

# Application of Tax Rate Reductions in JGTRRA to Closely Held Foreign Corporations

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## Introduction

The Jobs and Growth Tax Relief Reconciliation Act of 2003<sup>1</sup> (JGTRRA) significantly reduced the U.S. long-term capital gains rates applicable to individuals, providing that long-term capital gains will be taxed at a maximum rate of 15 percent (or five percent in the case of certain gains).<sup>2</sup> In addition, JGTRRA introduced a new provision to the Code,<sup>3</sup> which provides that certain dividends received by individuals and other taxpayers subject to tax under Code Sec. 1 are taxable at the new long-term capital gains rates.<sup>4</sup> Although the benefits of this reduced dividend rate apply broadly to dividends received from domestic corporations, dividends from foreign corporations are not entitled to the reduced rate unless the foreign corporations are qualified foreign corporations (QFCs).

For reasons discussed below, many closely held foreign corporations will not be QFCs. A number will be QFCs, however, and, even with respect to those that are not, JGTRRA's combination of capital gains rate reductions and dividend rate reductions may present opportunities for their shareholders. This article discusses some of those opportunities as well as some potential traps for the unwary.<sup>5</sup>

In general, a U.S. taxpayer's dividend income is taxed at the applicable long-term capital gains rate if it is "qualified dividend income."<sup>6</sup> Dividends generally constitute "qualified dividend income" if paid by foreign corporations that are QFCs in the year of the dividend distribution.<sup>7</sup>

Generally, a foreign corporation is a QFC if (1) it is incorporated in a possession of the United States, or (2) it is eligible for benefits of a comprehensive

income tax treaty with the United States which the Treasury determines is satisfactory for purposes of the reduced dividend rate and which includes an exchange of information provision.<sup>8</sup> If a foreign corporation does not meet the general QFC requirements, it may nevertheless be treated as a QFC if its shares (or American depositary receipts (ADRs)) with respect to which the dividend is paid are readily tradable on an established U.S. securities market.<sup>9</sup>

Even if a foreign corporation otherwise meets the QFC requirements set out above, it will not be a QFC if, for the year of the dividend distribution or the prior year, it is a foreign personal holding company (FPHC), a foreign investment company (FIC) or a passive foreign investment company (PFIC) (collectively “Excluded Regimes”).<sup>10</sup> A controlled foreign corporation (CFC) may be a QFC.<sup>11</sup>

### Issues to Consider in Applying the JGTRRA Capital Gains and Dividends Provisions to Closely Held Foreign Corporations

The rate reduction provisions of JGTRRA raise a number of issues for the owners of closely held foreign corporations. Several of these issues are unique to the closely held context. Although the first two issues discussed below are not, they are mentioned here because of the prominent role they can play in that context.<sup>12</sup>

#### Treatment of Subpart F Inclusions

Although dividends are eligible for the reduced dividend rate, and CFCs are not excluded from the category of QFCs, it appears that inclusions under subpart F are not eligible for the reduced rate. Some might take the position that subpart F inclusions are the functional equivalent of dividends and, therefore, qualify. The literal statutory language, however, would appear to make such an interpretation difficult.<sup>13</sup>

From a policy perspective, arguments exist for consistent treatment of subpart F inclusions with domestic dividends, dividends of CFCs from nonpreviously taxed earnings, and Code Sec. 1248 amounts, all of which qualify for the reduced dividend rate. Although U.S. corporations and their owners both pay U.S. tax on corporate earnings, the United States generally does not tax foreign corporations, even if they are CFCs. And although the United States seeks to neutralize the benefits of deferral by taxing a CFC’s shareholders on the CFC’s subpart F income, it is unclear why the United States should for that reason tax a CFC’s shareholders at a higher rate on the deemed-distributed earnings of their CFCs than on their actual distributions of non-subpart F income and on their distributions from U.S. corporations.

#### Is a Holding Company a FIC?

A foreign corporation is a FIC if, *inter alia*, it is engaged in the business of investing or trading in securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) when at least 50 percent of the total voting power of all classes

of stock entitled to vote, or the total value of all classes of stock, is held (directly or indirectly) by U.S. persons (as defined in Code Sec. 7701(a)(30)).<sup>14</sup> An issue exists as to whether a non-U.S. holding company is, *per se*, a FIC, provided the ownership requirements set forth above are met. The risk is that such a holding company will be viewed as being engaged in the business of investing in securities by holding its subsidiary’s stock and performing ancillary holding company functions. If this were the case, no dividends distributed by such a non-U.S. holding company to its U.S. shareholders would qualify for capital gains treatment. The policy reasons militating against such a result are obvious.

