**Controlled Foreign Corporation Tax Guide**

Under limited circumstances, a U.S. person can be a shareholder of a foreign corporation who is not required to pay U.S. income taxes on the income of the corporation until that income is distributed to the U.S. owners as a dividend (or possibly as a salary). Many years ago, the income of foreign corporations was not taxed unless it was derived from U.S. sources. In 1962, exceptions were created to deter the use of foreign corporations as a way to avoid taxes. These exceptions have evolved into the insanely complex rules referred to as the "controlled foreign corporation" rules. U.S. shareholders of a controlled foreign corporation (CFC) are subject to current income tax on "certain" income of the CFC. Generally, foreign investment income and certain kinds of foreign source business income are subject to current taxation to U.S. shareholders.

This report attempts to provide a simplified and abbreviated explanation of the "certain" types of income that are taxable and not taxable.

**U.S. Source Income of a Foreign Corporation**

A foreign corporation, whether owned by U.S. shareholders or foreign shareholders, may be subject to U.S. income taxation. If the foreign corporation has U.S. source business income (defined in IRC Section 861) that is effectively connected with the conduct of a U.S. trade or business or if the foreign corporation has a permanent establishment in the U.S., then it is subject to U.S. taxation. The foreign corporation, irrespective of who the shareholders are, will file a Form 1120 and pay U.S. corporate income taxes on its U.S. source income from a trade or business in the U.S. If the foreign corporation is subject to U.S. income taxation and it also has U.S. shareholders, then later distributions to those shareholders, if treated as dividend distributions, will be subject to an additional personal income tax (double tax since the corporation receives no deductions for dividends paid). However, this is the same treatment as dividends received by U.S. shareholders of U.S. corporations.

The U.S. has no taxing authority over a foreign corporation with no U.S. source income and no permanent establishment in the U.S. However, the U.S. tax laws do have taxing authority over U.S. shareholders (as defined below) of foreign corporations.

**Description of U.S. Shareholders**

This authority of taxation comes from the controlled foreign corporation rules that tax U.S. shareholders on "subpart F" income (described below).

A controlled foreign corporation is one in which U.S. shareholders own more than 50 percent, by vote or value, of the foreign corporation. Only U.S. persons can be "U.S. shareholders." IRC Section 957(c) refers to IRC Section 7701(a)(30) for the definition of a U.S. person (which is very broadly defined to include individuals, partnerships, corporations, trusts and estates).

A U.S. shareholder, for purposes of determining whether there is a controlled foreign corporation, is one who owns 10 percent or more, by vote, of the foreign corporation [IRC Section 951(b)]. In determining the 10 percent or more ownership, the attribution rules (described below) of both IRC Section 958(a) and IRC Section 958(b) apply. Once it is determined (through direct ownership, indirect ownership under IRC Section 958(a) and constructive ownership under IRC Section 958(b)), that there are, in the aggregate, U.S. shareholders who own more than 50 percent, by vote or value, in the foreign corporation, it is classified as a controlled foreign corporation (CFC).

Please note that only those shareholders that own (directly or indirectly) 10 percent or more of the foreign corporation stock are included in the "more than 50 percent" ownership test. Thus, a foreign corporation with twenty U.S. shareholders with equal shares of 5 percent of the foreign corporation is not a CFC. Or, if a foreign person owns 50 percent or more of the corporation, then no combination of U.S. persons can own "more than 50 percent" of the foreign corporation. If one U.S. person owns 40 percent of a foreign corporation, and ten U.S.
persons each own 6 percent, it is not a CFC, even though U.S. persons own 100 percent of the stock. Only one of those U.S. persons is a "U.S. shareholder" as defined for this purpose.

However, each U.S. person's ownership percentage is determined by taking into account the attribution and constructive ownership rules. The phrase "attribution" means that one taxpayer is deemed to own the shares of certain other related taxpayers - such as a spouse, child or parent - because the law presumes that these persons have a common interest. "Constructive ownership" is the same as attribution but it is usually applied with respect to entities in which the taxpayer has some control or beneficial interest. A beneficiary of a trust or estate is deemed to own a portion of any stock owned by the trust or estate, based on the rights of the beneficiary with respect to distributions from the trust or estate.

