Economic Substance and the (Foreign) Dividends Received Deduction

By Donald P. Board • Wood LLP

Despite their promising rubric ("Special Deductions for Corporations"), Code Secs. 241-249 may not be as high on tax practitioners' reading lists as they should be. Everyone, of course, is familiar with Code Sec. 243, which (post-TCJA) lets a corporation deduct 50, 65, or even 100 percent of any dividend received from a domestic corporation. New Code Sec. 245A is making a bit of a splash, but some of us might have trouble recognizing the other provisions if we ran into them on the street.

When enough dollars are at stake, however, you can bet that there's somebody in a skunkworks somewhere looking *very* closely at what seems like an obscure and mild-mannered set of provisions. Their goal is to concoct a potion that will transform these Dr. Jekylls into tax Mr. Hydes. Consider Code Sec. 245(a)(1):

> In the case of dividends received by a corporation from a qualified 10-percent owned foreign corporation, there shall be allowed as a deduction an amount equal to the percent (specified in section 243 for the taxable year) of the U.S.-source portion of such dividends.

That sounds pretty innocuous. Foreign corporations are generally taxed on their U.S.-source income. If that income is taxed when distributed to a domestic corporation, it will have been subjected to two layers of U.S. tax even *before* leaving corporate solution. Code Sec. 245(a)(1) avoids the triple taxation of a foreign corporation's U.S. earnings by, in effect, allowing the recipient to deduct the U.S.-source portion of a foreign dividend in accordance with Code Sec. 243.

Code Sec. 245(a)(1) is one more of those high-minded provisions in which the United States tries to remain neutral in its treatment of domestic and foreign enterprises. When it comes to tax, however, no good deed goes unpunished. It was only matter of time until

ingenious planners invented a structure to convert run-of-the-mill interest income into deductible dividends of U.S.-source income—but *without* subjecting the original income to the indignity of U.S. taxation.

Congress definitively blocked this gambit in 2015 by enacting Code Sec. 245(a)(12), discussed below. But both the targeted transaction and the IRS's objections to it continue to be matters of interest. One half of tax planning is devising ways to transmute base metal into gold. The other half is recognizing what kinds of tax plans are likely to collapse if reviewed under the economic-substance or substance-over-form doctrines.

Chief Counsel Advice 201640018

In CCA 201640018, the IRS provided a detailed analysis of a transaction designed to exploit Code Sec. 245(a)(1). Common Parent, a publicly traded domestic corporation, filed a consolidated return with a large number of other domestic entities (the "U.S. Group"). Common Parent was the head of a long chain of wholly owned U.S. corporations, beginning with Sub A and continuing through Sub B, Sub C, Sub1, Sub2. Sub3, and Sub4. Sub4 owned Sub5, a U.S. limited liability company that had elected to be classified as a corporation.

The U.S. Group was engaged in banking and brokerage activities, and held large amounts of cash deposited by customers as collateral. Regulatory authorities allowed the U.S. Group to invest these customer funds for its own account, but only in high-grade, domestic liquid assets—primarily short-term debt. The U.S. Group earned mostly interest income from these investments, attracting federal corporate income tax at the (former) 35-percent rate.

The U.S. Group figured it could do better. It began by converting Sub4 into a foreign corporation. Sub4 was rechartered in Country U, which removed both Sub4 and Sub5 from the U.S. Group.

Sub5, however, *retained* its U.S. charter. That set up the second step in the plan. Sub5 sold all its assets for cash, registered with the SEC under the '40 Act, and elected to be classified as a regulated investment company ("Sub5 RIC") under Code Sec. 851(a).

RIC Dividends for Foreign Corporation

Once the new structure was in place, the U.S. Group sent its customers' funds down to Sub3, which passed them along to Sub4, which invested them in Sub5 RIC. Sub5 RIC purchased securities that generated interest income and some incidental short-term capital gains. Sub5 RIC dividended its profits up to Sub4.

As a regulated investment company, Sub5 RIC was able to claim a dividends paid deduction under Code Sec. 852(b). This conveniently eliminated Sub5 RIC's potential U.S. corporate tax liability on the income it had earned. Sub4, in turn, avoided the 30-percent U.S. withholding tax imposed by Code Sec. 881(a), because Code Sec. 881(e) exempts interest-related and short-term-capital-gain dividends paid by a RIC.

Sub3, a domestic corporation, owned all the stock of Sub4, which was therefore a controlled foreign corporation. Sub5 RIC's distribution to Sub4 was foreign personal holding company income as defined in Code Sec. 954(c). Ordinarily, one would have expected Sub3 to report this Subpart F income pursuant to Code Sec. 951(a)(1).

However, Sub3 escaped the Subpart F inclusion by selling its Sub4 stock to Sub2 just before the end of Sub4's taxable year. Sub4 continued on as a CFC, but Sub2 was able to reduce its *pro rata* share of Sub 4's Subpart F income by any amounts previously distributed to Sub3 [*see* Code Sec. 951(a)(2)(B)]. Sub4 had already distributed most of the funds it had received from Sub5 RIC, so Sub2 had to pay only a small amount of U.S. tax under Code Sec. 951(a)(1).

(Foreign) Dividends Received Deduction

Although Sub4 had not paid tax on the distribution from Sub5 RIC, it still counted as part of Sub4's earnings and profits [*see* Reg. §1.312-6(b)]. Sub4's distribution to Sub3 was therefore a dividend under Code Sec. 316(a).

This brings us to the critical juncture. Under Code Sec. 245(a)(1), a U.S. corporation may, in effect, apply Code Sec. 243 to the U.S.-source portion of any dividend paid by a 10-percent-owned foreign corporation. The U.S.-source portion is determined under Code Sec. 245(a)(3), which looks to the ratio of the foreign corporation's post-1986 undistributed *U.S.*

earnings to its post-1986 undistributed *total* earnings.