#### Liquidation Opportunity

Although closely held corporations may not qualify for the reduced rate on dividends if they are FPHCs, FICs or PFICs, this status should not preclude their shareholders from qualifying for the reduced capital gains rate on built-in gains of those corporations’ shares that they may have been reluctant to realize heretofore.

**Example 1.** Prior to enactment of the PFIC rules, a wealthy U.S. individual (A) and a foreign person entered into a 50/50 joint venture. The foreign person has since left the venture. Assume that the venture is conducted in corporate form; that the corporation (FC) is foreign and is a CFC, FPHC and FIC; that FC’s assets are regularly traded, and therefore have a basis relatively close to fair market value; and that FC has outstanding stock with

a value of 100 and a basis of 50, the difference being attributable to the fact that FC's trading gains were not always includible in the income of its U.S. shareholder.

A's FC stock will not be eligible for a basis step-up on the death of A because FC is an FPHC and a FIC.<sup>15</sup> As such, A will not be able to eliminate the built-in gain in the FC stock by holding that stock until death. Now that capital gains rates have come down, however, A might consider liquidating FC, either actually<sup>16</sup> or with a check-the-box election.<sup>17</sup>

The liquidation of FC will result in the imposition of significant taxes on A. Nevertheless, for a number of reasons, it may be advisable to liquidate FC at this time.

- Under certain circumstances, the present value of the taxes that would be paid on a future liquidation of FC could be higher than the taxes to be paid upon an imminent liquidation of FC. This could occur, for example, if capital gains tax rates are higher in the future than they are today, at a time when A or his heirs determine to liquidate FC.
- The sooner FC is liquidated, the sooner trading gains can be taken into income by A as capital gains, rather than ordinary income. If such capital gains are realized with respect to assets held for the requisite holding period, they can be eligible for taxation at long-term capital gains rates, which for individuals currently are lower than the ordinary income rates that now would apply to such trading gains. In addition, any dividends paid on the FC assets might now be eligible for

the 15-percent rate, rather than the higher rate applicable to subpart F inclusions.

- If FC is liquidated, unrealized gains in the FC assets can be eliminated upon the death of A, whereas the shares of FC are not eligible for this basis step-up.
- The liquidation of FC should simplify the tax structure in which the assets of FC are currently owned, potentially reducing professional fees incurred in connection with tax planning and compliance, and potentially providing increased peace of mind regarding a structure that is easier to understand.

It is important to note, however, that there are potential advantages of not undertaking such a liquidation, at least at this time. For example, the benefit of delaying the liquidation could increase to the extent that:

- capital gains tax rates remain constant or decline in the future;
- A generates favorable returns on the funds that would be used to pay the tax on an imminent liquidation;
- A (and his heirs) would be willing to hold the stock of FC for an extended period of time without liquidating it; and/or
- the value of FC decreases in the future.

It should also be noted that FC may recognize gain on its distribution of property in liquidation. These gains could be passed

through to A as subpart F income, subject to tax at ordinary income rates.<sup>18</sup> Moreover, Code Sec. 1248 would treat as dividend income A's gain not passed through as subpart F income. In this instance, such dividend income would not be entitled to capital gains treatment since FC is a FPHC.

### *Impact of Overlapping Regimes*

Since Congress adopted the CFC and FIC regimes in 1962 to correct perceived abuses not addressed by the FPHC regime, it has adopted a

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number of rules intended to prioritize the application of the various anti-deferral regimes in the Code to foreign corporations ("the Priority Rules"). However, in a given case, these rules may raise issues rather than create a coherent priority system of carefully integrated anti-deferral regimes. The QFC rules contained in Code Sec. 1(h)(11) add to the complexity. The following examples highlight some of the issues created by the interaction of the Priority Rules and the QFC rules and describe potential planning issues.

**Example 2.** A, a U.S. resident individual owns all of the outstanding shares of FC, a non-U.S. corporation. FC owns stocks and securities that generate dividend and interest income. In addition, FC regularly sells or exchanges stocks and securities in its

portfolio thereby generating trading gains. FC owns no other assets and conducts no other business.

