TAX TREATMENT OF FOREIGN DIVIDENDS UNDER JGTRRA: ambiguities and opportunities

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supporters of the Jobs and Growth Tax Relief Reconciliation Act (P.L. 108-27, May 28, 2003) (JGTRRA) claim that it will benefit (1) small businesses by reducing tax rates, increasing deductions when purchasing new equipment, and stimulating business investment; (2) American families by accelerating income tax rate reductions, increasing the child tax credit, and providing marriage penalty relief; and (3) the U.S. as a whole by creating jobs, enhancing corporate accountability, and promoting overall economic growth. Critics of JGTRRA, on the other hand, argue that the law will ultimately prove detrimental to the U.S. by escalating the national deficit, reducing savings, exacerbating the future economic woes related to Social Security and Medicare, eliminating domestic jobs, and necessitating enormous tax increases in the near future. Regardless of one's opinion of JGTRRA, one thing is clear: things remain unclear.

This lack of clarity is particularly acute with the JGTRRA provisions intended to encourage investment by lowering the tax rates applicable to certain dividends and capital gains. JGTRRA permits some dividends that are normally taxed as ordinary income at rates up to 35% to be taxed as long-term capital gains. This change in characterization could lead to significant tax savings since the capital gains rates under JGTRRA are reduced to 15% or less. JGTRRA accomplished this tax decrease through a two-step process: the tax rates on capital gains were lowered and Section 1(h)(11) was added to provide that "net capital gain" includes not only normal capital gains, but also "qualified dividend income" (QDI).

Meeting the standards to take advantage of the reduced dividend rates does not seem overly problematic at first glance, but further analysis of the criteria (especially for foreign dividends) reveals lingering uncertainties. Concluding a two-part series, this article examines some of the unresolved issues surrounding the application of JGTRRA with respect to dividends (both actual and constructive) from foreign corporations and related foreign tax credit implications. While resolution of these issues is well beyond the scope of any discussion that precedes further guidance from the IRS, this article is designed to alert taxpayers and tax practitioners alike to the impact that JGTRRA has on a broad range of topics.

Overview of JGTRRA, Conference Report, and IRS Guidance

Part 1 of this article contained a detailed analysis of the QDI provisions under JGTRRA. Following is a brief review.

QDI includes dividends distributed by either "domestic corporations" or "qualified foreign corporations." Identifying a "domestic corporation" is relatively trouble free since a corporation is considered domestic if it is formed in the U.S. By contrast, determining whether an entity meets the definition of "qualified foreign corporation" is quite difficult. Help in making this determination is derived from JGTRRA, its Conference Report, and a series of IRS notices. For a foreign corporation to be characterized as a qualified foreign corporation, it must be one of the following:

- Established in a U.S. possession ("Possessions Test").
- Eligible for the benefits in a comprehensive income tax treaty that includes an exchange-of-information program and that Treasury has determined is satisfactory for JGTRRA purposes ("Treaty Test").
- Readily tradable on an established U.S. securities market ("Market Test").

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Along with establishing these threshold tests, JGTRRA also identifies certain entities that will not be considered qualified foreign corporations. In particular, shareholders of foreign personal holding companies (FPHCs), foreign investment companies (FICs), and passive foreign investment companies (PFICs) are prohibited from enjoying the tax advantages offered by JGTRRA (“Foreign Investment Company Exclusion Test”).

While investors and the international tax community were enthused about JGTRRA, imprecise language in parts of the legislation and its Conference Report caused many persons and groups to express concerns to the IRS. In an attempt to placate these concerns, the IRS issued a series of notices addressing ambiguities associated with QDI and qualified foreign corporations.

The IRS first issued Notice 2003-69, 2003-42 IRB 851, to provide additional guidance regarding the Treaty Test. Specifically, the Notice identifies countries that have comprehensive income tax treaties with the United States that contain an exchange-of-information program, and that Treasury deems “satisfactory” for JGTRRA purposes. Notice 2003-69 also identifies four U.S. income tax treaties that fail to meet the Treaty Test: the Bermuda and the Netherlands Antilles treaties are not considered “comprehensive income tax treaties”; the former U.S.S.R. treaty is objectionable because it lacks an exchange-of-information provision; and the Barbados treaty is inadequate because it purportedly grants tax benefits designed to mitigate or eliminate double taxation when there is no risk of such double taxation.

