor has a $0 basis in its treasury stock, so when it contributed it in a § 351 transaction, the TC took a $0 basis under § 362(a) in respect of the transferor's contributed treasury stock
- Regulatory approach – 2008 (temporary) and 2011 (final)
  - Where CFC acquires stock/obligations of a domestic affiliate in an exchange where the CFC's basis is determined under § 362, then *solely for § 956 purposes* its basis in such property will not be less than FMV of property the CFC transferred in the exchange

***Barnes Group* – April 2013 decision**

- Relied on Rev. Rul. 74-503 (which applied § 362) prior to its revocation by Rev. Rul. 2006-2

# Zero Basis § 956 Transactions



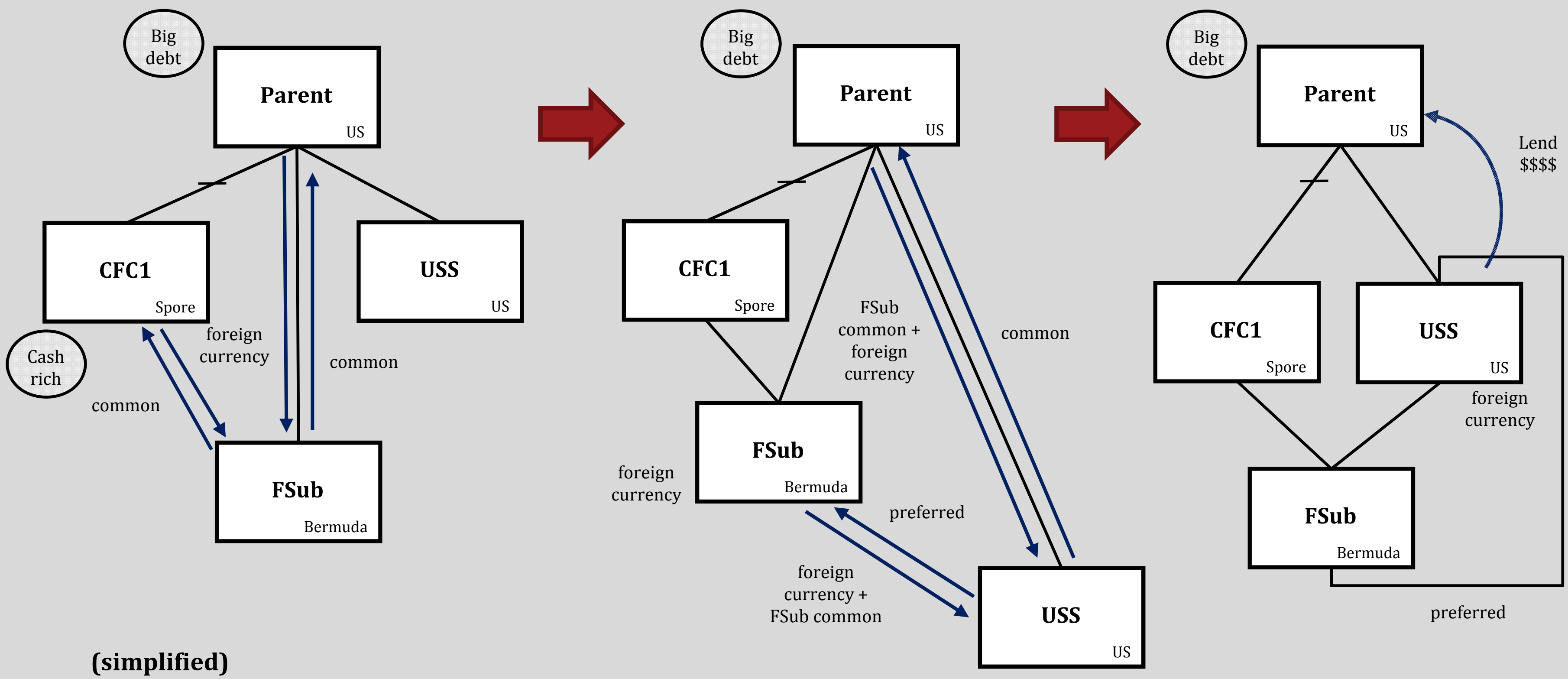

**Pre-regs**

- D1's contribution is tax-free § 351 txn per Treas. Reg. § 1.1502-34, and it is protected under § 1032
- CFC recognizes no gain on issuance of its stock per § 1032; under § 362(a), CFC takes D1's basis in the D1 stock contributed (plus any gain recog.)
- D1's basis was $0 via Rev. Rul. 74-503, so no § 956 inclusion for D1 or D2 due to CFC's ownership

**Regulatory approach**

- CFC is deemed to have basis in a domestic affiliate's stock or obligations equal to FMV of property that CFC transferred in the exchange with such domestic issuing corp, if CFC's basis would otherwise be determined under § 362(a)
- Basis exists *solely for* § 956 purposes

