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International Tax ADVISORY ■

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CFC Rules Are a Popular Topic for IRS Legal Memoranda

In two recent generic legal advice memoranda, AM 2015-001 and AM 2015-002, the Associate Chief Counsel (International) addressed issues relating to controlled foreign corporations (CFCs). AM 2015-001 discussed the effect of Subpart F inclusions on the U.S. parent's earnings and profits (E&P), while AM 2015-002 illustrated how Section 954(d)(2) applies to treat certain foreign branches of a CFC as separate corporations. In addition to providing practical information in a complex area of the Code, the advices reflect the IRS's continued focus on offshore investments of U.S. taxpayers in general and of U.S. shareholders of CFCs in particular.

AM 2015-001

A CFC is a foreign corporation that is more than 50 percent owned by "U.S. shareholders." Generally, a U.S. shareholder is a U.S. person that owns at least 10 percent (by vote) of the corporation. Under Section 951(a)(1), U.S. shareholders must include in income their pro rata share of certain income of the CFC ("Subpart F income") and the amount determined under Section 956 (relating to a CFC's investments in U.S. property). AM 2015-001 considered whether a U.S. parent must increase its E&P for income inclusions with respect to its CFC under Section 951(a)(1) and concluded yes—regardless of whether the CFC makes distributions to its U.S. parent in the same year as the inclusion.

Though E&P is not defined in the Code, the regulations state that "[a]mong the items entering into the computation of corporate earnings and profits for a particular period are… all items includible in gross income under section 61." Section 61, of course, provides that gross income means "all income from whatever source derived." The first part of the advice's analysis reasons that, because Section 951(a) mandates inclusions in a U.S. shareholder's gross income, the E&P of that (corporate) shareholder should be increased by those inclusions. The IRS views the rules of Subsections 312(k) and (n) as mere "deviations" from a general rule that E&P adjustments be coupled with income inclusions. Absent a clear rule to the contrary, statutory provisions that govern the timing of income will have "a corresponding effect" on E&P. There is no special rule concerning E&P as it relates to Section 951 inclusions.

In the second part of its analysis, the advice bolsters its position by reviewing authorities showing the relationship among the timing of income inclusion and E&P and basis adjustments. Under Sections 959 and 961, respectively,

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Section 951 inclusions also increase a U.S. shareholder's "previously taxed income" (PTI) account and basis in the CFC stock. These PTI account and stock basis adjustments are intended to prevent the double-counting or exclusion of amounts in the shareholder's gross income and E&P. When the CFC actually makes distributions, the shareholder does not include the earnings again, but rather decreases its CFC stock basis and PTI account. As a corollary, under Section 312(f)(2), nontaxable distributions that reduce basis generally do not increase a shareholder's E&P.

The advice concludes by dismissing possible counterarguments. In response to the U.S. parent's argument that Section 951 inclusions should not increase E&P because those inclusions do not enhance the parent's ability to pay a dividend (as cash or property distributions would), the IRS stated simply that E&P is not a mere measure of cash flow and that various statutory and regulatory provisions require E&P increases regardless of whether a corporation receives cash or property. While the U.S. parent might also contend that "E&P cannot be in two places at once"—both as retained earnings at the CFC and as an increase in the U.S. parent's E&P attributable to those earnings—the IRS counters that there are exceptions to the general rule that a corporate shareholder does not have E&P until it receives a distribution, e.g., in the consolidated return context.

AM 2015-002

The foreign base company sales income (FBCSI) rules of Subpart F were enacted to prevent a U.S. taxpayer or its foreign subsidiary from artificially separating manufacturing and sales to reduce tax on its sales income. Under Section 954(d)(1), FBCSI generally includes income derived by a CFC in connection with the purchase of personal property from a related person and its sale to any person, the purchase of personal property from any person and its sale to a related person, and the purchase or sale of personal property on behalf of a related person. However, such income is not FBCSI if the personal property is (1) manufactured by the CFC (the "manufacturing exception"), (2) manufactured by anyone in the CFC's country of organization (the "same-country manufacturing exception"), or (3) sold for use in that country (the "same-country sales exception").

Absent the special rules under Section 954(d)(2) (the "branch rules"), a CFC that manufactures products in its own country but sells them through a sales branch in a low- or no-tax jurisdiction would avoid having FBCSI due to the manufacturing exception. AM 2015-002 explains the application of the branch rules, which, in determining FBCSI of the CFC, treat a foreign branch of a CFC as though it were a wholly-owned subsidiary corporation of the CFC if the use of the branch has "substantially the same effect" as if it were a wholly-owned subsidiary.

The regulations under Section 954(d)(2) use a tax rate disparity (TRD) test to determine whether the branch rules will apply. The use of a foreign branch has substantially the same tax effect as if it were a wholly-owned subsidiary if the income allocated to the branch is, by statute or treaty or otherwise, taxed in the year earned at an effective tax rate (the actual effective tax rate, or AETR) that is less than 90 percent of, and at least five percentage points less than, the effective tax rate (the hypothetical effective tax rate, or HETR) that would apply, under the laws of the CFC's country of organization, if the income were considered from sources in that country and allocable to a permanent establishment therein.

Warning that an appropriate common tax base must be used for the comparison between the AETR and the HETR to be meaningful, the advice sets forth five steps to conduct the tax rate disparity test:

1. Determine the branch's income derived in connection with the sale of property on behalf of the CFC (the "TRD gross income").

2. Calculate the actual tax, if any, on the TRD gross income.
3. Determine the TRD gross income that would hypothetically be subject to tax in the CFC's jurisdiction.
4. Calculate the hypothetical tax (using the applicable marginal rate in the CFC's jurisdiction).
5. Determine whether there is a tax rate disparity by comparing the AETR (Step 2 divided by Step 3) and the HETR (Step 4 divided by Step 3). If the AETR is at least five percentage points below the HETR and less than 90% of the HETR, the branch rules require that the branch be treated as a subsidiary corporation of the CFC, which will likely result in FBCSI for the CFC.

The advice illustrates the five-step methodology with a numerical example.

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