One week after releasing Notice 2003-69, the IRS issued Notice 2003-71, 2003-43 IRB 922, to address the uncertainty surrounding the Market Test. Notice 2003-71 stated that, for JGTRRA purposes, common or ordinary stock, as well as American Depositary Receipts (ADRs) in respect of such stock, will be considered “readily tradable on an established securities market in the United States” if it is listed on a national securities exchange that is registered under the Securities Exchange Act of 1934 or on NASDAQ.

Last, the IRS issued Notice 2003-79, 2003-50 IRB 1206, which establishes five presumptions relevant to persons required to file an information return regarding dividends issued by a foreign corporation (i.e., a Form 1099-DIV) for the 2003 tax year. First, to be considered QDI, a distribution must be made with respect to equity, such as stock, rather than debt, such as bonds and loans. Notice 2003-79 provides that, for purposes of filing Forms 1099-DIV for dividends issued during 2003, a person may treat the security as satisfying this requirement if it is common or ordinary stock. If the security is not common or ordinary stock, the person may treat the security as satisfying this requirement if the foreign corporation has a public statement filed with the Securities and Exchange Commission stating that the security “will be, should be, or more likely than not will be” properly classified as equity rather than as debt.

Second, to be considered QDI, a distribution must first be a “dividend” for federal tax purposes, which means that the corporate distribution was made out of current or accumulated earnings and profits (E&P). Notice 2003-79 recognizes that a person required to file a Form 1099-DIV may not know in some instances whether a distribution meets this requirement. Accordingly, where a person is unable to determine what portion of a particular corporate distribution is a dividend, he must treat the entire distribution as a dividend.

Third, Notice 2003-79 states that a person required to file a Form 1099-DIV may treat a foreign corporation as satisfying the Treaty Test as long as (1) the foreign corporation is organized in a country whose income tax treaty with the United States is listed in Notice 2003-69; and (2) if the relevant treaty contains a limitation-on-benefits provision, the corporation’s common or ordinary stock is listed on an exchange covered by the “publicly traded” test in that provision.

Fourth, Notice 2003-79 explains that a person may treat a foreign corporation as satisfying the Foreign Investment Company Exclusion Test unless the person knows or has reason to know that the corporation is or expects to be an FPHC, FIC, or PFIC.

Finally, JGTRRA provides that a shareholder who receives a dividend must satisfy certain holding period requirements for the dividend to be considered QDI. According to the instructions to Form 1099-DIV, a person required to make such a filing must report in Box 1b (i.e., as QDI) any dividends for which it is impractical to determine whether the recipient has met the holding period requirements. Therefore, if a person required to file Form 1099-DIV determines that a particular shareholder has satisfied the relevant holding period requirements or if it is impractical for the person to make this determination, the person may presume that the shareholder satisfies the holding period.

JGTRRA’s Wake—Further Unsettled Issues

Part 1 of this article described several open issues under JGTRRA related to the Possessions Test, Treaty Test, Market Test, and Foreign Investment Company Exclusion Test, and it identified the issues that the IRS opted to intentionally leave unresolved in Notices 2003-69, 2003-71, and 2003-79. Examined below are additional issues under JGTRRA that exacerbate the existing atmosphere of uncertainty.

CFCs and qualified foreign corporations. As explained above, the Foreign Investment Company Exclusion Test identifies three specific types of entities that will not be considered qualified foreign corporations—FPHCs, FICs, and PFICs. Absent from this list is another type of entity commonly found in international corporate structures, the controlled foreign corporation (CFC, defined in Section 957). Consequently, applying the canon of statutory construction expressio unius est exclusio alterius, one could conclude that dividend distributions from CFCs qualify for reduced tax rates under JGTRRA.

