Tax Considerations for Foreign Subsidiary Sales

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U.S. corporations operating overseas commonly do so through subsidiaries that are controlled foreign corporations ("CFCs"). And when it comes time to raise capital, selling off one or more of these CFCs is common too. To accomplish such a sale, however, the U.S. parent must navigate complex U.S. tax rules to ensure that the transaction not only makes business sense, but is also tax efficient.

Failing to drill down can raise the tax cost of a deal, sometimes months after the sale has closed. Code Sec. 1248 provides tax characterization rules for sales of foreign corporations. These rules, plus foreign tax credit considerations, can help or hurt you materially.

Code Sec. 1248 and Foreign Tax Credits

A CFC is a foreign corporation more than 50-percent owned by a U.S. shareholder. The ownership and attribution rules for CFCs are laid out in Code Sec. 958. Of course, a U.S. parent company and wholly owned foreign subsidiary ("sub") makes the sub a CFC.

Code Sec. 1248 applies to U.S. persons who own a 10-percent interest in a foreign corporation. When a U.S. parent sells stock in a foreign subsidiary, Code Sec. 1248 characterizes the gain as a deemed dividend to the extent of the lesser of the sub's earnings and profits ("E&P") or built-in gain of the stock. For our purposes, we will assume that E&P is the relevant limitation. Gain in excess of E&P are generally treated as capital. For the U.S. parent, this deemed dividend treatment is a potential source of significant value because it brings with it deemed-paid foreign tax credits under Code Secs. 902 and 960.

Because dividends are ordinary income, the deemed dividends on the sub's E&P generate general basket foreign-source income and are treated as an actual dividend and as if foreign taxes thereon had been paid. The capital gain on the sub's stock in excess of E&P will usually be sourced to the United States as the sale of a capital asset held by a U.S. person. Foreign tax, if any, on the capital gain should typically produce passive foreign tax credits, which are less valuable than general basket credits.

Foreign tax credits can be of tremendous value to a selling parent, particularly if the foreign sub has high-taxed E&P. This can occur in foreign jurisdictions with a high tax rate or in cases where there are differences between U.S. E&P and foreign tax base. However, multi-tiered CFCs present additional complications.

If the foreign sub has its own foreign sub with its own E&P, should the sale be by the first-tier sub of the second tier, or by the parent of the first tier? Where the first-tier sub is the seller, it will receive Subpart F income, creating an immediate deemed dividend as well as immediate U.S. tax liability for foreign tax credit purposes.

Nevertheless, if the parent effectively sells both subs by selling its stock in the first-tier sub, the second-tier's E&P could be included in the Code Sec. 1248 deemed dividend. Notably, Code Sec. 964(e) can help harmonize these differences, providing Code Sec. 1248 treatment for lower-tier CFCs. Another possible solution may be having the second-tier sub make a check-the-box election to be disregarded for U.S. tax purposes, if that would not negatively impact the first-tier sub's income.

Timing Considerations

Fundamentally, E&P measures the profits retained by a corporation during the entire year, minus dividends. Thus, the final E&P on which a foreign tax credit can be generated is as of year-end, not the date of sale. Post-purchase earnings and dividends from a CFC can significantly alter the deal for the parent.

> **Example:** The sale closed on June 30, 2014, at which time the sub had $1 million in E&P. On December 31, 2014, the CFC issues a dividend of $1 million wiping out its E&P. As a result, the parent winds up with no foreign tax credit.

Buyers and sellers should negotiate an acceptable arrangement to account for post-sale activities. They may include warranties by the buyer not to issue dividends, or make-whole provisions indemnifying the seller for lost foreign tax credits.

Code Sec. 338 Elections

A final consideration concerns Code Sec. 338. In the domestic context, Code Sec. 338(h)(10) permits a qualified stock purchase to be treated as an asset purchase *via* a joint election by both buyer and seller. The buyer receives a stepped-up basis in the sub's assets, and the seller is taxed on any built-in gains on those assets. The sub's E&P generated by the deemed-asset sale is added to the seller's consolidated E&P.

Unfortunately, this election applies only to consolidated groups, which cannot include a foreign affiliate.

In the foreign context, Code Sec. 338(g) permits a corporate buyer to make a unilateral election to treat a qualified stock purchase (80 percent or more of the target's stock) as a deemed asset purchase. The election also closes the target's tax year, fixing the E&P for Code Sec. 1248 purposes. The deemed asset sale also generates E&P, which can increase the Code Sec. 1248 deemed dividend amount. If the CFC has substantial built-in losses, however, the Code Sec. 338(g) election could potentially absorb E&P, driving down the deemed dividend. After the sale, the purchased company receives a stepped-up basis, but forfeits tax attributes pre-dating the sale.

For a parent, the Code Sec. 338(g) election can be dangerous as it can generate Subpart F income for the CFC, resulting in immediate U.S. taxation on the built-in gain of the passive assets of the CFC. The real concern with the Code Sec. 338(g) election is that it is a unilateral election by the buyer. As with the timing of post-sale dividends, whether a Code Sec. 338(g) election is made should be the subject of negotiations between the parties.

Conclusion

There are many concerns beyond Code Sec. 1248 for U.S. parent companies, but the potential for foreign tax credits should not be overlooked. Similarly, foreign buyers should be aware of the U.S. tax position of their counterparties when determining overall price and side agreements, such as limitations on dividends from new acquisitions. Well-represented parties should plan ahead and achieve both maximal value and favorable tax treatment.