In Example 2, FC is a CFC, PFIC, FPHC and FIC.<sup>19</sup> The dividends and interest income and trading gains earned by FC are foreign personal holding company income under both the CFC and FPHC regimes.<sup>20</sup> The PFIC rules

are not sufficient to turn off the Excluded Regime taint generally applicable to FPHCs and FICs.

Example 3, below, illustrates how modest changes in FC's ownership and assets could drastically change the analysis above.

**Example 3.** A, B, C, D, E, F, G and H, all U.S. resident unrelated individuals, each own 12.5 percent of the outstanding

shares of FC, a non-U.S. corporation. Shareholders A through H have owned their FC shares since FC was formed. FC owns a portfolio of commercial properties that it leases on a triple-net basis. FC has no other business.

Although FC earns only passive income, prior to the application of any Priority Rules, FC is a CFC and a PFIC, but not an FPHC or a FIC. FC is not an FPHC because it has more than five shareholders.<sup>24</sup> FC is not a FIC because it is neither registered under the Investment Act of 1940 either as a management company or as a unit investment trust nor engaged in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including futures contracts or options) in securities or commodities.<sup>25</sup> The PFIC rules do not apply to FC in this instance because all of FC's shareholders are U.S. shareholders of a CFC.<sup>26</sup>

The rental income earned by FC is subpart F income.<sup>27</sup> All of the FC shareholders will be subject to U.S. taxation on their *pro rata*

shares of FC's dividend and interest income under the CFC rules.<sup>28</sup> In the event that any FC shareholder sells its FC shares, Code Sec. 1248 would apply to any amounts of FC's E&P not previously subject to tax under subpart F.<sup>29</sup>

FC should be treated as a QFC because FC is not a PFIC.<sup>30</sup> In this particular example, FC's earnings from its leasing activities will be includible in the income of shareholders A through H without benefit of the reduced rate. Other (non-subpart F) income of FC, however, could be distributed with the benefit of such reduced rate.

**Example 4.** Same facts as Example 3 except FC owns a property management business engaged in the active management of commercial properties in addition to its commercial real estate portfolio.<sup>31</sup> Rents from the real estate portfolio generate 76 percent of FC's annual income while the remainder of FC's income is derived from the services provided by its management business to unrelated persons. FC annually distributes its accumulated earnings and profits to its shareholders.

Like the foreign corporation in Example 3, FC is a CFC that should qualify as a QFC. However, in Example 4, actual dividends distributed by FC to its U.S. shareholders may, in part, be subject to JGTRRA's reduced rates for dividends. When FC distributes to its shareholders all of its accumulated earnings at the end of the calendar year, the portion of FC's income that is subpart F income (76 percent) will be a distribution of PTI which has no tax conse-

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do not apply to A's ownership of FC shares since A is a U.S. Shareholder of a CFC.<sup>21</sup> A is subject to U.S. taxation on FC's dividend and interest income and trading gains under the CFC regime rather than the FPHC regime.<sup>22</sup> In the event that A sells its FC shares, the FIC regime will not apply to the earnings and profits of FC previously included in A's income as subpart F income.<sup>23</sup>

A must be careful, however, because the Priority Rules sometimes, but do not always, turn off the Excluded Regime taint for purposes of the dividend rate reduction. For example, although FC is not a PFIC, and, therefore, is not disqualified for that reason, the override of the FPHC inclusion rules by subpart F and the override of the FIC recharacterization rules by subpart F and Code Sec. 1248

quences to FC's U.S. shareholders other than reducing the basis that they have in their FC shares.<sup>32</sup> The remainder of the actual dividend, however, should be treated as a distribution of a dividend from a QFC taxable at the applicable long-term capital gains rate since such portion of the dividend has not been subject previously to U.S. taxation.

Before the JGTRRA provisions became law, these amounts would have been subject to tax at ordinary income tax rates, like the subpart F income earned by FC. Thus, the dividends provisions of JGTRRA in this instance provide a substantial benefit to FC's shareholders previously unavailable to them. As illustrated in the following example, however, this benefit is apparently available only for U.S. Shareholders of a CFC (*i.e.*, those shareholders owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation).

**Example 5.** Same facts as Example 4, except that FC has 10 shareholders: A, B, C, D, E, F, G, H, I and J. Shareholders A through H each own 11 per-

cent of F's outstanding shares. I and J each own six percent of F's outstanding shares. I and J have both elected to treat FC as a QEF.