# Barnes Group – TC Memo 2013-109




- Pre-restructure, Parent had large US debt (from deals) at high interest rate, was OFL and had approx. $2m (US) and $40m (foreign) cash earning low returns
- In Step One, Parent and CFC1 transferred foreign currency to new FSub in exchange for common (§ 351)
- In Step Two, FSub transferred foreign currency and stock, and Parent transferred FSub common and foreign currency, to new USS in exchange for preferred and common, respectively (§ 351)
- Thereafter, USS converted the foreign currency to USD and loaned $$$ to Parent (which was used to pay down debt)

Not shown: CFC1 also borrowed from 3rd party bank (Parent guaranteed) to further fund the structure

# Barnes Group (cont.)

**Tax Court rules against taxpayer**

- Ruling that structure in essence a § 301 dividend – looked at transaction as whole
- Taxpayer argued no § 956 b/c $0 basis, but court said Rev. Rul. 74-503 not sufficiently similar
- Application of step-transaction doctrine (interdependence test)
  - Taxpayer asserted but failed to demonstrate independent business/economic purpose for newly-created entities (i.e., for FSub and USS)
  - Court did not feel a need to take up the IRS § 269, conduit or "in essence a § 956 loan" arguments
- Taxpayer failed to respect the form of its transactions – interest and dividends rarely paid
- PwC opinion (MLTN or stronger) did not protect against substantial misstatement penalty

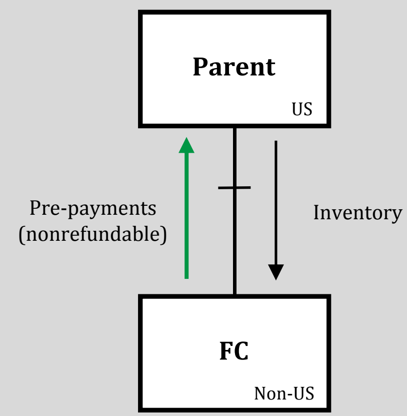
**Key takeaways**

- Reminder that taxpayers cannot merely rely on highly-technical opinions, but need to also consider judicial doctrines in the repatriation context
- And must always respect your own structure!

# Operational Pre-Funding

**Inventory pre-payment strategy**

- **Facts:** FC gives Parent a *non-refundable* upfront payment (e.g., cash for 2 years of purchases), properly discounted to reflect that it is an early advance
- **Considerations**
  - Can Parent defer income?
    - If so, for how long?
    - Would immediate income be a benefit?
  - What is the discount that FC receives?
    - Sub F or expense reduction?
  - Repeatable?
- **Alternate scenarios**
  - May be available for services, royalties, etc.



# Killer Bs

**Treasury / IRS first addressed – starting in 2006**

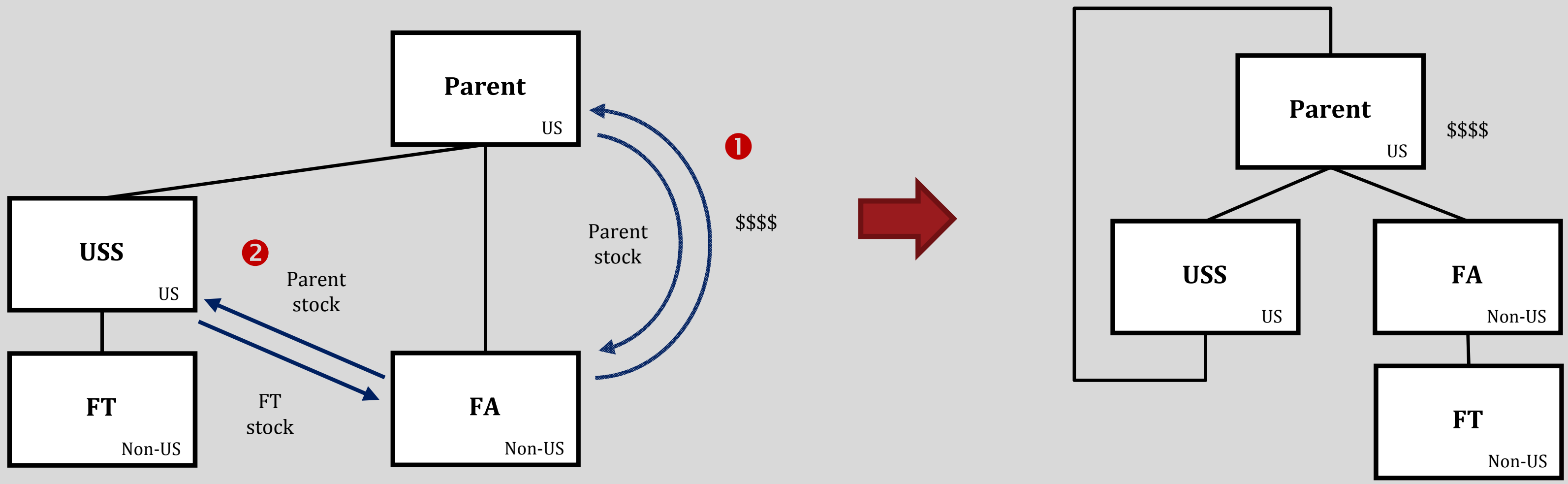
- Triangular reorganizations
  - Gaps between subchapter C and international provisions
  - US MNEs were using to repatriate untaxed cash
  - Foreign MNEs could use to lever-up US subs and strip-out dividends even if no treaty
- Notices issued in September 2006 and May 2007
- Temporary 367(b) regulations issued in May 2008

