

Taxable Acquisitions of Foreign Corporations in a Brave New World

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I. Introduction

This article discusses the U.S. tax considerations of buying and selling foreign companies, particularly controlled foreign corporations (“CFCs”), in light of the Tax Cuts and Jobs Act of 2017.¹ Planning for a foreign acquisition is considerably different than for a domestic acquisition, not only because a foreign acquisition requires serious thought about the subpart F and foreign tax credit picture that will emerge post-closing, but also because there is a range of new regimes that can apply to CFCs, which can result in unexpected interactions with Code Sec. 338. The Code Sec. 338(g) election,² long ago cast into the attic as a relic of the past for domestic deals, but often used in foreign deals, must now be scrutinized differently in the foreign context. Below, we discuss the taxable foreign acquisition both with and without a Code Sec. 338(g) election, taking into account the implications of the TCJA. Part II addresses the tax planning issues for a U.S. buyer, while Part III addresses the U.S. seller’s perspective, which layers in significant complexity with the question of whether a Code Sec. 338(g) election should be made. Part IV addresses the sale of a CFC by another CFC, along with so-called “check and sell” transactions. This article does not discuss in detail all of the post-acquisition consequences under the various new regimes—*e.g.*, GILTI, FDII, BEAT, the new dividends received deduction, and the indirect FTC—except as they relate to the acquisition deal itself.

II. Buyer Tax Planning Issues

(A) Buyer Issues in General

A U.S. buyer’s options are whether it will (a) purchase foreign assets directly from seller and operate them as part of a branch; (b) form a new foreign company to purchase assets so that the business can be operated in foreign corporate solution; (c) purchase stock of a foreign target company (“Foreign Target”) without a Code Sec. 338(g) election; or (d) purchase stock of Foreign Target with a Code Sec. 338(g) election. Asset deals are somewhat uncommon in the international context. Consequently, this article addresses stock acquisitions with and without a Code Sec. 338(g) election from both the buyer and seller perspectives.³



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(B) Buyer Issues—No Code Sec. 338(g) Election

(1) In General

If a U.S. Buyer makes a qualified stock purchase (“QSP”) of the stock of Foreign Target and does not make a Code Sec. 338(g) election, then the buyer receives a fair market value (*i.e.*, cost) basis in the stock of Foreign Target, without any step-up in the tax basis of assets inside the company. One practical drawback to a stock acquisition without a Code Sec. 338(g) election is that the U.S. Buyer will likely have to calculate the U.S. tax attributes of Foreign Target, particularly if the stock is purchased from a foreign seller that was unconcerned with U.S. tax attributes. Prior to the TCJA, this involved establishing the historic post-1986 earnings and profits (“E&P”) and foreign tax credit pools.⁴ For tax periods beginning after December 31, 2017, it is no longer necessary to calculate historic foreign tax credit pools, as Code Sec. 902 has been repealed.⁵ However, the Target’s FTCs still might matter, and the buyer must calculate the historic tax basis of assets, as depreciation is relevant for purposes of calculating E&P and GILTI.⁶ And, of course, E&P must be calculated under federal tax concepts, as modified for CFCs. Gathering the related data and making the required calculations for all prior years is a critical drawback to forgoing a Code Sec. 338(g) election. Also, if Foreign Target operated prior to 1986, then the E&P and foreign tax credits must be calculated under pre-1986 tax principles. This calculation can be very cumbersome and, accordingly, prior to the enactment of Code Sec. 901(m) (which modestly penalizes the election), it was common to make the Code Sec. 338(g) election to eliminate the need to re-create this history; such practice continued even after the enactment of Code Sec. 901(m). However, forgoing the Code Sec. 338(g) election can be beneficial where making the election might give rise to a “trapped foreign tax credit” problem or where Foreign Target has desirable tax attributes.⁷

(2) Buyer Inherits PTI

In the absence of a Code Sec. 338(g) election, the buyer inherits any previously taxed income (“PTI”), *i.e.*, subpart F income, and now GILTI, previously included in income by a U.S. shareholder of a CFC (but not if Target was not a CFC or if seller was not a U.S. shareholder).⁸ The PTI may now be quite substantial in light of the TCJA, which imposed a one-time tax under Code Sec. 965 on all of the CFC’s pre-2018 E&P, which most CFCs will not have distributed. This inherited PTI is beneficial to the buyer, who can take distributions of cash up to the

amount of PTI without being taxed.⁹ The buyer wanting to use PTI must obtain from a U.S. Seller detailed information about the creation of the PTI and must be able to demonstrate that the PTI was not previously used by the U.S. Seller.¹⁰ This requirement would include obtaining tax return information that the U.S. Seller views as confidential, which could make compliance difficult. In any event, it should be addressed in the stock purchase agreement. In addition, if a portion of the U.S. Seller’s gain is re-characterized as a dividend under Code Sec. 1248, that re-characterization also gives rise to PTI in the hands of the buyer.¹¹

(3) Buyer’s Pro Rata Share of Subpart F Income in Year of Acquisition

The novice who advises on the acquisition of a Foreign Target will be immediately baptized with excruciatingly technical rules. The U.S. Buyer will hold the stock of Foreign Target as of the end of Target’s normal year after it is acquired and, accordingly, will be required to include in income its *pro rata* share of subpart F income and GILTI.¹² The buyer’s “pro rata share” of subpart F income for the first year of ownership will depend on whether the Target’s tax year closed when it was acquired, which would occur if a Code Sec. 338(g) election was made.¹³ If Target’s tax year did not close, the Buyer’s share is reduced in proportion to the number of days for which Foreign Target was not a CFC during the taxable year.¹⁴ The buyer’s *pro rata* share of subpart F income and GILTI may also be reduced by dividends paid to the seller (U.S. or foreign) during the taxable year but before the sale.¹⁵ Additionally, if the seller was a U.S. shareholder and Foreign Target was a CFC, then any amount of current year E&P included as a dividend under Code Sec. 1248 is treated as a distribution for purposes of this rule, as illustrated below, even if the DRD applies.¹⁶

Example. Assume that a U.S. Seller held 100% of the stock of Foreign Target, a CFC, and sells that stock to a U.S. Buyer on September 30 at a gain of \$1,000. Assume that there was \$100 of either subpart F income or GILTI and additional accumulated E&P of \$200 on December 31 of that year. Under Code Sec. 1248, the U.S. Seller includes $\$300 \times 270/365 = \221 as a dividend on the date of the sale. The remainder of the gain ($\$1,000 - \$221 = \$779$) retains its character as a capital gain. Under Code Sec. 951(a)(2)(A), the starting point for U.S. Buyer’s subpart F/GILTI income is the \$100 multiplied by ratio of days during the year that Foreign Target was a CFC, or $\$100 \times 365/365 = \100 . Under Code

Sec. 951(a)(2)(B), this amount is then reduced by any dividends distributed, including Code Sec. 1248 dividends deemed distributed, to the seller. This reduction is limited by the \$100 of subpart F income multiplied by the proportion of days that the U.S. Buyer did not own the shares during the entire year, or, in this example, $\$100 \times 270/365 = \74 . Thus, the U.S. Buyer's subpart F inclusion for the year of the sale is $\$100 - \$74 = \$26$. Note that the U.S. Buyer inherits \$221 of PTI from the seller's Code Sec. 1248 inclusion.¹⁷

Note that GILTI is treated the same as subpart F income for purposes of the *pro rata* share analysis above.¹⁸

(C) Buyer Issues—Code Sec. 338(g) Election

(1) Buyer Treatment with Code Sec. 338(g) Election in General

When a Code Sec. 338(g) election is made, Foreign Target (the putative “old” corporation) is deemed to have sold its assets to itself (a fictional “new” corporation), which gives rise to gain realized at the level of Foreign Target and a step-up in the basis of assets in the hands of the fictional new corporation.¹⁹ The new corporation is deemed to purchase the assets as of the beginning of the day after the acquisition date.²⁰ The buyer generally recognizes no gain on the transaction unless the buyer already holds shares in Foreign Target.²¹ The taxable year of Foreign Target closes on the acquisition date,²² and on the next day the buyer is deemed to own stock of a new corporation with no previous tax history.²³ The election is made by the purchasing corporation without the consent of the seller, and it must be made by the 15th day of the ninth month after the QSP.²⁴ A Code Sec. 338(h)(10) election normally cannot be made for a foreign corporation.²⁵ Where the buyer is a CFC and does not file a U.S. tax return, the Code Sec. 338(g) election may be made by the U.S. shareholders of the CFC buyer.²⁶

(2) Impact on GILTI

The TCJA introduced the GILTI regime, under which part of the CFC's normal income can be taxed currently, similar to subpart F income. The amount of GILTI includable in the income of a U.S. shareholder is the aggregate of the U.S. shareholder's *pro rata* share of tested income, less tested losses of all CFCs in which the U.S. shareholder owns stock, less net deemed tangible income return (“NDTIR”).²⁷ The NDTIR is 10% of qualified

business asset investment (“QBAI”) less interest paid to third parties or to related persons that are not CFCs.²⁸ QBAI is the CFC's adjusted basis in depreciable tangible property used to produce tested income.²⁹ QBAI does not include goodwill or other intangible property.