In general, the Priority Rules are personal to each shareholder of a foreign corporation. In Example 5, FC is a CFC with respect to shareholders A through H. However, FC is a PFIC with respect to shareholders I and J because they each own less than 10 percent of the total voting power of FC.

Shareholders A through H account for only their *pro rata* shares of FC's subpart F income (*i.e.*, FC's rental income from its commercial property portfolio) for U.S. tax purposes.<sup>33</sup> Their *pro rata* shares of the remainder of FC's income are not currently subject to U.S. taxation. Under the QEF provisions, I and J account for their *pro rata* shares of *all* of FC's income, without benefit of JGTRRA's reduced rates.<sup>34</sup> When shareholders A through H sell their FC shares, they would take into income, at JGTRAA's reduced rates, their *pro rata* share of FC's earnings and profits attributable to FC's real estate management busi-

ness, which have not been previously subject to U.S. taxation.<sup>35</sup>

Neither the language of Code Sec. 1(h)(11) nor its legislative history provide that a foreign corporation's QFC status is personal to each of a foreign corporation's U.S. shareholders. Nonetheless, as described above, and perhaps without strong justification, the PFIC/CFC priority rules appear to make FC a QFC with respect to A through H, but not with respect to I and J.

Example 5 also illustrates the broader questionable policy of disallowing QFC status to a foreign corporation's shareholders that treat such foreign corporation as a QEF under the PFIC rules. As with subpart F inclusions, discussed above, it is unclear why QFC status should be denied to I and J.

## Conclusion

Shareholders of closely held foreign corporations should examine the rules associated with JGTRRA's reduced rates. Such an in-depth analysis reveals both opportunities and traps for the unwary.

### ENDNOTES

<sup>1</sup> Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27).

<sup>2</sup> Code Sec. 1(h)(1).

<sup>3</sup> References to the "Code" are to the Internal Revenue Code of 1986, as amended, and section references are to the Code and the Treasury regulations issued thereunder.

<sup>4</sup> Code Sec. 1(h)(11).

<sup>5</sup> This article, however, does not address the foreign tax credit calculation issues created by Code Sec. 1(h)(11)(C)(iii). Moreover, this article does not address the so-called "special rules" in Code Sec. 1(h)(11)(D). These rules outline the interaction of Code Sec. 1(h)(11) with (1) the interest deductibility rules of Code Sec. 163, (2) the extraordinary dividend rules of Code Sec. 1059, and (3) the regulated investment company and real

estate investment trust rules of Code Secs. 854 *et. seq.* and 857 *et. seq.*, respectively.

<sup>6</sup> Code Sec. 1(h)(11)(A).

<sup>7</sup> Code Sec. 1(h)(11)(C)(i). As noted below, however, a dividend from a corporation otherwise qualifying as a QFC in the year of the dividend distribution may not be "qualified dividend income" if that corporation has one of a number of tainted statuses in the preceding year.

<sup>8</sup> The Treasury and the IRS recently released a notice listing the U.S. tax treaties that meet these requirements. See Notice 2003-69, IRB 2003-42, 851 (Sept. 30, 2003). Notice 2003-69 lists the current qualifying treaties, and further provides that four treaties (the treaties with Bermuda, the Netherlands Antilles, the U.S.S.R., which currently ap-

plies to certain former Soviet Republics, and Barbados) do not meet the statutory requirements. The treatment of Barbados in Notice 2003-69 is based on directions contained in JGTRRA's legislative history, which provide that the U.S. tax treaty with Barbados is not satisfactory for purposes of the dividend tax rate reduction provision. See H.R. CONF. REP. NO. 108-126, at 42.

<sup>9</sup> The Treasury and the IRS have announced that, for tax years beginning January 1, 2003, and thereafter, common or ordinary shares (or American depositary receipts (ADRs) in respect of such shares) are considered "readily tradable on an established securities market in the United States" if such shares (or ADRs) are listed on one of the following exchanges: the American Stock Exchange, the

Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the NYSE, the Philadelphia Stock Exchange and the Pacific Exchange, Inc. See Notice 2003-71, IRB 2003-43, 922 (Oct. 3, 2003). In addition, the Treasury and the IRS announced that they are considering regulations regarding the treatment of dividends with respect to shares listed only on the OTC Bulletin Board or on the electronic pink sheets. In particular, the Treasury and the IRS are considering whether or to what extent the treatment of such shares for purposes of Code Sec. 1(h)(11) should be conditioned on the satisfaction of “parameters regarding minimum trading volume, minimum number of market makers, maintenance and publication of historical trade or quotation data, issuer reporting requirements under SEC or exchange rules, or issuer disclosure or determinations regarding passive foreign investment company, foreign investment company, or foreign personal holding company status.” *Id.*

<sup>10</sup> Code Sec. 1(h)(11)(C)(iii).

