

A Note From the Editor-in-Chief

The Reclassification of DEs As CFCs Under Obama's CTB Proposal Can Result in Subpart F Income

The Obama Administration proposes to classify as corporations foreign entities with a single foreign owner, which would cause existing disregarded entities (DEs) to be reclassified as corporations.¹ For example, a U.K. DE owned by a Luxembourg controlled foreign corporation (CFC) would become a separate U.K. CFC. The classification rule, however, would not apply to an entity whose owner is organized under the laws of the same country.

The purpose of preventing foreign entities from being classified as DEs is to create subpart F income where it otherwise would not arise. Formerly disregarded dividends, interest, rents and royalties would become recognized and generally be foreign personal holding company income. Sales and services transactions involving previous DEs would become related-party transactions, which can result in foreign base company sales or services income. Dispositions of a former DE would result in subpart F gain from the sale of stock in a CFC.²

An important consequence of the reclassification of the above U.K. DE would be the deemed transfer by the Luxembourg CFC ("LuxCo") of the assets of the U.K. DE to the new U.K. CFC in exchange for stock and the assumption of liabilities.³ This transaction generally should qualify as a tax-free transfer under Code Sec. 351, and Code Sec. 367 generally should not override the tax-free treatment. Nevertheless, under certain circumstances, the deemed transfer can result in taxable gain where the DE has liabilities.

Under Code Sec. 357(a), liabilities assumed in a Code Sec. 351 transaction generally are not treated as money or other property, and therefore would not result in taxable gain.⁴ On the other hand, if liabilities assumed exceed the aggregate basis in the assets transferred, gain would be recognized to the extent of such difference.⁵

Furthermore, taxable boot would result where, for example, LuxCo has a loan to the U.K. DE that is not recognized for U.S. tax purposes.⁶ The debt would "spring" into existence when the U.K. DE becomes regarded as a corporation and treated as property received by LuxCo. Gain would be recognized by LuxCo to the extent of the amount of the boot.⁷

Gain recognized by LuxCo with respect to the deemed transfer of assets used in a trade or business generally should



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not result in subpart F income (e.g., plant, equipment and goodwill). On the other hand, gain on the deemed sale of passive assets generally would result in subpart F income taxable immediately to the U.S. shareholder.⁸ Income from the deemed sale of inventory would be subpart F income if it falls within the definition of foreign base company sales income. In any event, such gain would result in earnings and profits to LuxCo (previously taxed earnings to the extent the gain is subpart F income), which may dilute its foreign tax credit pools because no foreign taxes would be imposed on such gain.

If LuxCo is deemed to transfer stock in a subsidiary to the new U.K. CFC, Code Sec. 304 can apply. Pursuant to that provision, the amount of liabilities assumed and liabilities that spring into existence allocated to such stock would be treated as a dividend to the extent of the earnings and profits of the U.K. CFC (i.e., current year earnings) and of the subsidiary transferred.⁹ The remaining amount would be treated as a return of basis to the extent of basis in the stock of the U.K. CFC, and then as capital gain.¹⁰

With a Code Sec. 304 transaction, the deemed dividend and capital gain generally would be subpart F income (since the Code Sec. 954(c)(6) look-through exception for dividends will likely

have sunset). Any foreign tax credits associated with the earnings deemed distributed should accompany the dividend.¹¹

If the U.K. DE holds a disregarded loan to LuxCo, the reclassification also causes such loan to become recognized. This should not result in taxable gain. Nevertheless, the IRS has taken the position that the U.K. DE would have a zero basis in the note, although two circuit courts have disagreed with this conclusion.¹² A CFC with a zero basis note would have taxable income as the loan is repaid, and such income generally would be considered as subpart F income.¹³

A taxpayer that desires to avoid the above reclassification consequences may consider restructuring liabilities of DEs before 2011, the effective date of the proposed legislation. For example, disregarded debt might be eliminated with capital contributions from the owner, although this likely would result in foreign tax inefficiencies. Alternatives might be considered that maintain the leverage for foreign tax purposes while avoiding taxable income for U.S. tax purposes. Indeed, it would be entirely appropriate for the new legislation to provide that liabilities assumed or springing into existence as a result of the reclassification of DEs do not result in taxable income.¹⁴

ENDNOTES

¹ See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010: Analytical Perspectives* (H. Doc. 111-3, Vol. III), at 268. See also Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009.

² Code Sec. 954(c), (d) and (e).

³ See Reg. §301.7701-3(g)(1)(iv).

⁴ See Code Sec. 351(b) & (h)(1).

⁵ Code Sec. 357(c). Also, if there is a tax avoidance purpose or the lack of a bona fide business purpose for the liability assumption, Code Sec. 357(b) provides that the liabilities assumed are treated as money received.

⁶ Interest on such loan may provide a deduction that offsets income of a U.K. subsidiary

under the U.K. group relief rules.

⁷ Rev. Rul. 80-228, 1980-2 CB 115.

⁸ Code Sec. 954(c)(2); Reg. §1.954-2(e). Gain on the sale of an interest in a partnership where the CFC owns at least a 25-percent interest is analyzed as gain on the sale of a proportionate share of the partnership's assets. Code Sec. 954(c)(4).

⁹ See Code Sec. 304(a)(3) (Code Sec. 357(a) does not apply).

¹⁰ See Lowell D. Yoder, A Note from the Editor-in-Chief, *New Code Sec. 367(a) Regulations Apply to International Code Sec. 304(a)(1) Transactions*, INT'L TAX J., May-June 2009, at 3 (discussing basis of shares taken into account).

¹¹ See Lowell D. Yoder, A Note from the Editor-

in-Chief, *International Tax Planning Using Code Sec. 304*, INT'L TAX J., July-Aug. 2007, at 3.

¹² Rev. Rul. 68-629, 1968-2 CB 154; *D.J. Peracchi*, CA-9, 98-1 USTC ¶50,374, 143 F3d 487; *S. Lessinger*, CA-2, 89-1 USTC ¶9254, 872 F2d 519; but see *Coltec Indus. Inc.*, CA-FC, 2006-2 USTC ¶50,389, 454 F3d 1340, 1344 n. 2; *Wilmington Partners L.P.*, 98 TCM 138, Dec. 57,915(M), TC Memo. 2009-193.

¹³ Reg. §1.954-2(e)(2)(ii).

¹⁴ See Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment, Staff of the Joint Committee on Taxation (Sept. 2009), at 115.

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