Since having relatively high QBAI would reduce GILTI, a Code Sec. 338(g) election might help by increasing the basis in depreciable property. Note that a Code Sec. 338(g) election steps up the basis in property to its fair market value. Tangible property, such as machinery and equipment, may or may not be valued more highly than its tax basis before the Code Sec. 338(g) election. So, careful valuation is required for successful results. This may become an area of IRS concern if taxpayer valuations of tangible property appear excessive.

Note that the Code Sec. 338(g) election can lead to trapped QBAI and foreign tax credits. For example, if a CFC produces a tested loss (deductions of the CFC exceed gross income³⁰), the QBAI of that CFC is not counted in determining NDTIR.³¹ Likewise, any foreign tax credits in CFCs with tested losses are trapped and lost forever.³² Consequently, it would be wise to model the impact of the election on tested income to ensure maximum utilization of QBAI and foreign tax credits.

(3) Requirements for a Valid Code Sec. 338 Election

To have a valid Code Sec. 338 election, the buyer must be a corporation or a disregarded entity owned by a corporation.³³ Foreign Target must also be a corporation for U.S. tax purposes.³⁴ The buyer must make a “qualified stock purchase,” which is a purchase (in one transaction or a series of transactions) of 80% of the voting power and value of Foreign Target during a 12-month period.³⁵ The “purchase” must take place in a taxable transaction, rather than a Code Sec. 351 transfer or a tax-free reorganization, and the seller must generally be an unrelated person.³⁶

(4) Deemed Purchase of CFC Stock as Part of a Code Sec. 338(h)(10) Election

Stock of a CFC may often be “sold” as part of the sale of the domestic parent accompanied by a Code Sec. 338(h)(10) election. As mentioned above, a foreign corporation (including a CFC) cannot itself be the subject of a Code Sec. 338(h)(10) election. When a domestic parent sells stock of a domestic target owning stock of a CFC, and a Code Sec. 338(h)(10) election is made with respect to the domestic target, then that domestic target is deemed to sell its stock in the CFC as part of its overall deemed

asset sale.³⁷ The buyer can make a separate Code Sec. 338(g) election with respect to the CFC stock but is not required to do so.³⁸ As mentioned previously, the buyer can unilaterally make the Code Sec. 338(g) election for the CFC, even though both the parent and the buyer must jointly make the Code Sec. 338(h)(10) election for the domestic target.³⁹

(5) Code Sec. 901(m) and Anti-Hyping

(a) Background to Code Sec. 901(m). With a Code Sec. 338 election, it was possible to increase or “hype” foreign tax credits due to the differences between U.S. and foreign tax accounting. In the typical scenario, the deemed purchase price under the Code Sec. 338 election would give rise to goodwill and other amortizable assets under Code Sec. 197 that did not exist for foreign tax purposes. Thus, after the acquisition, Foreign Target would amortize Code Sec. 197 assets for purposes of determining U.S. E&P, while calculating foreign income taxes without such amortization for foreign tax purposes. This mismatch would lead to relatively high foreign tax credit pools and relatively low E&P pools, thus driving up the effective foreign tax rate. Consequently, a distribution of profits would lead to a relatively high, or “hyped,” carryout of foreign tax credits under Code Sec. 902.

We are in the midst of significant change in terms of both U.S. and foreign tax laws, and it will be interesting (perhaps a little too interesting) for practitioners to wrestle with these structures over the coming years.

Congress felt that foreign tax credit hyping due to Code Sec. 338 elections was inappropriate and, accordingly, enacted Code Sec. 901(m) to prevent or reduce the foreign tax credit available to the buyer where the acquisition results in a stepped-up basis in the assets of Foreign Target for U.S. tax purposes but not for foreign purposes. Code Sec. 901(m) denies a portion of the foreign tax credits in proportion to the current year impact under foreign tax law of differences in the tax basis of assets under foreign vs U.S. law. While not creditable, the amount of any disqualified foreign tax

credit is nevertheless deductible against E&P if directly incurred (or not included in income under Code Sec. 78 as a dividend).⁴⁰ This deduction will normally make the Code Sec. 338 election desirable because the additional depreciation and amortization arising from the basis step-up, and the deduction for the disqualified foreign tax credits, produces a favorable U.S. effective tax rate notwithstanding the application of Code Sec. 901(m).⁴¹

(b) Future Desirability of Code Sec. 338 Elections.

Going forward, it is generally desirable to make a Code Sec. 338 election for covered asset acquisitions despite the loss of the disqualified tax credits under Code Sec. 901(m). In most cases, the election still reduces the overall U.S. effective tax rate because the disqualified portion of the foreign tax credits is deductible against E&P. In addition, the election would generally increase the adjusted basis in QBAI for GILTI purposes. Finally, the step-up in tax basis of assets can facilitate group restructurings without subpart F income and GILTI. This would include, for example, the sale of stock of any U.S. subsidiaries of Foreign Target into the U.S. group for business integration purposes. On the other hand, the election would eliminate pre-acquisition PTI, which might be substantial in light of the one-time tax under Code Sec. 965.

(6) Applying Code Sec. 338(g) to Multiple Tiers

In an acquisition where Foreign Target has foreign subsidiaries, it is often desirable to make Code Sec. 338(g) elections for those subsidiaries. The election must be made separately for each subsidiary.⁴² The election at the level of the subsidiaries provides the same benefits as described above (subject to the same limitations under Code Sec. 901(m)). When the election is made for Foreign Target, no gain or loss is recognized on the shares of a foreign subsidiary if a Code Sec. 338(g) election is made for that foreign subsidiary.⁴³ Instead, the foreign subsidiary recognizes gain or loss on the deemed sale of its assets with the usual consequences (e.g., no U.S. tax consequences or potential subpart F income for U.S. shareholders). This planning is helpful where Foreign Target owns enough stock to make a “qualified stock purchase” with respect to the foreign subsidiary.

Where Foreign Target owns less than 80% of the voting power or value of the foreign subsidiary, the Code Sec. 338(g) election cannot be made for that subsidiary.⁴⁴ In such case, the U.S. Buyer can achieve tax results

similar to the Code Sec. 338(g) election by having the seller make a “check-the-box” election for the subsidiary to treat it as a partnership or disregarded entity immediately before the acquisition date.⁴⁵ The check-the-box election is treated as a taxable liquidation under Code Sec. 331(a) and, accordingly, the foreign subsidiary (now a flow-through entity) would have a fair market value basis in its assets.⁴⁶ In addition, the post-1986 E&P and foreign tax credit history of that subsidiary would be eliminated. The one drawback to a check-the-box election is that minority partners must sign the election on Form 8832.⁴⁷ It may be difficult to obtain all required signatures, especially if they are foreign persons who may be reluctant to sign U.S. tax forms even if they are unaffected by the election. The seller is often unwilling to list the check-the-box election as a condition to closing. In that event, the U.S. Buyer generally has 75 days after closing to convince the minority partners to sign the form.⁴⁸

III. Seller Tax Planning Issues

(A) Foreign Sellers

The foreign seller of stock in Foreign Target is generally indifferent to any U.S. tax planning associated with the sale. For example, a foreign seller of Target stock is unaffected by a Code Sec. 338(g) election. Normally, the stock purchase agreement will either remain silent about the Code Sec. 338(g) election or expressly allow the U.S. Buyer to make the election unilaterally.

(B) U.S. Corporate Sellers Sell CFC Stock—No Code Sec. 338(g) Election

(1) In General

A U.S. Seller generally cares about the amount of gain recognized on the sale and the character of that gain, including the impact of Code Sec. 1248 and whether the resulting dividend would qualify for the new DRD under Code Sec. 245A. In addition, the U.S. Seller should carefully consider both the source of the income and its basket classification for foreign tax credit limitation purposes. In certain circumstances, the U.S. Seller should also consider the amount of subpart F and GILTI income it will recognize as of the closing date in certain circumstances. This article covers these consequences, first without a Code Sec. 338(g) election and then with a Code Sec. 338(g) election (which the U.S. Buyer normally prefers).

(2) Treatment of Code Sec. 1248 Gain

Where a U.S. Seller is a corporation and sells stock of a CFC, the U.S. Seller generally recognizes gain equal to the difference between the amount realized and its basis in the stock.⁴⁹ However, under Code Sec. 1248, a portion of the gain is re-characterized as a dividend to the extent of the seller’s share of the CFC’s previously untaxed E&P.⁵⁰ The original purpose of Code Sec. 1248 was to ensure that U.S. shareholders of a CFC were taxed at ordinary rates on any E&P of a CFC upon exit.⁵¹ However, for a U.S. corporate seller, the portion recharacterized as a dividend under Code Sec. 1248 is now subject to a DRD under Code Sec. 245A.⁵² As discussed below, foreign countries often impose tax on the sale of stock by a non-resident. The portion of tax allocable to the Code Sec. 1248 gain recharacterized as a dividend is not creditable to the extent that the dividend itself is subject to a DRD under Code Sec. 245A.⁵³

In determining the stock basis for purposes of calculating the gain (and any amount re-characterized as a dividend), any PTI arising from previously included subpart F income is added to the stock basis, thereby reducing the gain.⁵⁴ In addition, that amount of PTI that has not been previously distributed is excluded from the E&P pool that is used to calculate the amount recharacterized as a dividend.⁵⁵ For sales occurring in the first few years after the enactment of the TCJA, most E&P of CFCs will consist of PTI arising from the one-time tax imposed under Code Sec. 965. Thus, there might not be significant untaxed E&P for Code Sec. 1248 and DRD purposes.