While distinguishing between CFCs and the three entities identified in the Foreign Investment Company Exclusion Test may seem relatively simple, the pertinent anti-deferral regimes are riddled with overlapping application. Specifically, U.S. shareholders of CFCs were historically obliged to address the possible overlap of the PFIC rules and the CFC rules. Fortunately, Subpart F and the PFIC rules contained several coordination provisions to address the issues that could arise in applying mul-
multiple anti-deferral regimes to the same entity. Then, in 1997, Congress added Section 1297(e) to provide that a foreign corporation would not be treated as a PFIC with respect to a U.S. shareholder of a CFC after December 31, 1997. For many U.S. shareholders of CFCs, Section 1297(e) eliminated an unnecessary area of complexity.

In the context of JGTRRA, however, Section 1297(e) raises additional questions. To begin with, shareholders who own less than 10% of the voting stock of a CFC that technically qualifies as a PFIC may be ineligible for the benefits of JGTRRA. Would dividend distributions by such foreign corporations to the less-than-10% shareholders not qualify as a QDI, while the same dividend distributions to the U.S. shareholders (i.e., those owning 10% or more of the voting stock) qualify as a QDI?

Further, one of the more infamous PFIC provisions, Section 1298(b)(1), generally states that once a foreign corporation constitutes a PFIC, it is always a PFIC. This same provision allows taxpayers to purge the PFIC taint by electing to recognize gain as of the last day of the last tax year during which the company was a PFIC. By making this election, the foreign corporation no longer constitutes a PFIC.

In the context of JGTRRA and Section 1297(e), Section 1298(b)(1) has broader implications. For instance, when Section 1297(e) was enacted, the statute and Proposed Regulations provided the same mechanism for former PFICs to purge their PFIC taint (Section 1297(e)(3)(B)). Absent a purging election, a foreign corporation technically continues to constitute a PFIC, even though it may not be treated as a PFIC with respect to U.S. shareholders solely because of Section 1297(e). The unanswered question, therefore, is whether actual dividend distributions (or Subpart F income for that matter) from a CFC that constituted a PFIC prior to January 1, 1998, and that did not purge its PFIC taint under Section 1298(b)(1), qualify as QDI, or whether such dividend distributions are rendered ineligible for QDI treatment.

Subpart F Issues. One of the most apparent unresolved issues for U.S. investors and international tax practitioners is whether income inclusions...
under Subpart F qualify as QDI under JGTRRA. At first glance, it would appear that Subpart F income would not be eligible as QDI because actual dividends are not necessary for inclusion under Subpart F. On the other hand, for those who deal with Subpart F regularly, the notion that income under Subpart F would be eligible as QDI is not farfetched given that Subpart F essentially implements a constructive dividend mechanism to prevent deferral of certain types of income.

Subpart F requires U.S. shareholders of CFCs to include in gross income their pro rata share of the CFC’s Subpart F income and amounts determined under Section 956 (related to investments in U.S. property) regardless of whether the CFC actually makes a distribution (Section 951(a)(1)). Dividends are generally defined as distributions of property from a corporation’s current or accumulated E&P (Section 316(a)). Therefore, Subpart F income is not technically a “dividend” since no distribution of property is required.

While Section 951 does not specifically state that this income is included as a “dividend,” it is commonly understood that income inclusions under Subpart F constitute “deemed dividends.” In fact, the IRS requires that Subpart F income be reported on Schedule B of Form 1040 as a “dividend.”

The statutory framework under Subpart F also supports the constructive dividend characterization of inclusions. Under Subpart F, U.S. shareholders include in gross income neither actual CFC distributions of E&P that are attributable to amounts previously included in gross income as Subpart F income, nor amounts determined under Section 956 (Section 959(a)). Stated another way, when a U.S. shareholder includes income under Subpart F, a “previously taxed income” account is created against which future distributions from the CFC are offset. The clear implication is that the CFC’s income is taxed only once (as a dividend of sorts) by the U.S.