**Final regulations issued – May 2011**

- Treas. Reg. § 1.367(b)-10
- Alternatives?

# KILLER BS (CONT.)

**Pre-Notice**




**Triangular B to repatriate cash**

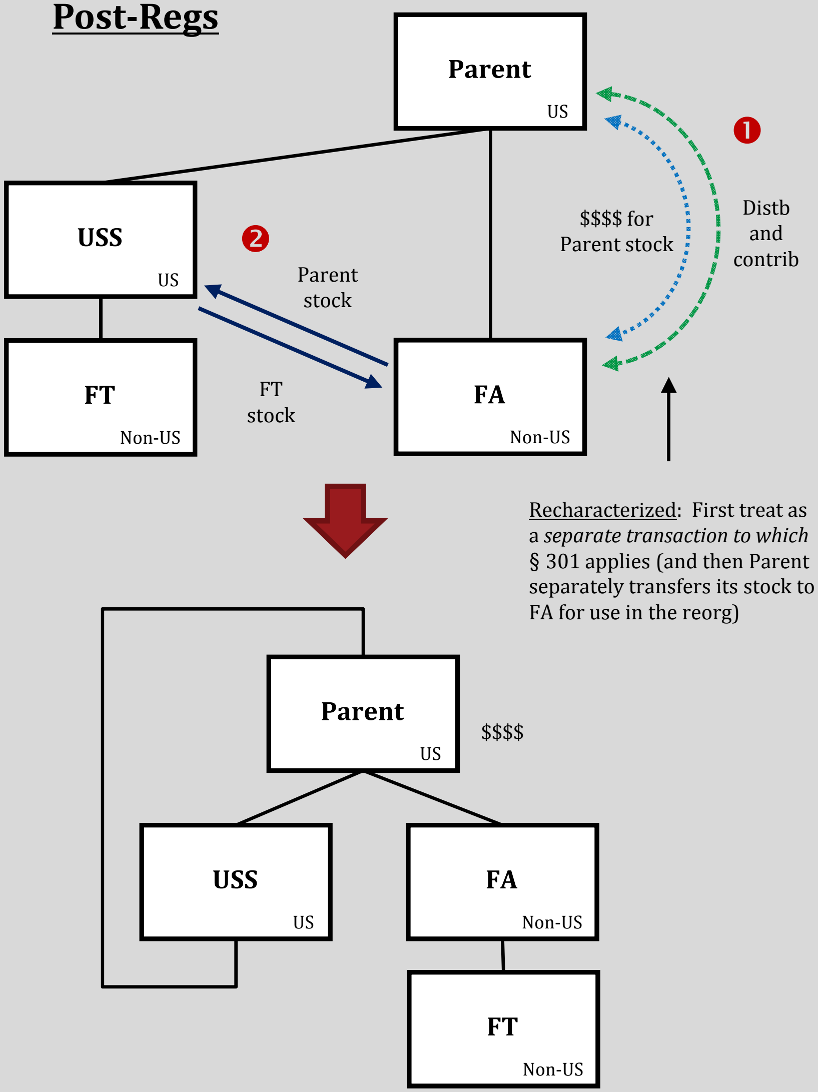
- Parent protected under § 1032
- FA protected b/c no gain in Parent stock, and no § 956 event b/c FA transferred Parent stock before quarter end
- Newly-issued § 367(b) regs did not require USS to suffer a § 1248 inclusion (due to exclusion)

**Government's initial reaction**

- *Notice 2006-85* –Killer B txns raise "significant policy concerns" and gov't will issue regs under § 367(b) to treat FA as distributing property to Parent in a transaction separate from the reorg transaction (i.e., distb will be subject to § 301)
- *Notice 2007-48* – amplified Notice 2006-85, to cover situation where FA acquires Parent stock from public SHs

# KILLER BS (CONT.)

## Post-Regs




## Killer B regs provide new approach

- The new regulations mandate a two-leg fiction:
  - *Up/Down Transaction.* FA's acquisition of Parent stock is treated as a transaction *separate and before* the triangular B-reorg. FA is treated as distributing an amount to Parent equal to the value of Parent stock used in the triangular B-reorg. Parent is then deemed to contribute that amount back to FA. This removes Parent's § 1032 protection and the distribution thus must run the trappings of § 301(c).
  - *Triangular B Reorg.* After the up/down transaction, FA is the deemed to acquire Parent stock used in the triangular B-reorg, and normal Code rules apply.