(3) Treatment of Non-Code Sec. 1248 Gain

(a) In General. Any gain in excess of the amount re-characterized as a dividend under Code Sec. 1248 (“residual gain”) is capital gain and is taxed like any other capital gain, currently at a rate of 21% in the hands of a domestic corporation.

(b) Sourcing the Capital Gain. Normally, the sale of personal property is sourced according to the residence of the seller.⁵⁶ Consequently, under the default rule, gain on the sale of foreign stock by a U.S. Seller is U.S. source income. However, the residual gain is foreign source under Code Sec. 865(f) if (A) the U.S. Seller held stock representing at least 80% of the voting power and value of Foreign Target⁵⁷; (B) such sale occurs in a foreign country in which Foreign Target is engaged in the active conduct of a trade or business; and (C) more than 50% of the gross income of Foreign Target for the preceding three taxable years was derived

from the active conduct of a trade or business in the foreign country where the sale occurred (a “qualified foreign sale”).⁵⁸ It is not necessarily clear where a sale “occurs.” The conventional wisdom is that the closing must take place in the foreign country in which Foreign Target is engaged in a trade or business. Note that if Foreign Target has an active trade or business in more than one foreign country, the sale must “occur” in the country in which more than 50% of the Foreign Target’s gross income for the preceding three taxable years was derived, which is not necessarily the foreign country in which Foreign Target is incorporated. Furthermore, it is not clear that a domestic target that is deemed to sell stock of a foreign corporation by virtue of a Code Sec. 338(h)(10) election can qualify for Code Sec. 865(f) absent an actual sale.

(c) Basket Classification. Generally, the source of the gain on the sale will matter only if the gain is taxable in a foreign country, or if the seller otherwise has unutilized tax credits in the passive basket. The residual gain is generally classified in the passive basket.⁵⁹ Most countries do not tax foreigners who realize capital gains on the sale of shares unless there is a significant real estate component (similar to the provisions of the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”). However, several countries, including Mexico, China, Brazil, and India, impose a capital gains tax on foreigners regardless of the real estate component. In those cases, it is important that the residual gain be treated as foreign source income under Code Sec. 865(f) so that the foreign tax on the sale can be credited.⁶⁰ Otherwise, the foreign tax is not likely to be creditable for U.S. tax purposes and double taxation could arise.

(d) Treatment of Gain Re-Sourced by a Tax Treaty. Some income tax treaties contain a rule that re-sources capital gains on the sale of stock as foreign source, which may be useful if the taxpayer does not qualify for Code Sec. 865(f). For example, the U.S.-Mexico Income Tax Treaty (“Mexico Treaty”) allows Mexico to tax gain realized by a U.S. joint venture partner on the sale of a 50% joint venture interest,⁶¹ which would not qualify as foreign source under Code Sec. 865(f).⁶² In that case, the Mexico Treaty re-sources the gain as foreign source for U.S. foreign tax credit limitation purposes.⁶³ However, any gain on the sale of stock that would be U.S. source under Code Sec. 865(f), but which is re-sourced as foreign under a treaty, is placed in a separate basket for foreign tax credit purposes.⁶⁴ Consequently, that gain (and the resulting Mexican tax) cannot be blended with other passive basket income for foreign tax credit purposes.

(4) Differences in Tax Basis in CFC Stock Between U.S. and Foreign Tax Law

There may be cases where the tax basis in Foreign Target has been so increased by the one-time tax under Code Sec. 965 that there is little or no gain recognized for U.S. tax purposes. However, the basis increase for this Code Sec. 965 PTI does not apply for purposes of foreign law, giving rise to a taxable gain under foreign tax law that does not exist for U.S. tax purposes. This can lead to double taxation because of the foreign tax credit limitation. Even assuming that the sale meets the requirements of Code Sec. 865(f), such that what little gain there is may be foreign source, that foreign source income may not be sufficient to allow foreign tax on the sale to be credited.

(5) No Closing of the Books

In determining the Code Sec. 1248 amount, the books of the CFC do not close (as they do under a Code Sec. 338(g) election). Instead, the Code Sec. 1248 amount is determined with regard to (1) accumulated E&P of the CFC as of the beginning of the taxable year, plus (2) the E&P earned during the taxable year of the sale, less any distributions (pre- or post-closing), multiplied by the proportionate number of days that the seller held the shares during the taxable year.⁶⁵ For example, if the sale occurred on June 30 of the taxable year, the Code Sec. 1248 amount for that year is 50% of the E&P of the *entire* year. Thus, any post-sale distributions and other activity affecting E&P can adversely affect the seller’s Code Sec. 1248 amount.

Consequently, in many cases, a corporate seller would prefer to preserve the Code Sec. 1248 amount to maximize the amount subject to a DRD. In that case, the seller would contractually prevent the buyer from taking distributions during the remainder of the taxable year in which the sale occurred. The seller may also require undertakings to prevent the post-closing sale of assets with built-in losses, which would reduce E&P during the year of the sale. However, subpart F income allocable to the buyer reduces E&P available to support a Code Sec. 1248 dividend in the hands of the seller. Finally, the stock purchase agreement should also allow the seller to access the information necessary to calculate its Code Sec. 1248 inclusion. These factors need to be carefully weighed in framing the stock purchase agreement. In some cases, it may be better to avoid these issues entirely by simply requiring the buyer to make a Code Sec. 338(g) election. However, the buyer sometimes cannot decide whether to make the election as of closing. In such case, the contract

should contain the aforementioned protections, and the buyer should be required to notify the seller as to whether the election is being made with enough time for the seller to prepare its tax return.

The seller also needs to consider whether it must include subpart F income and GILTI for the period ending on the closing date if the Code Sec. 338(g) election is made, or if the CFC's status as a CFC ends because the buyer is not a U.S. shareholder. Under the Subpart F and GILTI rules, a U.S. shareholder must include in gross income its *pro rata* share of subpart F income and GILTI if it owns stock of the CFC "on the last day, in such year, on which such corporation is a [CFC]."⁶⁶ For example, if a U.S. shareholder owns 100% of the stock of a CFC and sells all of its CFC shares to a foreign person during the year, such that the corporation's CFC status terminates on the closing date, the U.S. shareholder would include in gross income a portion of the subpart F income for the entire year based on the number of days it owned the stock of the CFC.⁶⁷

If the buyer is a U.S. person who would become a U.S. shareholder, such that the foreign target would remain a CFC for the remainder of the tax year, then the seller has no inclusion of subpart F or GILTI income for the tax year in which the CFC is sold unless the Code Sec. 338(g) election is made. In such case, the buyer is the person who owns stock in the CFC "on the last day on which the corporation is a [CFC]"; accordingly, the buyer must include all of the subpart F and GILTI income for the taxable year. However, the U.S. Buyer would reduce its *pro rata* share of subpart F income by the portion that is deemed distributed to the seller under Code Sec. 1248, which is limited based on the number of days the buyer did not own the CFC stock.⁶⁸

It is interesting to consider the tax consequences where Foreign Target remains a CFC based solely on the downward attribution rule pursuant to the repeal of Code Sec. 958(b)(4).⁶⁹ For example, assume that U.S. Seller sells 100% of the stock of a CFC (with a calendar tax year) to a Foreign Buyer on June 30. Assume further that Foreign Buyer has a U.S. subsidiary that will have nothing to do with the operation or ownership of Foreign Target. Under Code Sec. 318(a)(3)(C) (now unhindered by the old Code Sec. 958(b)(4)), the stock in Foreign Target would be attributed to the U.S. subsidiary of Foreign Buyer, such that Foreign Target would remain a CFC through the end of the tax year.⁷⁰ This would convert what would be subpart F and GILTI income for a portion of the tax year to E&P, which becomes part of the Code Sec. 1248 dividend and is subject to a DRD. Conversely, if Foreign Buyer itself has U.S. shareholders,

and Foreign Target remains a CFC, then those U.S. shareholders would have to include subpart F and GILTI from the acquired target.

(C) U.S. Corporate Seller of CFC Stock—Code Sec. 338(g) Election Made

(1) Code Sec. 338(g) Election—In General

A Code Sec. 338(g) election changes the landscape of the transaction quite dramatically from the seller's point of view. As previously outlined, the transaction is treated as a fictional sale of assets by Foreign Target to itself, giving rise to gain realized at the level of the CFC and a step-up in the basis of the assets. The gain at the level of the CFC is not normally taxed in the United States unless that gain is effectively connected with a U.S. trade or business,⁷¹ or unless the gain arises from the sale of a U.S. real property interest under FIRPTA.⁷² The gain on the sale could generate subpart F income or GILTI, depending on the type of assets sold, as discussed below. The Code Sec. 338 election closes the taxable year and, accordingly, any subpart F income either derived during the short period ending on the date of the sale, or caused by the Code Sec. 338 election itself, must be included in income by the seller.⁷³ However, the seller is unaffected by what may occur after closing, avoiding the need for the contractual protections discussed above.

