

Treas. Reg. § 1.951-1(e) Determination of Pro Rata Share

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Washington, DC
October 20, 2005

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Subpart F

- Anti-deferral regime for certain foreign corporations
 - Applies to CFCs: section 957
- Applies to certain types of passive income
 - “Subpart F income”: sections 952 & 954
- Current inclusions in gross income
 - Certain US persons must include amounts in gross income: section 951

Controlled Foreign Corporations

- Section 957
- Any foreign corporation in which more than 50% of its vote or value is owned (directly, indirectly or constructively) by “United States shareholders”
- Section 958(a) and (b) provide rules for determining stock ownership
 - Direct ownership: section 958(a)(1)
 - Stock owned indirectly through foreign entities is treated as owned proportionately by its shareholders, partners or beneficiaries: section 958(a)(2)
 - Constructive ownership determined by using modified section 318(a) rules: section 958(b)

United States Shareholders

- US persons
 - Special definition of US person: section 957(c)
 - US individuals
 - US corporations
 - US partnerships
 - US trusts
 - US partners of foreign partnerships
 - US beneficiaries of foreign trusts
- Directly indirectly or constructively owns 10% or more of the VOTE of the foreign corporation
 - Only vote, not value (unlike CFC test)

Subpart F Income

- Section 952(a) = the sum of
 - Foreign base company income defined in section 954
 - Insurance income as defined under section 953 (generally applies to foreign insurance companies)
 - Other “bad income” – e.g. bribes paid, boycott income, income derived in “bad” countries

Foreign Base Company Income

- Foreign personal holding company income
 - Passive types of income described in section 954(c)
 - Interest, dividends, rents & royalties
 - Certain property transactions
 - Certain commodities transactions
 - Exceptions for certain active business activities and certain related party transactions

Foreign Base Company Income

- Foreign base company sales income
 - Income derived from certain related party sales: section 954(d)(1)
 - Exceptions
 - Same country exception
 - Manufacturing exception
 - Agricultural exception

Foreign Base Company Income

- Foreign base company services income
 - Income derived in connection with the performance of certain services performed by or on behalf of a related person and which are performed outside of the CFC's country of incorporation
 - Excludes sales activities

Foreign Base Company Income

- Foreign base company oil related income
 - certain income related to processing and distributing oil and similar products

Section 951: Gross Income Inclusion

- US shareholders that directly or indirectly own stock in a CFC are required to include in gross income their pro rata share of the CFC's subpart F income
 - No inclusion for stock constructively owned
 - Inclusion occurs on the last day of the taxable year

Pro Rata Share

- Section 951(a)(2) provides for a hypothetical distribution construct
- What would have been distributed to the US shareholder if the CFC was to distribute “pro rata” the amount of its subpart F income derived during the time in which it was a CFC reduced by certain dividends paid to other persons?

Old Regulations

- Hypothetical distribution construct
 - Simple situation: what would have been distributed if all E&P were distributed at year end
 - More than one class of stock:
 - Use simple method unless the board had “discretionary power”
 - If board had discretionary power to allocate earnings between two or more classes of stock, treat those classes as if they were one class of stock and allocate the earnings between them on a share by share basis
 - E.g. 1000 Class A shares and 10 Class B shares, treat each share as entitled to $1/1010^{\text{th}}$ of the earnings

Problems with the Old Regulations

- “Unique” interpretations and structures
 - See Enron Apache Transaction as reported by the JCT
 - Other structures
- The old regulations only permitted the taxpayer to propose a different allocation of earnings under the discretionary rule
 - See Treas. Reg. 1.951-1(e)(3) (in effect prior to 2005)

Intent of New Regulations

- Create an economic link to allocations of subpart F income in situations in which the board of directors has discretion
- Reduce instances of abuse
- Make regulations administrable in light of the other purposes

Two General Methods for Determining Pro Rata Share

- Hypothetical distribution construct
- Single Class of Stock
 - Determined on a per-share basis
- Multiple Classes of Stock
 - Stock fixed distribution rights
 - Stock with discretionary distribution rights

Multiple Classes: Fixed Distribution Rights

- Allocate E&P to each class
 - e.g. Corp X has two classes of stock, common and preferred stock. Preferred stock is entitled to a 10x dividend every year. In Year 1 Corp X has 100x of E&P. Preferred stock is allocated 10x and the remainder, 90x, is allocated to the common stock.