## Other rules

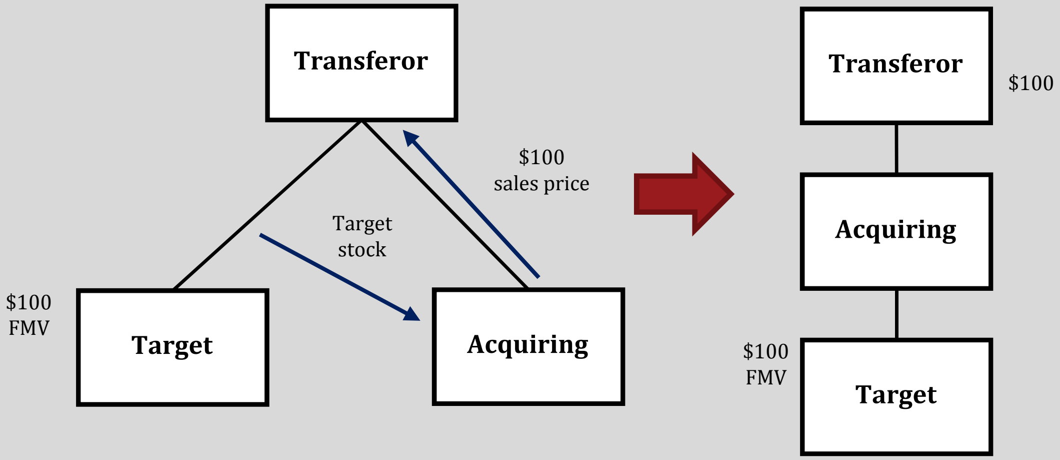
- *Priority rules* – Determine the up/down taxation to Parent (the "Relevant Inclusion"), and then compare that amount against: (1) USS's basic gain in FT stock (Base Gain); and (2) USS's basic gain in the FT stock taking into account any exception to 367(a)(1) (Modified Base Gain). Killer B regs turn off only if MBG ≥ RI
- *Anti-abuse rule* – "appropriate adjustments" will be made if, in connection with a triangular reorg, a transaction is engaged in "with a view to avoid" the purpose of the new Killer B regulations. (e.g., funding a holdco having little E&P)

# § 304 Transactions

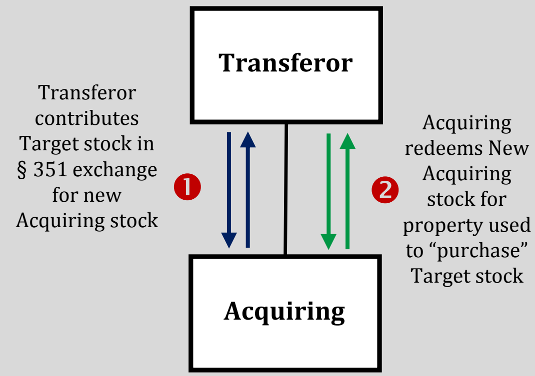
**Provisions may be helpful in planning**

- Transactions treated as purchase/sale of foreign sub for local tax purposes
  - Participation exemption possibility
  - No local withholding taxes on "deemed" dividend out of foreign jurisdiction
  - No "distributable reserves" (local corporate law restriction) on Acquirer's payment of cash
- Carry full consequences of dividends – E&P and FTCs move
- Need to be wary of the anti-abuse rule of Treas. Reg. § 1.304-4
  - "Funding" and structuring considerations
  - Now self-executing

# Basic § 304 Transaction




## Fictional § 351+ Redemption




## General rules

- *Recast as distribution* – if a person (Transferor) controls two corps (Target and Acquiring) and Acquiring pays Transferor for Target stock, it will almost always be the case that you have to treat the property payment as a § 301 distribution resulting from a fictional § 351 / redemption transaction

- *Dividend amount + sourcing* – although distribution is in reception of Acquiring stock, you determine *how much* of the distribution is a *dividend* (and from where):