(2) Potential Subpart F Income Arising from Deemed Sale

Gain arising from the Code Sec. 338 election in connection with assets used in a trade or business generally does not give rise to subpart F income.⁷⁴ However, gain on the sale of those assets is likely to produce GILTI. In addition, gain on the sale of assets that produce foreign personal holding company income ("FPHCI") would be subpart F income.⁷⁵ This income could include gains realized on the deemed sale of stock in subsidiaries, intercompany loans, certain intellectual property, and real property not qualifying for the active trade or business exception.⁷⁶ Gains on assets that produce income subject to either the "same-country exception"⁷⁷ or the temporary exception under Code Sec. 954(c)(6)⁷⁸ are also subpart F income.

(3) Potential GILTI Arising from Deemed Sale

While gain on the deemed sale of assets used in a trade or business pursuant to the Code Sec. 338(g) election does not give rise to subpart F income, it does give rise to tested income for GILTI purposes. Tested income includes all gross income of the CFC, subject

to certain adjustments not normally present in the sale of a business.⁷⁹ Consequently, the gain is likely to give rise to GILTI during the year of sale. This is not necessarily a bad thing for a corporate seller, as the GILTI income would increase the basis in the CFC stock, reducing the amount of gain subject to corporate tax at 21%. Thus, the Code Sec. 338(g) election may have the effect of converting gain subject to tax at 21% into GILTI subject to an effective tax rate of approximately 10.5%. On the other hand, the Code Sec. 338(g) election may cause GILTI that increases the U.S. Seller's basis in the shares to the point of wiping out gain that could be characterized as a dividend (subject to a DRD) under Code Sec. 1248. Consequently, the consequences should be modeled to ensure optimum results.

(4) Gain on the Deemed Sale of CFC Subsidiaries

Gains realized on the deemed sale of stock of regarded subsidiaries give rise to subpart F income.⁸⁰ Consequently, a common technique is to check-the-box on foreign subsidiaries prior to a Code Sec. 338 election to prevent subpart F income from arising.⁸¹ The check-the-box election treats the deemed stock sale as a sale of assets, which normally is exempt from subpart F under the principles outlined above.⁸² As discussed above, this effectively converts what would be subpart F income into GILTI, which is taxed at 10.5% (before credits).

(5) Gain on the Deemed Sale of Partnership Interests Held by Target CFC

Gain on the deemed sale of a partnership interest is treated as a sale of the proportionate share of the assets of the partnership if the CFC owns, directly, indirectly, or constructively, 25% or more of the capital or profits interest in the partnership.⁸³ Thus, the deemed sale of a qualifying partnership interest is treated as a sale of assets used in a trade or business, which is exempt from subpart F treatment, although it gives rise to tested income for GILTI purposes. Where the CFC owns less than 25% of the capital and profits interest in the partnership, any deemed gain would be subpart F income.⁸⁴

(6) Impact of the Code Sec. 338(g) Election on the Seller's Foreign Tax Credit Position

(a) Code Sec. 338(h)(16) and the Code Sec. 1248 Dividend. Code Sec. 338(h)(16) is a provision that ensures that the source and basket of income is unaffected

by the Code Sec. 338(g) election for foreign tax credit purposes. It provides as follows:

Except as provided in regulations, this section shall not apply for purpose of determining the source or character of any item for [foreign tax credit purposes]. The preceding sentence shall not apply to any gain to the extent such gain is includible in gross income as a dividend under section 1248 (determined without regard to any deemed sale under this section by a foreign corporation).

Code Sec. 338(h)(16) was added to Code Sec. 338 in 1988.⁸⁵ The legislative history provides a helpful example on how it operated prior to the TCJA:

Example. A U.S. corporation holds all the stock in a CFC and has a basis in that stock of \$0; assume the fair market value of that stock is \$180. Further assume that the accumulated E&P of the CFC through the end of its taxable year are \$100, the corporation's assets have an aggregate basis of \$100, and its assets have appreciated in value by \$80. The purchaser acquires all the stock of the CFC from the U.S. corporation for \$180 on the last day of the CFC's taxable year and elects under Code Sec. 338(g) to treat the CFC as if it sold all of its assets at the close of that day for \$180. For source and foreign tax credit limitation purposes, the \$180 of the U.S. corporation's gain is divided up as follows: \$100 of gain is treated as dividend income under Code Sec. 1248 and is subject to look-through treatment for foreign tax credit purposes; and \$80 of gain, although treated as ordinary dividend income under Temporary Reg. §1.338-5T(g) (which would ordinarily give rise to income subject to look-through treatment), is treated as stock gain for source and foreign tax credit limitation purposes. Under this rule then, the \$80 of gain will be treated as foreign source, passive income for foreign tax credit limitation purposes (assuming the stock affiliate rule of Code Sec. 865(f) is satisfied).⁸⁶

Consequently, prior to the TCJA, the portion of the Code Sec. 1248 dividend that represented historic E&P was treated as foreign source, general basket income, as it would be without the election. However, the portion of the Code Sec. 1248 dividend arising from the deemed gain from the Code Sec. 338(g) election was treated as

passive basket income (U.S. or foreign source depending on Code Sec. 865(f)) as if the election had not occurred.

The TCJA did not amend Code Sec. 338 at all, leaving Code Sec. 338(h)(16) to be applied in light of the repeal of Code Sec. 902 and the addition of the GILTI rules. After the TCJA, gain realized on the deemed asset sale pursuant to the Code Sec. 338(g) election would normally give rise to additional tested income at the level of the CFC, resulting in additional GILTI for the tax year ending on the closing date. This would reduce the gain recognized on the sale of the CFC stock, as the GILTI would provide additional basis in the CFC stock being sold.⁸⁷

Normally, under Code Sec. 960(d), a portion of any foreign tax credit at the level of the CFC would be carried out and potentially used as a credit against corporate income tax on that GILTI, which has a separate basket.⁸⁸ However, Code Sec. 338(h)(16) requires that the Code Sec. 338(g) election be ignored for foreign tax credit purposes, meaning GILTI income arising from the deemed sale would not be classified in the GILTI basket. This would come as a disappointment for U.S. shareholders with excess foreign tax credits in the GILTI basket.⁸⁹

It is not clear how the GILTI income would be basketed. One is tempted to think that the GILTI income should be classified as U.S. source, passive basket income (assuming Code Sec. 865(f) is complied with). However, note that the second sentence of Code Sec. 338(h)(16) says to ignore the first sentence of that provision “to the extent such gain is includible in gross income as a dividend under section 1248 (determined without regard to any deemed sale).” However, given the GILTI inclusion and the increase in basis under Code Sec. 961(a), *there may be no gain* for Code Sec. 1248 to apply to. Consider applying the new rules to the example in the 1988 Legislative History—the Code Sec. 338(g) election gives rise to a deemed gain of \$180 at the level of the Foreign Target. Assuming no QBAI, all of the \$180 gain would be GILTI giving rise to a \$180 basis increase under Code Sec. 961(a). Thus, there would be no gain to which Code Sec. 1248 could apply.

Perhaps the best reading of Code Sec. 338(g)(16), including the second sentence, is simply to ignore Code Sec. 338(g) and the GILTI that it causes and determine how the income would have been basketed in that case. For example, absent a Code Sec. 338(g) election in the prior example, there would have been a dividend equal to \$100, *i.e.*, the historic E&P of the CFC and residual gain of \$80. Thus, the first \$100 of GILTI would be treated as a dividend for foreign tax credits purposes.

In that case, it would be subject to a DRD and the foreign tax credits attributable to that amount would be disallowed. The remaining \$80 of GILTI would be foreign source, passive basket income (assuming Code Sec. 865(f) is complied with).

As a practical matter, any normal foreign taxes associated with normal GILTI derived during the tax year, *i.e.*, non-Code Sec. 338(g) GILTI, would be carried out as normal under Code Sec. 960(d) and would be unaffected by Code Sec. 338(h)(16).

(b) Impact of Code Sec. 338 Election on the Inclusion Percentage Under Code Sec. 960(d).

In the past, cases where the Code Sec. 1248 gain was less than the combined amount of historic and Code Sec. 338-related E&P gave rise to issues related to the amount of the post-1986 foreign tax credit pool carried out under Code Sec. 902.⁹⁰ The IRS took the view that the Code Sec. 338-related E&P was added to both the numerator and the denominator in calculating both the post-1986 E&P pool under Code Sec. 902 and the amount of foreign tax credits carried out of the post-1986 foreign tax credit pools.⁹¹ The IRS argued that Code Sec. 338(h)(16) only applied to the source and basketing of the gain on the sale of the stock and not to the amount of the foreign tax credits carried out under Code Sec. 902.⁹²

A similar issue is present when calculating the inclusion percentage with respect to the foreign tax credit against GILTI. The inclusion percentage is the actual amount of GILTI included in gross income of the U.S. shareholder divided by the total amount of tested income (after deductions) for CFCs that have tested income (*i.e.*, ignoring CFCs that have tested losses). This percentage is multiplied by the amount of tested foreign income taxes, and then multiplied by 80% to arrive at the foreign tax credits that are potentially creditable. If the gain recognized under Code Sec. 338(g) is added to both the numerator and the denominator of the inclusion percentage, it will increase that percentage, which is generally taxpayer-favorable.⁹³

(c) Impact of Subpart F Income Arising from the Code Sec. 338 Election on Foreign Target.

