Taxation of Dividends from Foreign Corporations

By Anthony Malik

Anthony ("Tony") Malik examines U.S. shareholder taxation upon their accessing foreign corporations' earnings in the form of cash dividends

U.S. persons frequently own legal entities abroad to pursue a variety of economic interests. Common U.S. ownership scenarios include expatriates forming foreign entities to locally operate businesses, U.S. residents forming foreign entities to capitalize on expansion opportunities, and entrepreneurial immigrants coming to the United States. More often than not, these foreign entities default to corporate status *à la* the tax law's default classification regime.[1] While the varying reasons for foreign corporate ownership[2] are premised on myriad nontax considerations, there are a slew of specific tax considerations that, for the most part, concern all U.S. owners. One of these tax considerations pertains to accessing the foreign corporations' earnings. This article will focus on U.S. shareholder taxation upon their access to these earnings in the form of cash dividends.[3]

Unarguably, consulting a U.S. owner of a foreign business lies firmly within the purview of the practice of international taxation. As in most all international tax determinations, it is imperative for practitioners to be aware of the special considerations, and modifications and exceptions to domestic tax rules, when analyzing an international transaction. The payment of dividends from a foreign, rather than a domestic, corporation is no exception. Treating a shareholder's foreign dividends solely under the same rules and assumptions applicable to purely domestic dividends is improper and will inevitably translate into U.S. income tax noncompliance on behalf of the shareholder. As such, practitioners must necessarily traverse beyond the periphery to gain an understanding of the economic backdrop to the dividend distribution. As we will learn, the relevant factual and financial information will govern the U.S. tax treatment of foreign dividends.

In the ensuing sections, this article will explore two common tax implications concerning U.S. owners upon receipt of dividends from their foreign businesses, *i.e.*:

ANTHONY ("TONY") MALIK is the Principal Consultant and owner of Point Square Consulting in Atlanta, Georgia. He specializes in business and international taxation. Tony can be reached at *tony@pointsquaretax.com*.

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- qualification for the favorable net capital gains tax rates and
- foreign tax credit ("FTC") considerations.

To keep the topic manageable, this article will assume the dividends to be paid out of a foreign corporation's pool of current or accumulated earnings and profits. Furthermore, to achieve the same end, this article will only consider dividends within the ordinary course of business operations and will not delve into special situations that trigger dividend income such as deemed dividend distributions, stock redemptions, liquidating distributions or foreign entity sales.

Qualification for Favorable Net Capital Gains Tax Rates

As in domestic tax practice, dividends in international tax practice are also bifurcated into the "nonqualified" and "qualified" characterizations.[4] This bifurcation, and the accompanying terminology, is important because the two separate characters of dividends are taxed differently. Specifically, nonqualified dividends are generally taxed at regular income tax rates whereas qualified dividends are taxed at net capital gains[5] tax rates to their recipients.[6] The tax rates applicable to net capital gains are invariably lower than those applicable to ordinary income.[7] Therefore, to the extent possible, it is almost always beneficial for U.S. individuals ("USI") to claim receipt of qualified, *in lieu* of nonqualified, dividend income. Fortunately, dividends from many foreign corporations qualify to be taxed to their recipients at favorable net capital gains tax rates, provided that certain requirements are met.[8]

Holding Period

A rudimentary condition for qualified dividend treatment stipulates a minimal stock holding period that spans before and after the corporation's ex-dividend date.[9] In the world of corporate finance, the ex-dividend date is typically the day following the record date on which the corporation finalizes its list of shareholders to receive dividends. To qualify for the favorable rates, business owners are required to hold the stock from which the dividend is paid for more than 60 days in the 121-day period beginning 60 days before the ex-dividend date.[10]

This requirement effectively precludes taxpayers from qualifying for the favorable rates in two instances. In the first instance, it bars those acquiring stock in a business on the ex-dividend date. In the second instance, it bars those who acquire the stock in question on the first day of the 121-day period and dispose of the stock on the ex-dividend date. This is because the law, for purposes of determining the 61-day (*i.e., more than 60 days*) minimum holding period, prohibits the day of acquisition, but not the day of disposition, from being taken into account.[11] As such, taxpayers in the first instance would fail to hold the stock before the ex-dividend date, whereas in the second instance, by holding the stock merely for 60 days, taxpayers would fail to hold the stock for the 61-day requisite minimum.