  *1st from Acquiring*

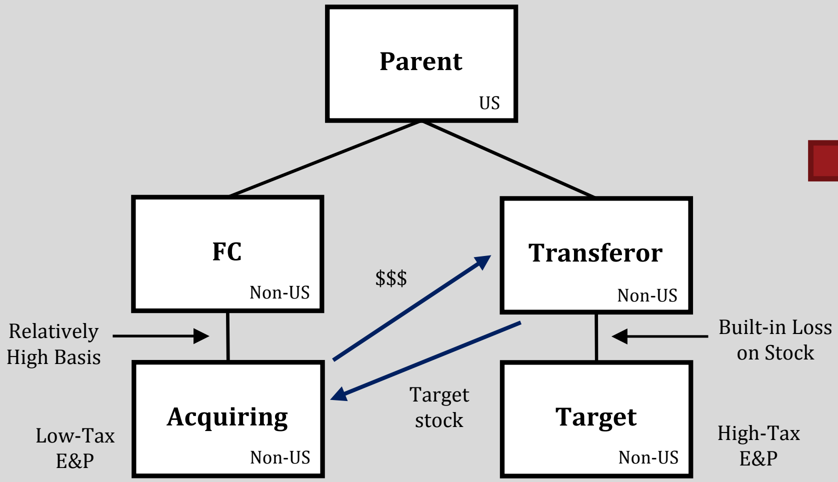
  *2nd from Target*

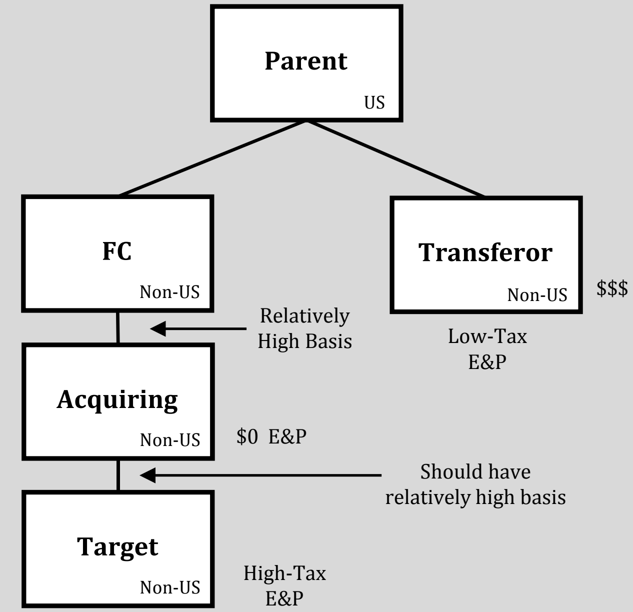
- *If Acquiring is foreign* – there can be limits on Acquiring's E&P that can be taken into account, but generally should not present problems here. See § 304(b)(5)

- *If Acquiring and/or Target are foreign* – the IRS can supply rules to eliminate multiple inclusions of items of income by reason of §§ 301-304 and provide appropriate basis adjustments (including re PTI). See § 304(b)(6)

- *FTC access* – the deemed dividends go directly to the transferor (Parent) from Acquiring and Target, even if direct ownership not present as required by § 902(a).

# Basic § 304 Example



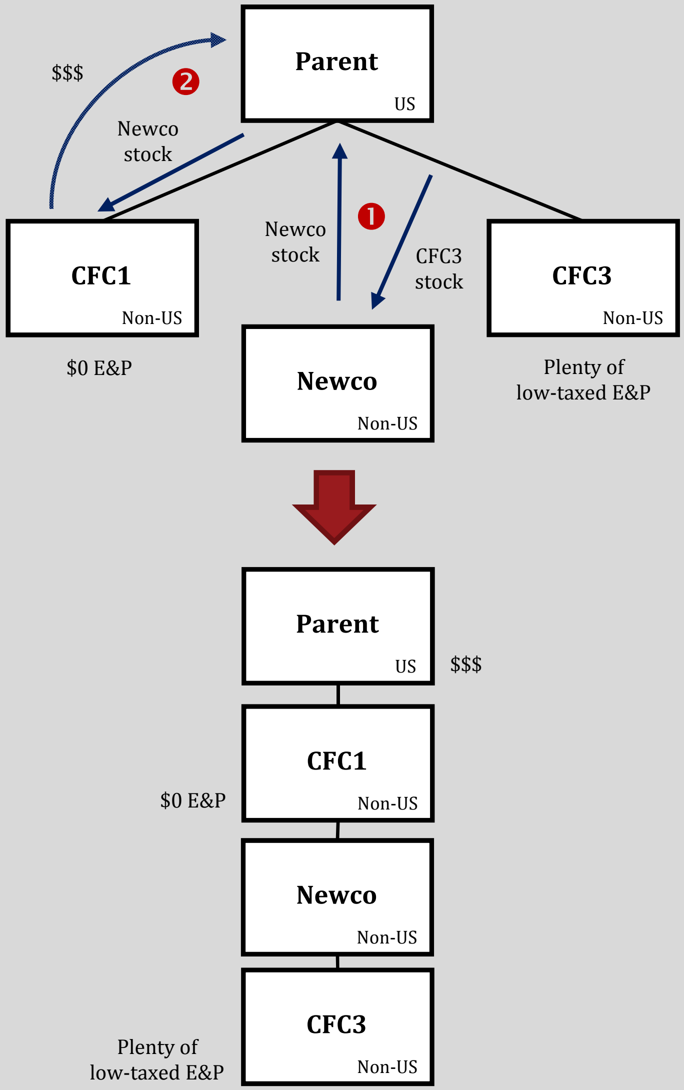

<u>Further assume</u>:

- There's only one block of Target shares
- FMV of Target is approx. equal to Acquiring's E&P

## Anticipated results

- *Transferor*
  - No gain/loss recognized
  - Dividend from Acquiring (then if necessary from Target)
  - § 954(c)(6) could protect – if still available
  - Ends up with Acquiring's low-tax E&P
  - Participation exemption?
- *Acquiring*
  - No gain/loss recognized
  - Low-tax E&P moves to Transferor
- *Target*
  - No gain/loss recognized
  - Maintains historic high-tax E&P

# The § 304 Anti-Abuse Rule




## Prior to § 304 anti-abuse rule

- *One fact pattern* – in the pattern at left, because neither CFC1 (Acquiring) nor Newco (Target) have E&P, the recast under § 304(a)(1) allows Parent to report the cash received in the deemed redemption of the newly-issued CFC1 shares as a ROC under § 301(c)(2)

## The § 304 anti-abuse rule

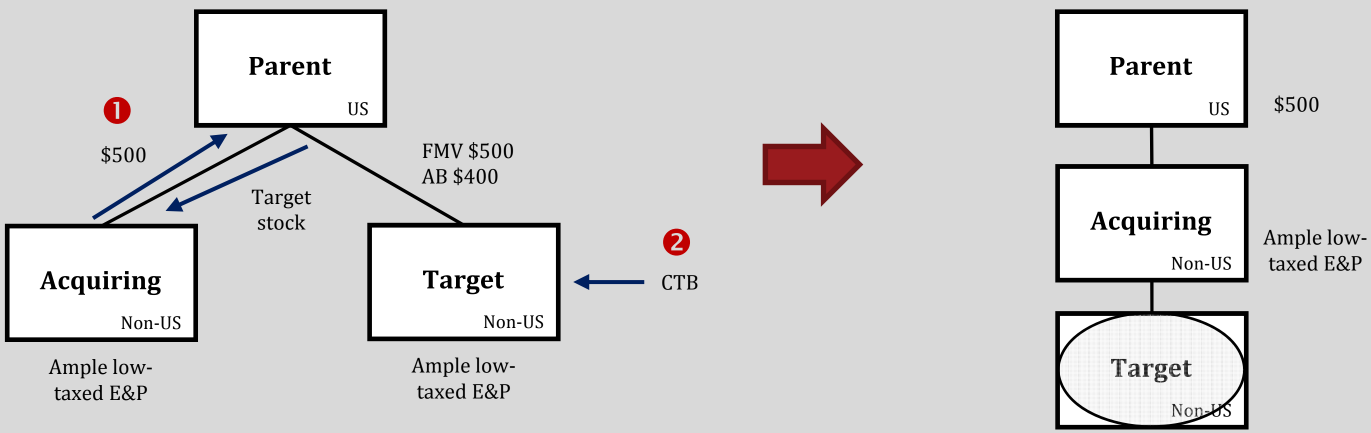
- *History* – Treasury / IRS issued original anti-abuse rule in 1988, but significantly revised in in December 2009 via Treas. Reg. § 1.304-4T; finalized December 2012
- *Final rules* – say that for purposes of determining the amount and source of distribution, a corporation will be deemed to be the acquiring corporation or deemed to be the target company "if a principal purpose" for avoiding § 304 treatment exists (either due to creating, organizing, or funding – e.g., through capital contributions or debt – or other delineated structuring).
  - The rules are self-executing (i.e., they apply automatically)
  - *On our facts* – the anti-abuse rule would say that CFC3 is actually the Target (rather than Newco) and a distribution would be sourced to it (assuming a principal purpose can be demonstrated)

# Cash Ds

**Guidance tends to drive transactions toward cash Ds**

- Transactions treated as purchase/sale of foreign sub for local tax purposes
  - Participation exemption possibility
  - No local withholding taxes on "deemed" dividend out of foreign jurisdiction
  - No "distributable reserves" (local corporate law restriction) on Acquirer's payment of cash
- Similar to § 304 transactions (but where overlap cash D wins)
- Obama proposals to limit "boot-within-gain" rule

# Basic F2F Cash D




## General thoughts

- *Foreign-to-foreign cash D* – Parent has $100 gain in Target stock, so under § 356(a) Parent's dividend potential is limited to that amount (even though $500 was paid)
- Application of § 356(a)(2) says source dividend by looking to the "corporation"
  - IRS says you look at E&P of *both* Target *and Acquiring* (rather than just Target)
- *Be careful with CTB election*