Any passive basket subpart F income created by the deemed sale can be disadvantageous if the seller receives additional stock basis, thereby reducing its gain and thus its ordinary dividend under Code Sec. 1248 that would be subject to the DRD.⁹⁴ The residual stock gain is taxed under the normal rules, *i.e.*, the gain is passive basket and potentially foreign source income if the target qualifies as a qualified foreign affiliate under Code Sec. 865(f).

(d) Recapture of Overall Foreign Loss. The tax consequences of selling stock in a CFC can change if a U.S. Seller has an overall foreign loss (“OFL”), in which case the sale can give rise to OFL recapture.⁹⁵ In such case, the gain on the sale is automatically treated as foreign source income and 100% of it is recaptured as U.S. source income up to the amount of the OFL.⁹⁶ The OFL recapture rule for dispositions of CFC stock applies “notwithstanding any other provision of this chapter.”⁹⁷ Consequently, the portion of the gain normally characterized as a foreign source dividend under Code Sec. 1248(a) is first treated as “foreign source” under Code Sec. 904(f)(3) and then immediately reclassified as U.S. source income to the extent of the OFL.⁹⁸ The same is true for any portion of the gain treated as foreign source under Code Sec. 865(f). Because the amount recaptured is treated as U.S. source income, its basket no longer matters for foreign tax credit purposes.⁹⁹ However, Code Sec. 1248 should still operate so as to treat a portion of the gain as a dividend for DRD purposes.

IV. Sale of Subsidiaries at the Level of a Holding CFC

As mentioned above, if a CFC sells the stock of another company (whether or not a CFC), any gain realized is potentially FPHCI. However, under Code Sec. 964(e), a portion of this gain is re-characterized as a dividend under Code Sec. 1248 principles to the extent of the CFC’s share of the E&P of the company sold.¹⁰⁰ The same-country exception does not apply to this deemed dividend.¹⁰¹ However, the exclusion under Code Sec. 954(c)(6) did apply, prior to amendment of Code Sec. 964(e) by the TCJA. In its original form, one of the potential benefits arising from Code Sec. 964(e) was to allow a deemed paid credit for the foreign taxes that were paid by the company sold.¹⁰²

However, the TCJA added new Code Sec. 964(e)(4), which provides that the “foreign-source portion” of such deemed dividend is treated as subpart F income of the selling CFC, includable in gross income in the hands of the U.S. shareholder.¹⁰³ The foreign-source portion of the dividend is determined under Code Sec. 245A principles.¹⁰⁴ The U.S. shareholder is entitled to a DRD to the same extent that it would have been if that amount of subpart F income were distributed to the U.S. shareholder.¹⁰⁵ However, note that the U.S. shareholder must qualify for the DRD under Code Sec. 245A. For example, individual U.S. shareholders do not qualify for the

DRD. This result is intended to harmonize the sale of a CFC indirectly, through a CFC, with the sale of a CFC directly by the U.S. shareholders.

Note that any residual gain (*i.e.*, gain in excess of the amount recharacterized as a dividend under Code Sec. 964(e)(1)) is also subpart F income in the hands of the U.S. shareholder, but no DRD applies. It has become customary to eliminate this subpart F problem by engaging in a so-called “check and sell” transaction. In that context, Holdco CFC makes a check-the-box election with respect to the stock of subsidiary CFC so that it becomes disregarded. This election converts gain on the sale of “stock” into gain on the sale of an operating business (*i.e.*, inventory, depreciable property, IP, goodwill, *etc.*) that does not give rise to subpart F income.¹⁰⁶

In *Dover*,¹⁰⁷ the taxpayer succeeded with a check and sell strategy. In that case, the taxpayer owned the stock of a holding company CFC, which sold the stock of an operating CFC at a gain. The sale took place without a check-the-box election, but the taxpayer sought and received relief from the IRS under Code Sec. 9100 to file that election retroactive to before the sale of stock.¹⁰⁸ The IRS later took the view that despite the check-the-box election, the sale was a sale of assets that does “not give rise to any income” because the business of operating CFC was not used in a trade or business of holding CFC.¹⁰⁹ Thus, in the view of the IRS, the gain gave rise to subpart F income. The Tax Court held that the check-the-box election was an effective transfer of the trade or business from the operating CFC to the holding CFC such that the exception for the sale of assets used in a trade or business applied.¹¹⁰ As a result of *Dover*, the taxpayer can be relatively confident that the check and sell strategy is reliable.

V. Conclusion

This article attempts to provide the novice with a basic background in U.S. tax planning for the structuring and financing of taxable foreign acquisitions from the perspective of U.S. buyers and sellers. This is not an area to dabble in and requires great care, but hopefully the reader has gained a solid foundation for further study with respect to his or her specific tax planning needs. We are in the midst of significant change in terms of both U.S. and foreign tax laws, and it will be interesting (perhaps a little too interesting) for practitioners to wrestle with these structures over the coming years.

ENDNOTES

- ¹ P.L. 115-97 (referred to as the “TCJA”). This article does not cover in detail changes proposed in the Tax Technical and Clerical Corrections Act Discussion Draft, proposed by Chairman Brady of the House Ways and Means Committee, January 2, 2019 (the “Technical Corrections Draft”).
- ² Unless otherwise specified, all “section” or “§” references are to the Internal Revenue Code of 1986, as amended, or to U.S. Treasury Regulations (“Treasury Regulations”) promulgated thereunder.
- ³ This article refers to a “U.S. Seller” and “U.S. Buyer,” and assumes in each case a domestic corporation as the buyer and as the seller. The term “Foreign Target” generally refers to a foreign company that is being acquired. If there is a U.S. Seller of Foreign Target, then assume it is a “CFC.”
- ⁴ Under Code Sec. 902(c)(1) and (2) (prior to repeal by the TCJA), a U.S. shareholder had to calculate the “post-1986 undistributed earnings” and the “post-1986 foreign income taxes” of Foreign Target and aggregate them for all taxable years after 1986. The undistributed earnings consisted of the E&P of Foreign Target under U.S. tax principles. See Code Sec. 964(a). This requirement led to recalculating foreign earnings under U.S. tax principles, in some cases, back to 1987.
- ⁵ Section 14301 of the TCJA repealed Code Sec. 902 in its entirety. Going forward, foreign tax credits will be taken into account in the current year, pursuant to subpart F income or GILTI, or not at all. See Code Sec. 960(a) (passthrough of foreign tax credits for subpart F income) and Code Sec. 960(d) (passthrough of foreign tax credits for GILTI).
- ⁶ Global intangible low-taxed income under Code Sec. 951A, added by the TCJA.
- ⁷ This can occur where the amortization arising from a Code Sec. 338(g) election causes E&P to be negative. Without positive E&P, a dividend carrying out foreign tax credits under Code Sec. 902 cannot be paid. Under the GILTI rules, if high amortization gives rise to a tested loss of a CFC, the qualified business asset investment and foreign tax credits of that CFC are ignored, which is generally detrimental.
- ⁸ Code Sec. 959(a).
- ⁹ A distribution of PTI is excluded from gross income even though it is otherwise treated as a dividend under Code Sec. 316.
- ¹⁰ Reg. §1.959-1(d).
- ¹¹ Code Sec. 959(e); Code Sec. 1248(j). See also Rev. Rul. 90-31, 1990-1 CB 147 (holding that while the buyer is entitled to PTI for E&P previously included in income of the selling shareholder under Code Sec. 1248(a), the E&P of the target CFC is not reduced until an actual distribution is made by the CFC to the transferor. In addition, the ruling holds that the buyer also cannot claim a foreign tax credit for taxes associated with the seller’s Code Sec. 1248 inclusion.)
- ¹² The only person required to include subpart F income is the shareholder who owns stock at the end of the day as of the close of the taxable year. Code Sec. 951(a)(1)(A).
- ¹³ Section 4(ee)(4)(A) of the Technical Corrections Draft would completely revamp how “pro rata share” is calculated.
- ¹⁴ Code Sec. 951(a)(2)(A).
- ¹⁵ Code Sec. 951(a)(2)(B). This reduction is limited by the amount of subpart F income, multiplied by the ratio of the number of days the buyer did not own the stock during the taxable year, divided by 365 days. For example, assume that the U.S. Buyer purchases the stock of a CFC on June 30, the CFC has subpart F income of \$100 as of December 31 of that year, and the CFC distributed \$75 to the U.S. Seller before the sale. The subpart F income of \$100 is reduced by $(182/365) \times \$100 = \50 . Thus, the amount of subpart F income the U.S. Buyer is required to include is \$50 (the \$100 of total subpart F income reduced by \$50). The U.S. Buyer receives no benefit for the \$25 distributed in excess of the limitation.
- ¹⁶ Code Sec. 951(a)(2)(B) (last sentence). Code Sec. 1248 re-characterizes gain on the sale of CFC stock as a dividend to the extent of E&P.
- ¹⁷ Code Sec. 959(e).
- ¹⁸ Code Sec. 951A(e).
- ¹⁹ Code Sec. 338(a).
- ²⁰ Code Sec. 338(a)(2).
- ²¹ If the buyer was a U.S. shareholder in Foreign Target and Foreign Target was a CFC as of the acquisition date, then the buyer can have subpart F income. See Reg. §1.338-9(f)(2) Ex. 4.
- ²² The “old corporation” has, in effect, been liquidated and would file a final tax return as if it were a domestic corporation or had effectively connected income. See Reg. §1.338-9(f)(2) Ex. 3.
- ²³ Reg. §1.338-1(b)(1).
- ²⁴ Reg. §1.338-2(d). The election is made on Form 8023 (*Elections Under §338 for Corporations Making Qualified Stock Purchase*). This form is also used to make an election under Code Sec. 338(h)(10), except that in the case of Code Sec. 338(h)(10), the seller must join in the election. If Foreign Target were a CFC or a passive foreign investment company, the buyer must provide written notice and a copy of the Form 8023 to certain U.S. sellers. Reg. §1.338-2(e)(4). This requirement is important because the Code Sec. 338(g) election is invalid if proper notice is not provided. Reg. §1.338-2(e)(4)(v).
- ²⁵ A Code Sec. 338(h)(10) election can only be made for members of an affiliated group, which cannot include a foreign corporation unless it qualifies under Code Sec. 1504(d) (relating to a subsidiary formed in Mexico or Canada that is required to do business in corporate form under foreign law), and S corporations, which must be domestic corporations. See Code Secs. 1361(b)(1) and 1504(b)(3).
- ²⁶ Reg. §1.338-2(e)(3). In that case, each U.S. shareholder (as defined under Code Sec. 951(b)) of the CFC must file the Form 8023 within the normal nine and one-half months of the purchase and must attach a copy of Form 8023 to the relevant Form 5471 included with the tax return for the taxable year that includes the qualified stock purchase. *Id.*
- ²⁷ Code Sec. 951A(b)(1).
- ²⁸ Code Sec. 951A(b)(2).
- ²⁹ Code Sec. 951A(d).
- ³⁰ Code Sec. 951A(c)(2)(B). For these purposes, gross income of the CFC includes all gross income, except income effectively connected with a U.S. trade or business, subpart F income, subpart F income that was excluded pursuant to the high-tax exception, dividends received from related persons, and certain foreign oil and gas extraction income. Code Sec. 951A(c)(2)(A).
- ³¹ Code Sec. 951A(d)(2) refers to “property used in the production of tested income,” which presumes that there is positive tested income rather than a tested loss.
- ³² Code Sec. 960(d)(3). The foreign taxes counted are taxes properly attributable to tested income of CFCs, which excludes taxes of CFCs with tested losses.
- ³³ Code Sec. 338(d)(1); Reg. §1.338-3(b)(1). The buyer cannot be a partnership.
- ³⁴ Code Sec. 338(d)(2).
- ³⁵ Code Sec. 338(d)(3) (refers to Code Sec. 1504(a)(2), which contains the 80% vote and value test); Code Sec. 338(h)(1).
- ³⁶ Code Sec. 338(h)(3). The buyer must ensure that its ownership is not transitory. Consequently, buyer is not the purchaser where it merges downstream into target, liquidates, or otherwise disposes of Foreign Target stock shortly after the purported purchase. Reg. §1.338-3(b)(1). A purchase from a related person is disqualified if the stock is purchased from a person whose Foreign Target stock could have been attributed to the buyer under the Code Sec. 318(a) attribution rules (except that option rule under Code Sec. 318(a)(4) is ignored). Code Sec. 338(h)(3)(A)(iii).
- ³⁷ Reg. §1.338-1(a)(1); Reg. §1.338-4(h)(4); Reg. §1.338(h)(10)-1(d)(3).
- ³⁸ Code Sec. 338(h)(3)(B); Reg. §1.338-3(b)(4) (the deemed sale of CFC stock is deemed to happen after the deemed sale of the domestic target); Reg. §1.338-8(a)(1) (no Code Sec. 338 election is deemed made or required with respect to any target or target affiliate); Reg. §1.338-8(a)(6) (no consistency rule for stock except for certain cases necessary to prevent avoidance of asset consistency rules).
- ³⁹ Reg. §1.338-2(d); Reg. §1.338(h)(10)-1(c)(3).
- ⁴⁰ Code Sec. 164(a)(3) permits a deduction for foreign taxes. However, if the taxpayer