**Ordering rules.** These previously taxed income rules invoke a complex ordering process that is necessary to avoid double taxation of a CFC’s income. The ordering rules require that for any given tax year, U.S. shareholders must first include their pro rata share of the CFC’s Subpart F income, then take into account actual CFC distributions to reduce the previously taxed income accounts, and finally calculate Section 956 inclusions (Sections 959(c), (f)). Based on these ordering rules, it can be argued that if Subpart F income did not qualify as QDI, U.S. shareholders of a CFC that distributed only its Subpart F income each year could not benefit from the 15% dividend rate under JGTRRA because the previously taxed income ordering rules would require that Subpart F income be included prior to any actual CFC distribution. Accordingly, the U.S. shareholder would include the CFC’s Subpart F income without the benefit of the QDI provisions and then receive a “tax-free” distribution of property from the CFC that otherwise may have qualified as QDI. Thus, for its U.S. shareholders to take advantage of the 15% tax rate, the CFC would be required to distribute property in excess of its Subpart F income.

**Inclusion/dividend distinction.** Some commentators have argued that a U.S. shareholder could convert inclusions that would normally be subject to high tax rates into dividends that would be taxed at reduced rates under JGTRRA by simply moving the income into a CFC. Allowing this, they claim, would be “blatantly at odds” with established IRS policy with respect to CFCs. To avoid incoherent tax policy, some practitioners suggest that the IRS craft a technical distinction between dividends (which would be eligible for the benefits of JGTRRA) and inclusions (which would not).

Such a distinction may give rise to unnecessary complexity, particularly since a CFC must be a qualified foreign

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12 For a complete description of these concerns, see Shepard, supra note 6.
13 See also “IRS Releases Treaty List for Reduced Dividend Tax Rates,” 2003 TNT 190-17 (October 1, 2003).
14 Id. Appendix. The acceptable treaty countries include Australia, Canada, China, Egypt, France, Germany, India, Japan, Korea, Mexico, Netherlands, Spain, Sweden, Switzerland, and the U.S.
18 Note 11, supra.
20 Section 951(f); Prop. Reg. 1.1291-2(b)(2).
21 “United States shareholder” has a very specific meaning and is defined in Section 951(b) as a U.S. person who owns 10% or more of the foreign corporation’s voting stock.
corporation (thereby satisfying the requirements of an applicable income tax treaty) to benefit from the 15% rate. As a result, U.S. taxpayers should not be able to route such income through CFCs organized in non-treaty tax haven jurisdictions and then distribute the E&P as a QDI.

The New York State Bar Association has expressed its opinion on the issue:

[We] think that these rules make sense in their current form, since the effect is that "passive" income earned abroad is not eligible for the benefits of Section 1(h)(11). The rules may be overbroad, however, to the extent that the foreign corporation's earnings and profits derive from dividends paid by qualified foreign corporations. And the effect of these rules is that Section 1(h)(11)'s benefits are denied for income of a kind that would not cause a foreign corporation to be a PFIC, such as foreign base company services income. We think consideration of whether these results are appropriate, or whether legislative changed should be made, is warranted.\(^{26}\)

In summary, opinions on whether income under Subpart F qualifies as QDI are divergent, thereby breeding continued uncertainty.

**Other constructive dividend inclusion issues.** Taxpayers are required to include in gross income constructive dividends from foreign corporations in several instances, which raises additional concerns regarding whether these constructive dividends qualify as QDI.

Section 1248 generally requires that gain from the sale of stock in a CFC be included in the seller's gross income as a "dividend" to the extent of the CFC's E&P attributable to the stock sold (Section 1248(a)). While the income is included as a dividend, no actual distribution of property from the CFC occurs. Therefore, it is unclear whether a dividend inclusion pursuant to Section 1248 would be eligible for the reduced 15% rate under JGTRRA. Excluding Section 1248 dividends from QDI may exalt form over substance in some transactions. For instance, if the selling shareholders of the CFC were able to induce the CFC to pay a dividend prior to the sale, they could simply circumvent most, if not all, of the Section 1248 dividend on the sale and qualify for the 15% rate.