# Deadly Ds

**Treasury / IRS first addressed – starting in late 2007**

- Notice issued December 2007
- Proposed regulations issued in August 2008

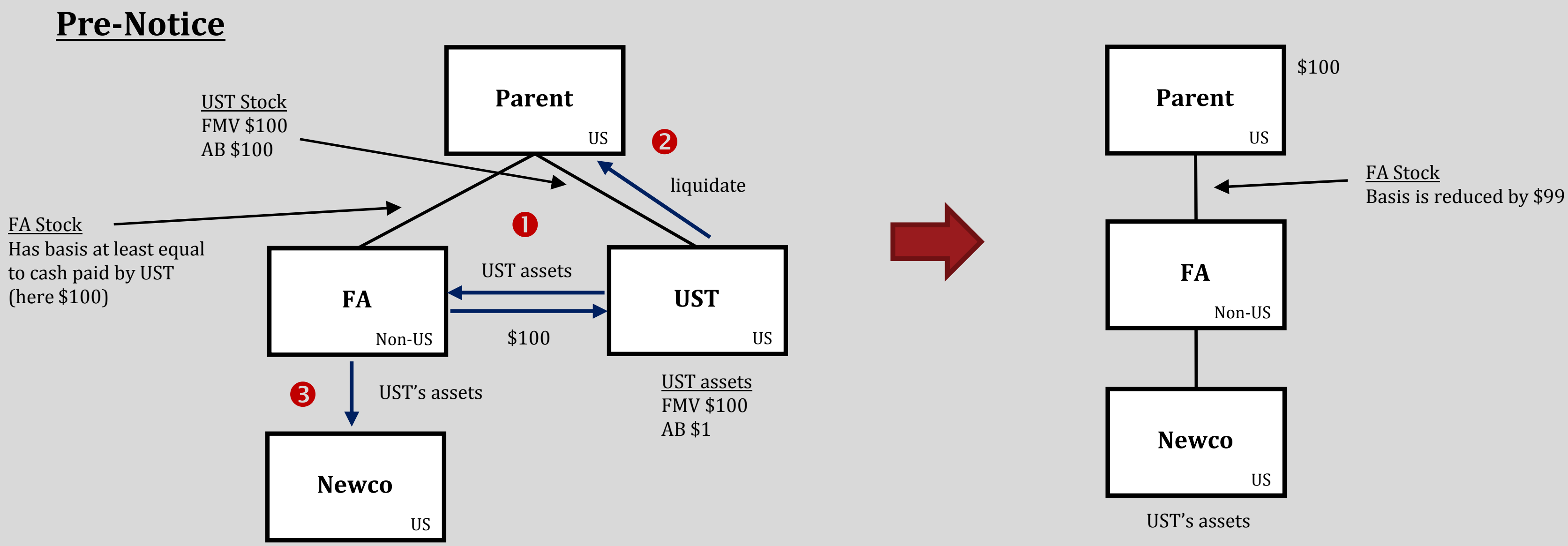
**Overview of transaction**

- Transactions effectively repatriate *cash* through complex outbound reorganization
  - Key tax rules included: § 356(a)(1), § 367(a)(5) and indirect stock transfer coordination rule exception
  - Treasury/IRS discovered *fortunate* word in legislative history and have seized upon it to write seemingly purposive regulations policing this area

**Final regulations issued – March 2013**

- Treas. Reg. § 1.367(a)-3 and -7
- Alternatives?