elects to utilize foreign tax credits, that deduction is eliminated by Code Sec. 275(a)(4), so the taxpayer does not receive both a tax deduction and a tax credit for the same foreign taxes. Code Sec. 901(m)(6) suspends the application of Code Sec. 275(a)(4) for the disqualified portion of the foreign tax. Likewise, for taxpayers with deemed paid credits, Code Sec. 78 requires the recipient of a dividend to gross-up the dividend for foreign taxes deemed paid (effectively denying a deduction for foreign taxes paid). Code Sec. 901(m)(6) suspends the application of Code Sec. 78 for the disqualified portion of foreign taxes.

⁴¹ See Lowell D. Yoder, *§338 Elections in the Age of Covered Asset Acquisitions*, TAX NOTES (May 30, 2011) for an excellent numerical analysis of the effective tax rate arising from several scenarios.

⁴² There is no procedure for combining Code Sec. 338(g) elections, though the form on which the election is made permits one form to be submitted for several companies. See Reg. §§1.338-2(d) and 1.338-3(b)(4).

⁴³ Reg. §1.338-4(b)(1).

⁴⁴ Code Sec. 338(d)(3).

⁴⁵ A check-the-box election to treat a foreign corporation as a partnership is treated as a liquidation of the corporation followed by a contribution of its assets to a new partnership. Reg. §301-7701-3(g)(1)(ii). Where a Code Sec. 338(g) election is not made due to insufficient ownership, the liquidation normally cannot qualify for tax-free treatment under Code Sec. 332(a) and, consequently, is taxable under Code Sec. 331(a). However, if the check-the-box election is made effective as of the acquisition date, the deemed liquidation is treated as having occurred at the end of the prior day. Reg. §301-7701-3(g)(3)(i). Consequently, the U.S. Buyer is not adversely affected by the taxable liquidation. If, however, the seller is a U.S. shareholder and Foreign Target is a CFC, the liquidation gain may give rise to subpart F or GILTI income because that gain arises prior to the close of the CFC's taxable year.

⁴⁶ Code Sec. 334(a).

⁴⁷ Reg. §301.7701-3(c)(2)(i). The election must be signed by each member of the electing entity who is an owner at the time the election is filed. The election may be signed by an officer, manager, or member of the electing entity who is authorized under local law or by the organizational documents to make the election. *Id.* The election may be made retroactively for up to 75 days prior to the filing date. Reg. §301.7701-3(c)(2)(iii). However, if the election is made retroactively, then each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed must also sign the election. Reg. §301.7701-3(c)(2)(ii).

⁴⁸ Generally, Rev. Proc. 2009-41 provides retroactive relief for up to three years and 75 days provided (i) Foreign Target failed to obtain its requested classification as of the date of its formation, the date its classification became relevant within the meaning of Reg. §301.7701-3(d), or the date of an intended change in classification solely because Form 8832 was not filed timely; (ii) no U.S. tax returns have been filed for Foreign Target or, if U.S. tax returns have been filed, the returns were consistent with the intended treatment of Foreign Target assuming an election had been filed timely, and (iii) Foreign Target has reasonable cause for its failure to timely make the entity classification election. 2009-39 IRB 439.

⁴⁹ Code Sec. 1001(a).

⁵⁰ Code Sec. 1248 applies to any U.S. person who sells or exchanges stock in a foreign corporation where the U.S. person owns 10% or more of the voting power of the foreign corporation and that foreign corporation is, or has been, a CFC at any time within the five-year period ending on the date of the sale or exchange. Code Sec. 1248(a). Consequently, for Code Sec. 1248 to apply, Foreign Target does not have to be a CFC on the date of the sale if it was a CFC at any time during the previous five years. In addition, the 10% voting stock test is with reference to stock owned directly, indirectly, or constructively. See Code Secs. 958(a) and 958(b). Note that the 10% voting test for being a U.S. shareholder under Code Sec. 951(b) was changed to 10% of voting power or value. See Section 14101(e)(1) of the TCJA. That change was made "for purposes of this title," which means that the definition of "U.S. Shareholder" applies for purposes of Code Sec. 245A. However, Code Sec. 1248 does not refer to a U.S. shareholder, and its 10% of voting power threshold has not changed.

⁵¹ The Code Sec. 1248 amount includes only E&P earned during the taxable years in which the seller owned stock in Foreign Target, and only during periods in which Foreign Target was a CFC.

⁵² Code Sec. 1248(j), added by Section 14102(a)(1) of the TCJA. Prior to the TCJA, Code Sec. 1248 was favorable for corporate sellers because the portion of the gain re-characterized as a dividend carried out with its foreign tax credits that could be used to shelter the gain. See Code Sec. 902(a) (prior to repeal); Reg. §1.1248-1(d)(1); Reg. §1.902-1(a)(11). However, Code Sec. 902 has been repealed. Prior to the repeal of 902 and the addition of 245A, the tax consequences were as follows: The recharacterized dividend was generally foreign source income. Code Sec. 861(a)(2)(B); Reg. §1.861-3(a)(3). The dividend was classified as either general or passive basket on a look-through basis in proportion to general and passive

E&P of the CFC. Code Sec. 904(d)(3)(D). Reg. §1.904-5(c)(4)(i). The Code Sec. 1248 inclusion was normally general basket income because any passive basket income would have previously been included in income as subpart F income (unless the high-tax kick-out rule applied). In addition, the dividend would have been "grossed up" for any foreign tax credits carried out under Code Sec. 902. Code Sec. 78; Reg. §1.902-1(c)(2).