Under Code Sec. 245(a)(5), the foreign corporation's post-1986 undistributed U.S. earnings are the portion of its total undistributed earnings attributable to either: (1) income effectively connected with a U.S. trade or business conducted by the foreign corporation (assuming that such income is subject to U.S. tax); or (2) any dividend paid by a domestic corporation if the foreign corporation has at least an 80-percent interest, by vote and value, in the payor.

The dividend that Sub4 paid to Sub3 was funded by the dividend Sub4 had received from Sub5 RIC, its wholly owned U.S. subsidiary. So, the entire dividend was attributable to Sub4's U.S.-source income. Sub3 deducted 80 percent of the Sub4 dividend in accordance with Code Sec. 245(a)(1) and the overall limitation imposed by Code Sec. 246(b).

Too Good to Be True?

That would have been a pretty nice result, if it had held up. Before the restructuring, the U.S. Group had to pay tax at 35 percent on the interest it earned on customer funds. By running the interest through a wholly owned RIC owned by a foreign corporation, the tax rate was reduced to a very civilized *seven percent*.

Code Sec. 245(a)(12), enacted in 2015, put an end to this by providing that a RIC does not count as a domestic corporation for purposes of Code Sec. 245(a)(5)(B). This sounds odd, because only domestic corporations can qualify as RICs pursuant to Code Sec. 851(a). But the point was simply to prevent RIC dividends paid to a foreign corporation from qualifying as U.S.-source income. That, in turn, would bar the foreign corporation's 10-percent U.S. shareholders from claiming a dividend received deduction under Code Sec. 245(a)(1).

Although the IRS presumably welcomed Code Sec. 245(a)(12), it was by no means ready to concede that the tax-reduction plan "worked" in the absence of this statutory patch. CCA 201640018 set forth an array of arguments intended to show that the seven-percent tax rate was indeed too good to be true, even without the new provision. Many of these arguments involve technical interpretations of special Code provision, but we will concentrate on the "common law" arguments for rejecting a tax scheme that at least *looked* like it was within the letter of the statute.

Economic Substance

The tax years at issue in CCA 201640018 antedated the enactment of Code Sec. 7701(o). The IRS's discussion of economic substance therefore relied on the welter of judicial authorities going way back to *E. Gregory* [SCt, 35-1 USTC ¶9043, 293 US 465, 55 SCt 266 (1935)]. But it seems unlikely that the analysis would have been different if Code Sec. 7701(o)'s "clarification" of the economic substance doctrine had applied.

The IRS took its bearings from the fact that Sub3 would *not* have been able to claim a dividend received deduction if: (1) it had earned the interest income directly; or (2) it had invested directly in Sub5 RIC. Should an 80-percent DRD become available simply because a foreign corporation (Sub4) was inserted between Sub3 and Sub5 RIC?

The IRS asked what purpose, other than tax reduction, was served by moving the investment of customer funds into a RIC and then paying all of its income out as dividends to a foreign corporation. Sub5 RIC was wholly owned by Sub4, so the U.S. Group did not achieve any diversification by adopting the RIC structure. The IRS also noted that Sub5 RIC's investments were overseen by the same member of the U.S. Group that had been in charge of investing client funds *before* the new structure was put in place.

The IRS acknowledged that the investment of client funds, *per se*, had a reasonable expectation of earning a profit without regard to tax considerations. But that was beside the point. The plan lacked "objective" economic substance because reincorporating Sub4 in Country U and converting Sub5 to a RIC did not offer any economic profit "over and above" what the U.S. Group had been earning under the *original* structure.

The "subjective" prong of the economic substance doctrine focuses on whether the arrangement serves a non-tax business purpose. The U.S. Group offered half a dozen makeweight arguments, *e.g.*, that non-U.S. investors might prefer to invest in Sub4 as a foreign corporation

in order to reduce U.S. bankruptcy concerns. The IRS picked these claims apart on various grounds, starting with the fact that many of them were inconsistent with statements the U.S. Group had made to regulatory authorities.

The IRS also raised the more fundamental objection that these alleged non-tax considerations had not *actually* played a role in the U.S. Group's decision to adopt the new structure. By some means or other, the IRS had gained access to what it called the U.S. Group's "tax-planning documents." These documents said nothing about attracting non-U.S. investors and the rest—their exclusive focus was on reducing the tax on the U.S. Group's interest income.

CCA 201640014 devoted several pages to showing that Sub3's invocation of Code Sec. 245(a)(1)(A) was not consistent with Congressional intent. The dividends received deduction was enacted to provide relief from *multiple* layers of corporate tax. There is zero reason to think that Congress wanted to let taxpayers use it to reduce a *single* layer of tax by 80 percent.

Substance over Form

The IRS also argued for a recast to reflect the substance of the arrangement. As is usually the case in "engineered" transactions that produce surprising results, there were steps that served no real purpose except to meet the literal requirements of the Code. Funds that would ordinarily have been invested directly by the U.S. Group were funneled into a new foreign corporation (Sub4) and then entrusted to, of all things, a wholly owned regulated investment company (Sub5 RIC). Income earned by Sub5 RIC was then sent back to Sub4 for distribution to Sub3 and, ultimately, other members of the U.S. Group.

These circuitous steps would have made no sense except as part of the U.S. Group's tax reduction plan. The intended tax result was completely dependent on the interposition of Sub4, but this entity operated as nothing more than a conduit as funds flowed into and out of Sub5 RIC. If the foreign conduit is ignored, Sub3 is investing directly in Sub5 RIC. That puts the kibosh on any DRD under Code Sec. 245(a)(1).

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