Redemptions through the use of related corporations under Section 304 are another area in which taxpayers may be required to include constructive dividends from foreign corporations. For example, when a shareholder controls two corporations and sells the stock of one to the other, the property received in the transaction is treated as a distribution in redemption of stock (Section 304(a)(1)). The redemption may be treated as a dividend from the acquiring corporation, thereby raising the question of whether such a dividend qualifies as QDI (Section 304(b)(2)). Section 304(b)(2) is relatively clear, stating that the amount of the dividend is determined "as if the

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23 Section 1298(b)(1); Temp. Reg. 1.297-3T permitted a deemed dividend election to be consistent with Section 1291(b)(2) election to recognize gain where company becomes qualified electing fund.
24 See instructions for Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations), page 6.
25 See Tolin, supra note 19.
26 See Berg, supra note 22.
28 See Tolin, supra note 19.
29 Section 1(h)(11)(B)(ii), referring to Section 246(c). "Ex-dividend" means the first day that a share of stock on which a dividend has been declared is sold without the purchaser being entitled to the dividend.
reflect any capital gain rate differential, will apply to any QDI. In addition, the Conference Report indicates that Congress anticipates that Regulations promulgated under Section 904 will coordinate the rules that apply to both capital gains and qualified dividend income.\textsuperscript{27}

It is safe to say that many tax practitioners, and most individual taxpayers, lack familiarity with Section 904(b) and the limitation on foreign tax credits connected to capital gains. Similar to the underlying policy that foreign tax credits may not exceed the applicable U.S. tax on foreign-source income, this provision is designed to limit the amount of creditable foreign tax to the applicable U.S. tax on foreign-source capital gain. Section 904(b) is implemented through a complex calculation, which essentially reduces foreign-source income, thereby reducing the foreign tax credit limitation (Section 904(b)(2)(B)).

The practical application of these concepts results in further confusion. For example, how should the IRS implement rules similar to Section 904(b)(2)(B) in the context of QDI? Should capital losses be available to offset QDI or should foreign-source capital gains/losses be treated separately from foreign-source QDI for purposes of determining the foreign tax credit limitation?\textsuperscript{28} Further, if Subpart F income does not qualify as QDI, taxpayers will need to apply different foreign tax credit limitation rules to distributions of previously taxed Subpart F income as opposed to dividend distributions of QDI from the same CFC.

**Continued uncertainty regarding holding-period requirements.** JGTRRA provides that QDI does not include dividends paid on stock that an investor has held for 60 days or less during a period of 120 days, which period begins 60 days before the stock becomes ex-dividend.\textsuperscript{29} These rules, although very new, are already in the process of being amended.

In February 2004, the IRS announced that the Tax Technical Corrections Act of 2003 ("the Act"),\textsuperscript{30} which has not yet been passed, would change the holding-period test for QDI. Under the Act, to qualify for the lower tax rate, a taxpayer must hold the dividend-paying stock for at least 61 days (instead of 60) during the 121-day period (instead of 120) beginning 60 days before the ex-dividend date. Stock purchased on the last day before the ex-dividend date can still meet the holding-period test because there would be 61 days remaining in the 121-day period. Likewise, stock sold on the ex-dividend date can meet the new holding-period test since that is the 61st day in the period. In summary, the Act provides that if a taxpayer holds stock for at least 61 continuous days, the holding period will generally be met for any dividend received.

Despite the relative clarity of this new rule, uncertainty still exists for at least two reasons—the Act is yet to be passed, and the IRS has not yet implemented the necessary administrative changes. In fact, according to the IRS, it "expects to post revised versions of three publications and the instructions for various forms related to dividend reporting—for payors and investors—to its Web site later this month."\textsuperscript{31} Even if these revised documents do manage to become available electronically within the given timeframe, the IRS will not reissue the already printed versions of these materials (including Form 1099-DIV) to reflect the changes in the Act. The existence of inconsistent IRS documents potentially could generate significant confusion and compliance headaches.

**Conclusion**

As U.S. taxpayers prepare their 2003 income tax returns, further IRS input on the issues examined in this article would be welcome. Indeed, guidance in regulatory or administrative form would greatly assist not only U.S. taxpayers with foreign holdings in preparing accurate returns, but also tax counsel in properly planning for the 2004 tax year and beyond.

While the QDI rules present an unprecedented opportunity for U.S. taxpayers to access foreign markets at reduced tax rates, JGTRRA complicates the already cryptic international tax provisions of the Code. Incorporating the QDI rules into this existing statutory quagmire will challenge the IRS and tax practitioners alike.