⁵³ Code Sec. 245A(d)(1). The tax is also not deductible for U.S. tax purposes. Code Sec. 245A(d)(2).

⁵⁴ Code Sec. 959(a). In addition, Code Sec. 1248(d)(1) excludes from the amount of E&P any E&P attributable to PTI. Note that E&P attributable to PTI remains in the CFC's E&P pool and, accordingly, the exclusion under Code Sec. 1248(d)(1) is needed to ensure that the same E&P is not taxed twice at ordinary rates. See also Reg. §1.1248-2(e)(3) (providing detailed rules on the exclusion of PTI). Moreover, Rev. Rul. 76-539, 1976-2 CB 232, addresses a situation where a U.S. shareholder includes all of the E&P of a CFC in income as subpart F income, while at the same time investing such E&P in U.S. property under Code Sec. 956. Because all E&P was included in gross income as subpart F income under Code Sec. 951(a)(1)(A), such E&P (normally Code Sec. 956 income) was excluded from gross income under Code Sec. 959(a)(2). Because the exclusion relating to the Code Sec. 956 income was not part of an actual distribution of E&P, the IRS ruled that the U.S. shareholder's basis in the CFC stock need not be reduced by the exclusion under Code Sec. 959(a)(2).

⁵⁵ *Id.*

⁵⁶ Code Sec. 865(a).

⁵⁷ The vote and value test is the same for determining whether a company is a member of an affiliated group, but without regard to the exceptions under Code Sec. 1504(b), namely, without regard to foreign status. Code Sec. 865(i)(4).

⁵⁸ The seller may elect to treat Foreign Target and all corporations wholly owned, directly or indirectly, by it as one corporation, essentially to ensure that the active trades or businesses of indirect subsidiaries are counted for purposes of the foreign sale test and the 50% gross income test.

⁵⁹ Code Sec. 904(d)(2)(B)(i); Code Sec. 954(c)(1)(B); Reg. §1.904-5(h)(3). Passive basket income that is "high-taxed," *i.e.*, taxed at a rate in excess of the highest U.S. corporate rate, is "kicked out" of the passive basket and classified in the active basket. Code Sec. 904(d)(2)(F); Code Sec. 904(d)(2)(B)(iii)(II).

⁶⁰ The foreign tax credit analysis is complicated where there is foreign tax imposed on the overall gain. A portion of the foreign tax must be allocated to the Code Sec. 1248 dividend and the remainder to the residual

gain, although it is not clear on how this allocation is to be made. The portion allocated to the Code Sec. 1248 gain, recharacterized as a dividend, is not creditable to the extent that dividend is subject to a DRD. Code Sec. 245A(d)(1).

⁶¹ Article 13(4) of the Mexico Treaty allows Mexico to impose capital gains tax on the sale of stock in Mexican company by a U.S. parent that owns 25% or more of the stock of the Mexican company.

⁶² Code Secs. 865(f)(1) and 865(i)(4) require that the U.S. Seller meet the requirements of Code Sec. 1504(a), *i.e.*, own 80% or more of the voting power and value of the foreign company.

⁶³ Article 24(3) of the Mexico Treaty, as amended by a protocol, provides that such gain is treated as arising from a Mexican source. See Article V of the *Second Additional Protocol that Modifies the Conventions Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Tax on Income*, dated November 25, 2002.

⁶⁴ Code Sec. 865(h)(1).

⁶⁵ Reg. §1.1248-2(e)(2); Reg. §1.1248-3(c)(1). Rev. Rul. 71-388, 1971-2 CB 314 (IRS construed Reg. §1.1248-1(d)(1) to rule that post-sale distributions reduce E&P derived during taxable year for purposes of applying Code Sec. 1248). Rev. Rul. 71-388 was suspended in part on other issues by Rev. Rul. 83-182, 1983-2 CB 149, and modified by Rev. Rul. 90-31, 1990-1 CB 147. See also TAM 199906035 where the IRS ruled that a post-sale distribution reduces E&P for purposes of determining the seller's Code Sec. 1248 inclusion, even though the post-sale distribution is a non-taxable distribution of PTI inherited under Code Sec. 959(e) (Feb. 16, 1999). The taxpayer in TAM 199906035 argued that this inclusion gives rise to an anomaly whereby the authorities listed above appear to assume that the post-sale distribution was a taxable distribution of E&P to the buyer, and that a non-taxable post-sale distribution should not reduce the Code Sec. 1248 inclusion of the seller. See Yoder, *TAM 9906035: A contorted Application of §1248*, 28 *Tax Mgmt. Int'l J.* 339 (June 11, 1999).

⁶⁶ Code Sec. 951(a)(1); Code Sec. 951A(e)(1).

⁶⁷ See Example 1, Reg. §1.951-1(b)(2). This result is predicated on Code Sec. 951(a)(2), which provides that the starting point for the *pro rata* share determination is the amount that would have been distributed to the U.S. shareholder on the closing date (*i.e.*, the last day of the year on which the corporation is a CFC), an amount equal to the subpart F income for the entire year, multiplied by the number of CFC days, divided by the total number of days in the taxable year of the CFC. In Example 1, the taxpayer sold 60% of the CFC shares to a non-U.S. shareholder on May 26 while the CFC

earned \$100 of subpart F income for the entire year (a calendar tax year). Thus, the selling shareholder should include $\$100 \times (146/365) = \40 in gross income as of December 31 of that year.

⁶⁸ Code Sec. 951(a)(2)(B).

⁶⁹ See Section 14213(a)(1)-(2) of the TCJA.

⁷⁰ A technical correction would eliminate downward attribution in most cases. Section 4(jj) of the Technical Corrections Draft.

⁷¹ In this regard, it is important to ensure that Foreign Target does not have income effectively connected with a U.S. trade or business. See Code Sec. 881(a). If target does have effectively connected income, then any gain recognized pursuant to a Code Sec. 338(g) election with regard to assets that give rise to effectively connected income would be deemed connected with that U.S. trade or business and therefore taxed in the U.S. Code Sec. 864(c)(2). However, generally, any U.S. assets would be ring-fenced in a U.S. blocker rather than held directly by the foreign target. If not, it may be wise to contribute these assets to a U.S. subsidiary.

⁷² Code Sec. 897(c)(2).

⁷³ Code Sec. 951(a)(1)(A). The taxable year of the target is deemed to close on the acquisition date, as a new corporation is deemed to have purchased the assets. Code Sec. 338(a)(2); Reg. §1.338-2(c)(10). The seller is considered to own the CFC stock at the end of the acquisition date and, accordingly, must include any subpart F income arising from the Code Sec. 338(g) election. See Reg. §1.338-9(b)(2); Reg. §1.951-1(f); LTR 8938036 (June 27, 1989) (the purchaser is not taxable on subpart F income as long as it did not previously own stock in the CFC).

⁷⁴ Subpart F income generally includes dividends, interest, royalties, rents, annuities, and any gains on the sale of assets that give rise to such income. Code Sec. 954(c)(1)(B)(i). On the other hand, gain on the sale of operating assets does not give rise to subpart F income. Reg. §1.954-2(e)(3). See Code Sec. 954(c)(1)(F). The sale of property used in a trade or business is not considered property "which does not give rise to any income." This exemption includes, for example, gain on the sale of depreciable or amortizable property (*e.g.*, buildings, equipment, patents, etc.) used or held for use in the CFC's trade or business. Reg. §1.954-2(e)(3)(ii) & (iii). This exemption also applies to inventory, dealer property, and property that gives rise to rents or royalties derived in the active conduct of a trade or business from non-related persons. *Id.* The Regulations also permit the IRS to publish additional guidance from time to time as to other forms of property that are not to be treated as "property that does not give rise to income." Reg. §1.954-2(e)(3)(vi). Property that does not give rise to income also does not include notional principal contracts because such contracts are taken into

account under other provisions. Reg. §1.954-2(e)(3)(v).

⁷⁵ Code Sec. 954(c)(1)(B)(i).

⁷⁶ Code Sec. 954(c)(2)(A) provides that rents and royalties derived in the active conduct of a trade or business are not subpart F income. The Treasury Regulations contain detailed tests for determining whether the active trade or business exception applies. See Reg. §1.954-2(c) (rents) and Reg. §1.954-2(d) (royalties). Rents or royalties received from related persons (defined by Code Sec. 954(d)(3)) do not qualify for the exception. Code Sec. 954(c)(2)(A). Consequently, gain on the sale of patents, know-how, trademarks, trade names, etc., licensed to other related CFCs will be subpart F income pursuant to the Code Sec. 338(g) gain.

⁷⁷ Code Sec. 954(c)(3)(A) provides an exception from subpart F income for dividends, interest, rents, and royalties received from related persons organized in the same country as the CFC recipient.

⁷⁸ Code Sec. 954(c)(6) provides another exception from subpart F income for dividends, interest, rents, and royalties received or accrued from related CFCs to the extent that such items are not attributable to subpart F income or effectively connected income.

