ALSTON + BIRD LLP

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Insights into Recent Regulatory, Judicial and Legislative Developments

New International Tax Developments

CFC'S Subpart F Earnings Not Qualified Dividends

On December 7, 2011, The U.S. Tax Court ruled that inclusions in U.S. residents' gross income that were required under the Subpart F provisions with respect to their controlled foreign corporation's (CFC) investments in U.S. property did not constitute qualified dividend income under Section 1(h)(11). The U.S. shareholders of the CFC were U.S. residents/Mexican citizens who owned 100 percent of the stock of a Mexican corporation. The taxpayers had included in their gross income amounts representing the CFC's earnings invested in U.S. property (taxable pursuant to Sections 951(a)(1)(B) and 956) and treated the income inclusions as qualified dividend income subject to a preferential income tax rate under 1(h)(11)(B). The court determined that these amounts, however, were taxable at ordinary income tax rates.

Pursuant to Section 1(h)(11)(B), qualified dividend income that is taxed at the favorable adjusted net capital gains rates includes dividends received during the tax year from qualified foreign corporations. Although there was no disagreement that the CFC was considered to be a qualified foreign corporation, the issue turned on whether the income inclusions under the Subpart F rules represented a dividend. The court applied the Section 316(a) definition of a dividend, which requires a "distribution" by a corporation, and a Supreme Court ruling (*Commissioner v. Gordon*, 391 U.S. 83, 90 n.5 (1968)) stating that "a distribution entails a change in the form of ownership of corporate property separating what a shareholder owns [as a] shareholder from what he owns as an individual." The court disagreed that a Subpart F inclusion involved a change in ownership of corporate property. According to the court, an income inclusion didn't arise from a distribution of property by a CFC, but from the CFC's investment in U.S. property. Because there is no distribution, there is no dividend.

The court refused to equate a Senate report (S. Rept. 1881, 87th Cong., 2d Sess. (1962)) relied upon by the taxpayers, which had accompanied the Subpart F legislation and stated that "earnings brought back to the U.S. are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them," with Congress's decision not to expressly treat Subpart F inclusions as dividends or distribution as Congress had done in other contexts. The court also noted that income inclusions represent earnings that CFCs have retained and reinvested in U.S. property instead of paying out as dividends; thus, characterizing them as qualified dividend income wouldn't further the legislative purpose of Section 1(h)(11)—to remove a perceived disincentive for corporations to pay out earnings as dividends instead of retaining and reinvesting them.

Reminder of Filing Requirements for U.S. Dual Citizens

On December 7, the IRS released a Fact Sheet (FS-2011-13, December 2011), reminding U.S. citizens and U.S. dual citizens about their U.S. filing tax obligations, including the filing of U.S. federal tax returns and Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). The fact sheet advised taxpayers of their basic federal income tax filing and payment requirements and related penalties. It reminds U.S. citizens and dual citizens that they are required to report their worldwide income on their federal tax return and that U.S. persons may be required to report their interest in certain foreign financial accounts on the FBAR.

It explained the applicable penalties for failure to file a U.S. federal tax return and for failure to pay the amount shown on the return, neither of which apply to taxpayers who owe no U.S. tax or to taxpayers who show that their failure is due to reasonable cause and not willful neglect.

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continued from front page...

The fact sheet further explained the applicable FBAR penalties for taxpayers who cannot show the failure to file an FBAR was due to reasonable cause (there are different penalties for willful and non-willful violations).

The fact sheet advised taxpayers who learn of their FBAR filing requirement for earlier years (within the six-year statute of limitation) to file the delinquent FBARs and attach a statement explaining why they are late. It also tells U.S. taxpayers that reporting pursuant to the Foreign Account Tax Compliance Act (requiring U.S. taxpayers who have an interest in certain specified foreign financial assets with an aggregate value exceeding $50,000 to report those assets to the IRS) will be required starting in 2012.

Final Regulations on Disregarded Entities Involved In Conduit Arrangements

On December 9, 2011, the IRS published final regulations that address the application of the conduit financing arrangements effected through disregarded entities. The final regulations apply to payments made on or after December 9, 2011, and adopt, with only minor changes, the regulations proposed in December 2008.

Under the check-the-box rules, entities owned by one person can be disregarded for federal tax purposes. Such entities are referred to as “disregarded entities.” Pursuant to the anti-conduit regulations, the IRS can disregard, for withholding tax purposes, the participation of any intermediate entity acting as a “conduit entity” in “financing arrangements” that are designed to avoid taxes and recharacterize what was presumably a multiple-party financing transaction as a transaction between the parties on either side of the conduit entity.

A “financing arrangement” is defined as a series of financing transactions by which one person (the financing entity) advances funds to another person (the intermediate entity) that, in turn, advances funds to another person (the financed entity). Except for a special rule for related parties, the regulations apply only if financing transactions link the financing entity, each of the intermediate entities and the financed entity. Financing transactions include debt, certain stock in a corporation (or a similar interest in a partnership or trust), leases, licenses or other transactions in which a person advances property or grants rights to use property to a transferee who is obligated to return a substantial portion of the property advanced.

The final regulations (Section 1.881-3(a)(2)(i)(C)) interpret the term “person” to include a business entity that is disregarded as an entity separate from its single member owner (within the meaning of Sections 301.7701-1 through 301.7701-3) for purposes of its treatment when it is involved in a multiple-party conduit financing arrangement. These regulations put to rest any uncertainty over the application of the conduit rules to structures that include disregarded entities. Taxpayers had taken the position that checking the box to disregard an entity would require disregarding that entity in back-to-back financing arrangements, thus making the conduit rules inapplicable. However, the IRS agreed with the sole comment to the 2008 proposed regulations from the New York State Bar Association Tax Section, which argued that to disregard an entity that is regarded for other purposes (e.g., for purposes of claiming treaty benefits) would be inconsistent with the policy and purpose of the anti-conduit regulations. Because a disregarded entity is a “person,” any transaction that it enters into will be taken into account for purposes of whether a conduit financing arrangement exists. An intermediate disregarded entity will be “regarded” under the conduit financing regulations and a multiple-party financing transaction may be recharacterized as a transaction directly between the parties on either side of the conduit entity.

The final regulations also say that the IRS will continue to study how the conduit financing regulations would apply to hybrid transactions (transactions in which a financing entity advances property to an intermediate entity in exchange for a hybrid instrument that is treated as debt under the laws of the foreign jurisdiction where the intermediate entity is a resident, but is treated as equity for U.S. federal tax purposes).

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