A 50 percent or more shareholder of a corporation or 50 percent or more partners in a partnership are deemed to have a proportionate interest in stock owned by the corporation or partnership. Thus, ownership of a foreign corporation is derived from the direct ownership of the taxpayer plus any indirect ownership arising from the attribution and constructive ownership rules. With respect to foreign corporations, these rules are insanely complicated and this is the shortest explanation without getting involved in the maze of code sections relating to this subject.

However, these terms will be further discussed below in connection with the explanation of "subpart F" income.

**Description of Subpart F Income**

Subpart F income is defined under IRC Sections 952 - 954. The following is a general summary of the income that is classified under subpart F. Basically, "U.S. source income" means income derived from conducting a trade or business in the U.S., income from services performed in the U.S. and income from property located in the U.S. It also includes dividends on the stock of U.S. corporations and interest on bonds or other evidences of debt from U.S. sources. (There are exceptions of course.)

There are two categories of "subpart F income" that are discussed below, but the following are the five categories listed in IRC Section 952:

1. insurance income as defined at IRC Section 953;
2. foreign base company income as defined at IRC Section 954;
3. income from countries subject to international boycotts [IRC Section 999];
4. illegal bribes, kickbacks and similar payments [IRC Section 162(c)]; and
5. income from countries where the U.S. has severed diplomatic relations [IRC Section 901(j)].

The major category applicable to most foreign corporations is "foreign base company income," which is defined to include:

1. foreign personal holding company income [IRC Section 954(c)];
2. foreign base company sales income [IRC Section 954(d)];
3. foreign base company services income [IRC Section 954(e)];
4. foreign base company shipping income [IRC Section 954(f)]; and
5. foreign base company oil related income [IRC Section 954(g)].

Foreign personal holding company income is basically income from passive investments such as interest, dividends, certain rents, royalties and capital gains.

"Foreign base company sales income" is defined by IRC Section 954(d), which provides the exact definition. However, it generally includes income from selling personal property purchased from a related person or sold to a related person.

For this purpose, a "related person" is an individual, corporation, partnership, estate or trust that controls the CFC or is controlled by the CFC. With respect to a partnership or corporation,
"control" means more than 50 percent. The phrase "related person" is defined in IRC Section 958 but that takes you through a maze of code section cross-references and exceptions. Basically, a related person includes a spouse, children, grandchildren or parents (see IRC Section 318) and any estate or trust in which the person is a beneficiary. It also includes any corporation or partnership that is owned 50 percent or more by the taxpayer or which owns 50 percent or more of a corporation or partnership. It does NOT include an individual who is a non-resident aliens even if that individual is related to the U.S. taxpayer. (IRC Sections 958(b)(1) and (4).)

The "bottom line" of these confusing rules is that income from a trade or business conducted entirely outside the U.S. is not subpart F income unless a "related" party is involved. For example, assume U.S. shareholders own a Bahamian-domiciled company. If the Bahamian company buys "widgets" from unrelated sources and sells them to unrelated sources, such income is not subpart F income and the profits (if any) are tax-deferred to the U.S. shareholders until they are distributed as dividends.

"Foreign base company services" income is defined as "income (whether in the form of compensation, commissions, fees or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services which:

(A) are performed for or on behalf of any related person (within the meaning of subsection (d)(3), and
(B) are performed outside the country under the laws of which the controlled foreign corporation is created or organized."

As a practical matter, international business companies formed in most tax haven countries are not permitted to conduct business in that country, so that any services provided by the company are subpart F income if the services are performed by any person (like a shareholder) "related" to the corporation. This is not referring to the definitions of foreign base company shipping or oil income.

If the foreign corporation has subpart F income, then, to the extent of the earnings and profits of the corporation, those earnings are taxable each year, whether distributed or not, to the 10 percent or more shareholders who are determined by direct ownership or the attribution rules under IRC Section 958(a) (but not IRC Section 958(b)).

"Earnings and profits" is another complicated subject that is difficult to briefly explain, but it is not the same as taxable income. "Earnings and profits" is more closely related to the accounting income of the corporation even though some items are not taxable and some items are not deductible. Black’s Law Dictionary describes "earnings and profits" as the economic capacity of a corporation to make a distribution to shareholders that is not a return of capital.