⁷⁹ Code Sec. 951A(c)(2)(A)(i). This gross income would exclude (i) any U.S. source income effectively connected with a U.S. trade or business; (ii) any subpart F income; (iii) any gross income excluded from subpart F income pursuant to the high-taxed income exception under Code Sec. 954(b)(4); (iv) any dividend from a related person (within the meaning of Code Sec. 954(d)(3)); and (v) certain foreign oil and gas extraction income.

⁸⁰ Code Sec. 954(c)(1)(B).

⁸¹ The "check and sell" strategy is covered in Part IV of this article.

⁸² See discussion *supra* at note 74 *et seq.* and accompanying text.

⁸³ Code Sec. 954(c)(4).

⁸⁴ Code Sec. 954(c)(1)(B)(ii).

⁸⁵ See Technical and Miscellaneous Revenue Act of 1988, P.L. 647, §1012(bb)(5)(A).

⁸⁶ H. Rep. No. 100-795, at 315; S. Rep. No. 100-445, at 334.

⁸⁷ Code Sec. 961(a). Code Sec. 312(f); Reg. §1.338-9(b)(2) (providing that the tax consequences of the deemed sale under the Code Sec. 338 election and any corresponding impact on E&P must be taken into account by Foreign Target's direct and indirect shareholders).

⁸⁸ Code Sec. 960(d) was added by TCJA Section 14201(b)(1) and provides that the U.S. shareholder (domestic corporations only) is deemed to have paid 80% of the "inclusion percentage" multiplied by the aggregate "tested foreign income taxes" paid or accrued by the CFC. The tested foreign income taxes mean the foreign taxes that are properly attributable to the tested income of the CFC, taken into account pursuant

to the GILTI rules. Code Sec. 960(d)(3). The inclusion percentage is the amount of GILTI included in gross income by the U.S. shareholder divided by the aggregate amount of tested income, before tested losses and before reduction for the deemed tangible income return. Code Sec. 960(d)(2). Thus, if the tested losses of one CFC reduce tested income of another CFC (thus reducing the GILTI inclusion), the inclusion percentage is diluted and the amount of foreign tax potentially creditable is reduced.

⁸⁹ Excess credits in the GILTI basket can arise due to the mechanics of the GILTI rules. Assume a foreign rate of 25% and GILTI of \$75 (after tax). The GILTI of \$75 would be grossed-up by \$25 under Code Sec. 78, resulting in total GILTI income of \$100. The 50% deduction under Code Sec. 250 would give rise to net GILTI income of \$50 and a tentative U.S. tax of \$10.50. Assuming no reductions for tested losses and deemed tangible income return, the inclusion percentage would be 100%. Thus, the foreign tax credit would be $\$25 \times 80\% = \20 , giving rise to excess GILTI credits of \$9.50 (assuming no allocations of interest or other expenses under Code Sec. 861). In addition, excess foreign tax credits in the GILTI basket cannot be carried back or forward.

⁹⁰ As mentioned above, the dividend created under Code Sec. 1248 carries out with it a portion of the post-1986 foreign tax credit pool. Code Sec. 902(a) (prior to repeal). The amount of foreign taxes carried out is equal to the amount of the dividend, divided by the full amount of post-1986 E&P, multiplied by the amount of post-1986 foreign tax credit pool. *Id.* CCA 200103031 (Jan. 19, 2001). This position is controversial because Code Sec. 338(h)(16) seems to require that the Code Sec. 338 election is to be ignored in calculating foreign tax credits. See Lowell D. Yoder, CCA 200103031: Does §338(h)(16) Apply to Deemed-Paid Credits? 30 TAX MGMT. INT'L J. 443 (2001).

⁹² CCA 200103031 (Jan. 19, 2001).

⁹³ In CCA 200103031, the IRS's position was taxpayer unfavorable because Code Sec. 1248 limited the numerator (i.e., the amount that could be carried out under Code Sec. 902) to the amount of gain recognized. Consequently, adding the Code Sec. 338(g) gain to the Code Sec. 902 fraction had the effect of adding only to the denominator, thus diluting that fraction and reducing the amount of foreign tax credits available on the U.S. tax return.

⁹⁴ Code Sec. 961; LTR 8938036 (June 27, 1989).

⁹⁵ Code Sec. 904(f)(3)(D). The OFL recapture rule generally applies to taxable dispositions of CFC stock where the U.S. Seller owned more than 50% (by vote or value) of the stock of the CFC immediately before the disposition. Code Sec. 904(f)(3)(D)(ii). The recapture rule can also apply to non-taxable dispositions, although there are exceptions for tax-free dispositions under Code Secs. 351 or 721 where the taxpayer retains the same percentage ownership (measured under the Code Sec. 958 attribution rules) in the CFC stock transferred. Code Sec. 904(f)(3)(D)(iii); Code Sec. 904(f)(3)(D)(vi). In addition, the CFC recapture rule does not apply where the taxpayer (or a member of its affiliated group) acquires the assets of a CFC in a Code Sec. 332(a) liquidation or a tax-free reorganization under Code Sec. 368(a). Code Sec. 904(f)(3)(D)(iv). However, if the taxpayer recognizes gain (such as in connection with the receipt of "boot") in one of the above-described tax-free transactions, the recapture rule applies to the extent of such gain. Code Sec. 904(f)(3)(D)(ii).

⁹⁶ The normal recapture rule provides that foreign source income is reclassified as U.S. source income in an amount equal to the lesser of the amount of the OFL or 50% of the taxpayer's foreign source taxable income. Code Sec. 904(f)(1). This recapture rule is applied each year until the full amount of the OFL is recaptured. However, in the case of a disposition of certain property (including CFC stock), the 50% ceiling is eliminated, so that 100% of foreign source taxable income is recaptured to the extent of the OFL. Code Sec. 904(f)(3)(A)(ii).

⁹⁷ Code Sec. 904(f)(3)(A)(i).

⁹⁸ *Id.*

⁹⁹ The American Jobs Creation Act of 2004 added Code Sec. 904(f)(3)(D) which, for the first time, made gain on the sale of CFC stock subject to OFL recapture. P.L. 108-357, Code Sec. 895(a). Previously, gain on the sale of stock could be subject to OFL recapture only if the investment was used predominantly in a trade or business, such as stock held to ensure a source of supply for a trade or business. Reg. §1.904(f)-2(d)(5)(ii). Because Code Sec. 904(f)(3)(D) only applies to taxpayers that own more than 50% of the stock of a CFC, the "used predominantly in a trade or business" rule continues to apply to other stock held by taxpayers.

¹⁰⁰ Code Sec. 964(e)(1). Thus, due to the application of Code Sec. 1248 principles, the foreign corporation being sold must be a CFC, and it must have earned E&P during the period that

the seller CFC owned the shares. Code Sec. 1248(a). The Code Sec. 1248 tests are applied by assuming that the CFC seller is a U.S. shareholder (which Code Sec. 1248 requires). However, that assumption is ignored for purposes of determining whether the foreign corporation being sold is a CFC—normal rules under Code Secs. 957(a) and 958 apply. Code Sec. 964(e)(1) (last sentence).

¹⁰¹ Code Sec. 964(e)(2).

¹⁰² Under prior law, the deemed dividend carries out a *pro rata* share of tax credits from the post-1986 foreign income tax credit pool of the company sold. Code Sec. 902(b)(1). That carry-out increases the post-1986 foreign income tax credit pool of the CFC. *Id.* The deemed dividend is FPHCI, which carries out a portion of the tax credits from the post-1986 foreign income tax credit pool of the CFC to the U.S. shareholders. Code Sec. 960(a).

¹⁰³ See Code Sec. 964(e)(4), added by Section 14102(c) of the TCJA, effective for sale or exchanges occurring after December 31, 2017.

¹⁰⁴ Code Sec. 964(e)(4)(C); see also Code Sec. 245A(c).

¹⁰⁵ Code Sec. 964(e)(4)(A)(iii).

¹⁰⁶ See Reg. §1.954-2(e)(3).

¹⁰⁷ *Dover*, 122 TC 324, Dec. 55,630 (2004).

¹⁰⁸ The letter granting the retroactive election stated that no inference should be made as to whether the sale does or does not give rise to FPHCI.

¹⁰⁹ The general rule is that gain from the sale of assets that do not give rise to any income is FPHCI. Code Sec. 954(c)(1)(B)(ii). However, there are exceptions for the sale of assets used in a trade or business of the CFC. Reg. §1.954-2(e).

¹¹⁰ The IRS had repeatedly taken the position that a Code Sec. 332 liquidation transferred a trade or business of the liquidated company to the 80% shareholder, treating the shareholder as having itself engaged in that trade or business. See Rev. Rul. 75-223, 1975-1 CB 109; Rev. Rul. 77-376, 1977-2 CB 107, GCM 37054 (Mar. 21, 1977); G.A. *Rauenhorst* 119 TC 157, Dec. 54,899 (2002). In *Dover*, the IRS conceded that there is no difference between a check-the-box deemed liquidation and an actual liquidation. See also Reg. §301.7701-2(a) ("if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner"). The Tax Court also noted that the IRS can amend the check-the-box regulations to require a minimum holding period for the holding company CFC to operate the business as a predicate to availing of the sale of a trade or business exemption but it had not done so. *Dover, id.*, at 352.

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