# Deadly Ds (cont.)



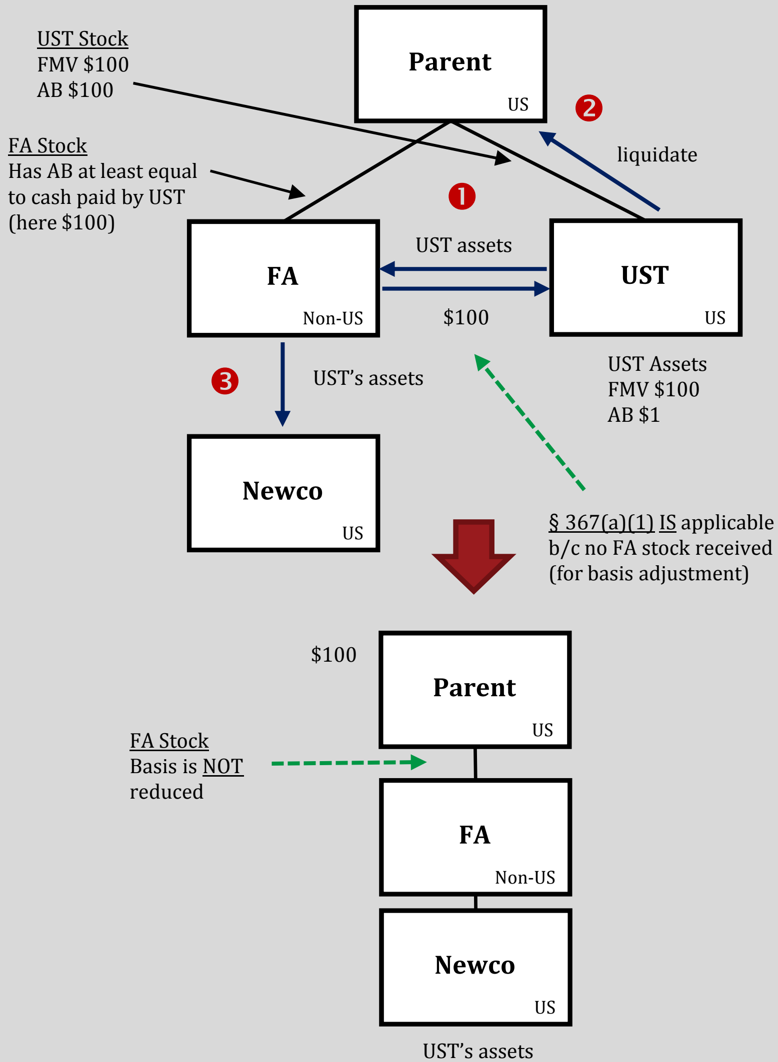

## Outbound cash D that repatriates cash

- As purely domestic transaction, UST's sale of its assets to FA for $100, followed by a distribution of the $100 as UST liquidates into Parent would normally be all cash D reorg and Parent would be OK (even though 100% boot) b/c of § 356's boot-within-gain rule
- However, this is outbound asset reorg into FA combined with a drop of those assets into a new US corp (Newco); implicates § 367(a) and (d) (unless exception applies)
- *Double Character* – Under § 367(a) regs, transaction is both:
  (1) § 361 outbound transfer by UST to FA; and
  (2) indirect stock transfer of UST to FA by Parent

  and 367(a) reg "coordination rule" says apply § 367(a) and (d) first to § 361 txn, and then run indirect stock transfer test. <u>However</u>, an exception applicable here says § 367(a) and (d) do not apply to the § 361 if § 367(a)(5) is applicable and "appropriate basis adjustments" made to FA stock
- Parent says no problem b/c it reduces basis in FA stock by $99, and indirect stock transfer results in no gain

# DEADLY DS (CONT.)

## Post-Notice




### Government focuses on "receipt" concept

- *Notice 2008-10* – the gov't argued that legislative history to § 367(a)(5) provided that Parent's FA stock *received* as part of the reorg was what had to be adjusted, not *old-and-cold* FA stock; called this a "clarification"
  - As a result, since Parent receives only deemed nominal share in cash D reorg (having $0 AB and FMV) there is no FA stock *received* to adjust; thus, UST must recognize $99 of gain under § 367(a)(1) (no coordination rule exception)
- *Proposed Regs. (August 2008).* Applies Notice 2008-10, noting that it is not reasonable to adjust old-and-cold stock; § 367(a) and (d) apply to extent cannot fully account for basis adjustment in stock rec'd for § 367(a) property (cannot count stock rec'd for 367(d) property) cannot benefit from basis adjustment regime) received. Basis adjustment regime elected on timely-filed return
- *Final Regs (March 2013).* Generally follow proposed regulations

### Notes

- *May still be possible to do partial repat* – but getting more difficult
- *Notice 2012-39* – regulations are foundational for further work in this area (described in the notice), including in respect of § 367(d)

# Legislative Proposals

# Int'l Tax Reform – Camp v. Baucus

**David Camp (R-Michigan) – U.S. House Ways & Means Committee Chairman**

- Moves foreign business income taxation in the direction of territoriality
  - Camp Option C – "carrot-and-stick" approach
- CTB system remains intact
- 5.25% mandatory repatriation of untaxed offshore E&P
  - Payable over 8 years

*Photo via Office of Representative Camp*

**Max Baucus (D-Montana) – U.S. Senate Finance Committee Chairman**

- Seemingly moves foreign business income taxation in the direction of a full-inclusion system
- Eliminates CTB system for foreign entities owned by CFCs
- 20% mandatory repatriation of untaxed offshore E&P
  - Payable over 8 years

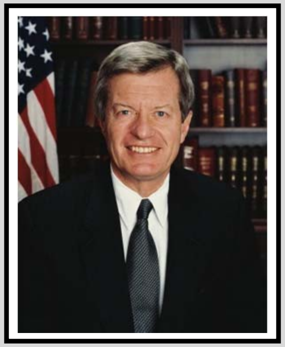


*Photo via Office of Senator Baucus*

# Thank you…

# J. Brian Davis

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Brian regularly speaks at events sponsored by TEI (where he previously served as a Vice Chair of the International Tax Committee), the International Fiscal Association and the American Bar Association. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

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# The Firm

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