A foreign corporation has foreign source income if it has no U.S. source income connected with a U.S. trade or business and has no permanent establishment in the U.S. Such a foreign corporation is a controlled foreign corporation if 10 percent or more shareholders (determined by IRC Section 958(a) and (b)) own, by vote or value, more than 50 percent of the stock of the foreign corporation. If such a controlled foreign corporation has subpart F income (due to dealing with or on behalf of a related party and applying the attribution rules), the question then arises as to which 10 percent or more shareholders are currently taxed on the earnings and profits of this controlled foreign corporation.

**U.S. Shareholders Subject to Tax on Foreign Corporation Income**

IRC Section 951(a)(1) requires certain shareholders of a controlled foreign corporation to include certain amounts in income, even if the corporation has not distributed these amounts. IRC Section 951(a) applies only if a foreign corporation is a controlled foreign corporation for a continuous period of at least 30 days during a taxable year (Treas. Reg. Section 1.951-1(a)). Income passes through under IRC Section 951(a) only to a person who is a "United States
shareholder," a term that has a general meaning and a special meaning. In addition, income passes through and is taxed only to a U.S. shareholder who owns stock in the CFC on the last day in the taxable year on which the corporation is a CFC. [IRC Section 951(a).]

Under IRC Section 951(a), stock ownership means direct ownership and indirect ownership under IRC Sections 958 (a)(1) and (2). The rules of constructive ownership under IRC Section 958(b) do not apply for purposes of income inclusion to a U.S. shareholder under IRC Section 951(a). IRC Section 951(a) does not refer to the constructive ownership rules of IRC Section 958(b.). The constructive ownership rules apply to an individual's spouse, children, grandchildren and parents. Thus, attribution among these related parties does not apply in determining the 10 percent ownership on the last day of the taxable year of the CFC for determining income inclusion.

Therefore, it is possible to legally defer taxes on the foreign source income of a CFC if the income does not come under the definitions of "subpart F income" and is not "U.S. source income." If a corporation is domiciled in a foreign country and is owned (in whole or in part) by U.S. persons, there is no current U.S. tax to the corporation if the corporation has no (1) U.S. source income or (2) subpart F income.

**Treatment of Foreign Entity Controlled by U.S. Persons**

When considering tax issues from a U.S. perspective for U.S. persons (citizens, resident aliens, and domiciliaries), it is important to understand the distinction between the legal aspects of an entity and how this entity may be classified for tax purposes.

When a U.S. person forms a foreign corporation, generally referred to as an international business company ("IBC"), in a favorable no-tax jurisdiction, the U.S. law will recognize that corporation, for legal purposes, as a corporation. However, for tax purposes (not legal purposes), Treasury Regulations may classify the corporation as a disregarded entity (one owner) or a partnership (two owners).

Under the check-the-box regulations, a U.S. person or persons can elect how the entity is treated for income tax purposes. One of the exceptions to this election is the formation of a corporation under state law in the U.S. Under the U.S. tax laws, a corporation formed in the U.S. will be treated both for legal purposes and tax purposes as a corporation. When forming a partnership under state law, however, an election can be made to treat the partnership, for tax purposes, as either a partnership (flow-through entity) or an association taxable as a corporation (corporation).

When U.S. persons form a foreign partnership or foreign limited liability company, an election can be made with respect to the tax treatment. For a foreign partnership, an election can be filed to treat the partnership as a partnership or as a corporation for tax purposes. For a limited liability company, an election can be made to treat the limited liability company, for tax purposes, either as partnership (more than one member) or a disregarded entity (one member) for tax purposes, or as a corporation for tax purposes.

Under the check-the-box regulations, however, if a foreign corporation is formed under the laws of some eighty currently listed foreign jurisdictions, that entity will be treated also as a corporation for tax purposes. In other words, forming a corporation under one of these jurisdictions is referred to as "per se" corporation for income tax purposes. As a result, if a person desires to form a foreign corporation, but have it treated as a partnership or a disregarded entity, a U.S. person should not form a foreign corporation under one of these jurisdictions. IRS Form 8832 is used to make this election.