Multiple Classes: Discretionary Distribution Rights

- Discretionary distribution rights = the allocation of E&P between two or more classes of stock depends on the exercise of discretion by the board of directors or similar body
 - First allocate earnings to stock with fixed distribution rights, if any,
 - Then allocation earnings between stock with discretionary distribution rights

Discretionary Distribution Rights: Allocation to Multiple Classes

- Determine value of each class of stock
- If substantially similar, allocate (remaining) E&P on per share basis (as if there was one class of stock)
 - Regulations imply substantially similar requires the value of each class to be within 7% of each other
- If not substantially similar, allocate (remaining) E&P between classes of stock based upon the ratio of value of such class to the value of all classes of stock with discretionary distribution rights

Discretionary Distribution Example

- Facts. CFC, a controlled foreign corporation, has outstanding 100 shares of Class A common stock, 100 shares of Class B common stock and 10 shares of 5-percent nonparticipating, voting preferred stock with a par value of \$50x per share. The value of the Class A shares on the last day of CFC's 2005 taxable year is \$800x. The value of the Class B shares on that date is \$200x. The Class A and Class B shareholders each are entitled to dividends when declared by the board of directors of CFC, and the board of directors of CFC may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. Corp D, a domestic corporation and a United States shareholder of CFC owns all of the Class A shares. Corp N, a domestic corporation and a United States shareholder of CFC owns all of the Class B shares. Corp S, a domestic corporation and a United States shareholder of CFC owns all of the preferred shares. CFC, Corp D, Corp N, and Corp S each use the calendar year as a taxable year. Corp D, Corp N, and Corp S are shareholders of CFC for all of 2005. For 2005, CFC has \$100x of earnings and profits, and income of \$100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, CFC distributes as a dividend \$25x to Corp S with respect to the preferred shares. The board of directors of CFC determines that CFC will make no other distributions during that year.

Example Cont'd

- Analysis
- if the total \$100x of earnings were distributed on December 31, 2005, \$25x would be distributed with respect to Corp S's preferred shares and the remainder, \$75x would be distributed with respect to Corp D's Class A shares and Corp N's Class B shares.
- The allocation of that \$75x between its Class A and Class B shares depends solely on the exercise of discretion by the board of directors of CFC.
 - Determine value of Class A and Class B shares to see if substantially similar.
 - The value of the Class A shares (\$8x/share) and the value of the Class B shares (\$2x/share) are not substantially the same on the last day of CFC's taxable year 2005. Therefore for CFC's taxable year 2005, the earnings and profits of CFC are allocated $\$60x (\$800/\$1,000 \times \$75x)$ to the Class A shares and $\$15x (\$200/\$1,000 \times \$75x)$ to the Class B shares.
- For the 2005 taxable year, Corp D's pro rata share of CFC's subpart F income will be \$60x, Corp N's pro rata share of CFC's subpart F income will be \$15x and Corp S's pro rata share of CFC's subpart F income will be \$25x.

Special Rules

- Hypothetical distributions do not include any amount that would be treated as a distribution in redemption, a distribution in liquidation or a return of capital
 - In other words, the ability to pay an additional amount as a redemption (a liquidation or a return of capital) will not affect the determination of a shareholder's pro rata share

Special Rules

- Any restriction or limitation on a shareholder's ability to receive a distribution is disregarded for purposes of determining pro rata share
 - Exception for ordinary preferred dividends

New proposed 951 regulations

- Special rule for section 304 transactions
- Special rule for certain cumulative preferred stock transactions
 - Requires the amount of the hypothetical distribution be equal to present value of the accrued but unpaid dividends for the taxable year