Notwithstanding, unless extraordinary or unusual circumstances prevail, virtually all owners of closely-held businesses qualify to have their share of dividends taxed at the favorable rates owing to the fact that owners of closely-held businesses are able to control the timing of their payouts. Most tax practitioners will no doubt be aware of this condition as it also applies equally to the holding period of the stock of domestic corporations.

"Qualified Foreign Corporations"

Moving onto qualification requirements that concern only foreign corporations, something that will undoubtedly be new for many tax practitioners is the concept of a *qualified foreign corporation* ("QFC"). This is an important concept within the dividends received context because only dividends from domestic corporations and QFCs are eligible to be characterized as qualified dividends.[12] QFCs include entities that are incorporated in a possession of the United States such as Guam or the U.S. Virgin Islands.[13] Otherwise QFCs include certain foreign corporations that are located in a country that:

- has a comprehensive income tax treaty ("treaty") with the United States;
- has an information sharing agreement with the United States; and
- is approved by the U.S. Department of the Treasury ("Treasury").[14]

Keeping the aforementioned provisos in mind, it is noteworthy that merely the existence of a ratified treaty between the United States and another contracting sovereign jurisdiction is not by itself sufficient to attain QFC status. In fact, according to the latest available guidance, the Treasury has specifically ruled that three U.S. treaties (*i.e.,* treaties with the U.S.S.R., Bermuda and the Netherlands Antilles) do not meet the aforementioned requirements.[15] On the other hand, more importantly, the Treasury has identified and listed 57 countries that do meet the aforementioned requirements.[16] The countries included on the list, in ecumenical fashion, range from the expected (*e.g.,* Canada, Mexico and the United

Kingdom) to the exotic (*e.g.,* Egypt and Thailand) to the rather unexpected (*e.g.,* Venezuela).

Axiomatically enough, dividends from corporations chartered in foreign jurisdictions besides those currently included in the Treasury's list of 57 do not qualify to be taxed to their recipients at the favorable rates. Notwithstanding, the Treasury has publicized its intention to continually update this list as appropriate[17] and thus it is imperative for practitioners to always seek the latest official guidance on this particular matter.

Foreign Tax Credit Considerations

The FTC mechanism, as applicable to dividends, particularly qualified dividends, from foreign corporations, bears special considerations for U.S. owners of foreign businesses and their tax advisors alike. Consider that a USI would likely be taxed abroad were the USI to carry on a trade abroad as a sole proprietor. USI could generally credit the foreign income taxes against the U.S. tax liability on their foreign source income.[18] Suppose instead that USI operates a trade abroad through a foreign corporation. Normally, the earnings of the foreign corporation are unexposed to U.S. taxation because the income is foreign source and is earned by a foreign person. Consequently, USI is not entitled to a FTC in the United States. Nonetheless, once the foreign corporation makes a dividend distribution to USI, they could generally credit the foreign income taxes withheld from, or otherwise levied on, the dividend income in their hands.[19]

Income Categorization

This brings us to the question of income categorization of the foreign dividends for FTC purposes. Determining the appropriate categorization of the income is a necessary first step because the law requires the computation of the FTC limitation for each separate category of foreign source income.[20] Dividends are generally categorized as passive category income.[21] However, it is critical for tax practitioners to know that the general rules for income categorization are inapplicable in cases where a USI owns at least 10 percent of the voting stock of a foreign corporation.[22] This minimum ownership mark is virtually always met by USI owners of closely-held foreign businesses.

Instead such a USI is required to "look through" any distributions of items of income to the distributing foreign corporation's underlying income, *i.e.,* the income items continue to retain their categorization in the hands of the USI as if the USI directly, and not indirectly through a foreign corporation, earned and received the items of income.[23] There is, therefore, a preservation of the symbolic order upon categorical inheritance by the items of income upon transfer. Looking through the distributions to the underlying income of the foreign corporation is a gesture of symbolic exchange wherein the USI first forms a foreign legal entity to transact business abroad, and then the USI—the true business operative—upon receipt of the income assumes the foreign entity's income categorization upon oneself. In this regard, dividend distributions from the USI's foreign business would most likely be categorized as general, not passive, category income in the hands of the USI.