<sup>11</sup> The significance of this may be limited, however, by the apparent treatment of subpart F inclusions, which is discussed below.

<sup>12</sup> Moreover, there are JGTRRA provisions that may apply to U.S. closely held corporations that are not described in this article. For a discussion of the impacts of JGTRRA on succession planning in the U.S. closely held corporation context, see Willens, *JGTRRA Eliminates Sting of Penalty for Section 306 Stock*, DAILY TAX REPORT, Nov. 17, 2003, at J-1.

<sup>13</sup> Compare Code Sec. 951(a)(1) (“if a foreign

corporation is a controlled foreign corporation ... every person who is a United States shareholder ... shall include in his gross income ...”) with Code Sec. 1248(a) (“If a United States person sells or exchanges stock in a foreign corporation ... then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend ...” (emphasis supplied)).

<sup>14</sup> Code Sec. 1246(b).

<sup>15</sup> Code Sec. 1014(b)(5); Code Sec. 1246(e).

<sup>16</sup> In the event that FC holds securities that cannot be owned by a U.S. person for nontax reasons, A may not be able to actually liquidate FC. Instead, A may be required to “check the box” with respect to FC to disregard it for U.S. tax purposes.

<sup>17</sup> In the event that FC is not a “box checkable” entity that could potentially be disregarded for U.S. tax purposes, A could simply liquidate FC or if, for nontax reasons, A cannot hold FC’s assets directly, A could transfer the shares of FC to a foreign eligible entity that becomes disregarded for U.S. tax purposes and cause the actual liquidation of FC into the disregarded entity.

<sup>18</sup> Code Sec. 954(c)(1)(B).

<sup>19</sup> See Code Secs. 957(a), 1297(a), 552(a) and 1246(a).

<sup>20</sup> See Code Secs. 954(c), 954(a), 952(a)(2) and 553.

<sup>21</sup> In the event that a foreign corporation is both a CFC and a PFIC with respect to a U.S. taxpayer, the PFIC rules do not apply to the U.S. person’s ownership of shares in the foreign corporation, with certain limitations.

See Code Sec. 1297(e).

<sup>22</sup> In general, if a U.S. person’s *pro rata* share of a foreign corporation’s income is taxable under both the CFC and PFIC regimes, only the CFC regime applies. See Code Sec. 951(d).

<sup>23</sup> In general, a foreign corporation’s earnings and profits taxed under the CFC regime are not subject to taxation under the PFIC regime when a foreign corporation’s U.S. shareholder disposes of his or her foreign corporation shares. Moreover, any amounts taxable under Code Sec. 1248 when the U.S. shareholder disposes of his or her foreign corporation shares are not subject to tax under the PFIC regime. See Code Sec. 1246(g).

<sup>24</sup> Code Sec. 552(a)(2).

<sup>25</sup> Code Sec. 1246(b).

<sup>26</sup> See Code Sec. 1297(e).

<sup>27</sup> Code Sec. 954(c)(1), (2)(A); Reg. §1.954-2(b)(2), (6) and (c).

<sup>28</sup> See Code Sec. 951(d).

<sup>29</sup> Code Sec. 1248.

<sup>30</sup> Code Sec. 1297(e).

<sup>31</sup> In practice, the more typical scenario is that property is managed in a different CFC owned by the same U.S. shareholders. In this example, however, the management and portfolio businesses are owned by the same CFC to illustrate the interaction of the CFC subpart F income rules with the Priority Rules and the QFC rules.

<sup>32</sup> Code Secs. 959(a) and 961(b).

<sup>33</sup> Code Sec. 951(a)(1)(A).

<sup>34</sup> See Code Sec. 1293(a).

<sup>35</sup> Such amounts would generally be treated as dividends. See Code Sec. 1248.

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