**Filing Obligations For A "Disregarded Entity"**

A U.S. person may form an IBC under a law that is not on the "per se" corporation list under the U.S. Treasury Regulations, and file an election with Form 8832 to treat the IBC as a disregarded entity for income tax purposes. A list of entities in each country that are treated as
"per se" corporations for income tax purposes are stated at Treasury Regulation Section 301.7701-2(b)(8). For legal purposes, the IBC is a corporation; however, by electing to treat the IBC as a disregarded entity, it is disregarded for federal income tax purposes. When assets are transferred to the IBC, directly or indirectly, by a U.S. person or by a foreign trust that includes a U.S. beneficiary, a Form 926 is required to be filed. If the IBC is treated, for tax purposes, as a CFC, a Form 5471 is required to be filed. However, assuming that the corporation is treated as a disregarded entity for tax purposes, a Form 5471 is not required to be filed.

The shareholder (or shareholders) reports the income earned from the IBC (as a disregarded entity) on a Schedule C, Form 1040, unless rental income is involved, in which case, the income is reported on Schedule E.

Also, Treasury Form TD F 90-22.1 is required to be filed (on June 30) and Schedule B, Part III, of Form 1040 is required to be checked "yes" since the shareholder (or his foreign grantor trust, which includes a U.S. beneficiary) has a beneficial interest in or signatory authority or other authority over a foreign account.

A foreign LLC with a single owner is treated as a corporation under the default rules of the check-the-box regulations; however, the owner can elect to treat the corporation as a disregarded entity for tax purposes by filings IRS Form 8832.

The Chief Counsel’s Office of the IRS and the Offshore Compliance & Foreign Trusts Examination Division informally agree that upon the election by the single owner to treat the foreign LLC as a disregarded entity, a Form 5471 is not due. A disregarded entity, for tax purposes, is not a CFC. The owner of the disregarded entity reports the income from the foreign LLC on Schedule C (or Schedule E for rental income) of his Form 1040.

**Other Foreign Corporation Issues**

Any gain on the subsequent sale of the foreign corporation stock is treated as dividend income to any U.S. shareholder who owns 10 percent or more of the stock at any time within five years before the sale of the stock. Gains from the sale of stock by shareholders who do not directly or indirectly own 10 percent of the company are eligible to be treated as a long-term capital gain rather than being taxed as ordinary income. For 10 percent or greater shareholders, it does not matter if the earnings of the foreign corporation are distributed as dividends or if the stock is sold at a gain. [IRC Section 1248.]

A CFC that buys or sells for or on behalf of a "related" U.S. business (or person), to the extent of earnings and profits, is subject to U.S. taxation on the U.S. shareholder’s pro rata share of the CFC’s income. If the CFC is not buying or selling on behalf of a related party, then the income is not classified as subpart F income. Such foreign source income of a CFC that is not classified as subpart F income is not taxable to the U.S. shareholders.

Of course, when dividend distributions are made (repatriated to the U. S.), the U. S. shareholder or holders are subject to U. S. income taxation. But, if the corporation accumulates and invests non-subpart F income, it may eventually be classified as personal holding company income or foreign personal holding company income (see IRC Section 553), and the U.S. shareholder may be taxed on his pro rata share of the undistributed or accumulated income (see IRC Section 551). However, Congress repealed a previous law that limited the deferral of income by a CFC by requiring the inclusion of passive income that exceeds 25 percent of the CFC’s underlying assets. As a consequence of the repeal of this law, a large amount of accumulations is required in order for the foreign personal holding company rules, to cause taxation.

However, some shareholders of a CFC with no subpart F income must still file Form 5471 with their personal tax return.
Since the corporation has a foreign bank account, the U.S. shareholders who have control, signatory authority or other authority over the account must file Form TD F 90-22.1.

To summarize, if a U.S. person, or persons, controls a corporation domiciled and operating in a foreign country and if that controlled foreign corporation has business profits from buying and selling personal property to and from unrelated persons, the profits of the foreign corporation are not subject to income tax by the U.S. and the U.S. shareholders are not taxed until the income is repatriated to the U.S. shareholder(s) in the form of dividends. Within some strict limits, the profits of the foreign corporation can be invested in passive assets without generating a current tax. Or if the profits are reinvested in other trade or business activities that are not "subpart F" income, then the tax deferral can continue for an extended time.