Treating a shareholder's foreign dividends solely under the same rules and assumptions applicable to purely domestic dividends is improper and will inevitably translate into U.S. income tax noncompliance on behalf of the shareholder.

Obviously, simply relying on perfunctory knowledge of the general categorization rules will cause noncompliance and invariably create exposure on behalf of the USI. Compliance oriented tax practitioners who rely heavily on tax preparation software are most likely particularly vulnerable to habitual malpractice in connection with this issue.

Technical Complexities

Irrespective of categorization, foreign qualified dividends introduce technical complexities to the FTC mechanism. Before delving straight into the adjustments required to the FTC calculation upon receipt of foreign qualified dividends, it will be helpful to briefly discuss the limitations built into the FTC mechanism.

Most thoughtful tax generalists will no doubt point out that the FTC mechanism functions to reduce or eliminate the possibility of double taxation. However, most practitioners will probably not readily conceive that the FTC mechanism inconspicuously achieves yet another goal all at once: to ensure that the United States preserves its right and ability to tax the income that it is entitled to tax. The FTC mechanism is thus not a simple embodiment of taxpayer welfare. It instead dualistically encapsulates both relief and imposition that belong to a long line of pro-taxpayer provisions stretching from the partial exemption

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of social security benefits to the eventual taxation of distributions from a traditional individual retirement account. To this effect, the FTC is subject to a slew of limitations designed to route funds from the taxpaying public to the government's coffers.[24] An elementary limitation of the FTC is that it cannot go beyond the excesses of the lesser of the following two amounts:

- The foreign taxes paid or accrued
- The U.S. taxes (pre-FTC) on foreign source taxable income[25]

Computationally, the basic FTC limitation is derived as follows:[26]

$$\frac{\text{Foreign source taxable income} \times \text{U.S. tax on worldwide taxable income (pre-FTC)}}{\text{Worldwide taxable income}}$$

Considering both the limitation formula above and the fact that qualified dividends are taxed at the favorable net capital gains tax rates, one should realize that computing the FTC limitation for each separate category of foreign source income using a given USI's tax liability for a given year would result in an artificially-inflated FTC limitation. This unintended benefit would result because the ultimate U.S. tax liability of a USI in a given year would include taxes levied on items of income for which the tax rates would be higher than those applicable to foreign qualified dividends. In essence, statically following the formulaic approach would artificially inflate the amount of the pre-FTC U.S. taxes attributable to foreign qualified dividends. Resultantly, in the absence of any modifications to the FTC limitation formula, USIs would be able to claim a larger FTC than they would be properly entitled to by crediting foreign taxes against U.S. taxes levied on U.S. source income.

To remedy this discrepancy, the law imposes yet another limitation on the FTC computation. It effectuates this result by requiring[27] USIs to reduce their numerator by the rate differential applicable to qualified dividends.[28] Accordingly, USIs whose foreign qualified dividends are taxed at the 15- and 20-percent rates are required to multiply the amount of their foreign qualified dividends in each separate category by 0.3788 and 0.5051, respectively, and use the resulting amounts as their foreign qualified dividends for purposes of computing their categorical FTC limitation.[29] Untaxed (*i.e.,* taxed at the zero-percent rate) foreign qualified dividends are simply disregarded for FTC computation purposes.[30] The rate differential also has a corresponding effect on the denominator of the FTC formula, *i.e.,* USIs must reduce their denominator by the rate differential as well.[31]

The consequence of these adjustments is that it produces the effect of a single tax rate by lowering the amount of preferably taxed income going into the FTC limitation formula to reflect more precisely the actual U.S. tax on that income. These adjustments accomplish this goal in an imprecise way as they are applied on the basis of a USI's highest applicable tax rate rather than the USI's actual effective tax rate on their ordinary taxable income.[32] However, this slight transgression is purely formal: it lies in the operation of the law without producing an ultraprecise legislatively intended result. Nonetheless, in the grand scheme of things, the adjustments pragmatically represent legislative aims and intents without unduly burdening taxpayers with mathematical theatrics.[33]

Conclusion

Dividend distributions from the foreign businesses of USIs trigger myriad international tax consequences. Some other tax consequences, not discussed herein, include procedures for claiming favorable foreign country withholding rates pursuant to applicable international tax treaties, deemed dividends triggered pursuant to an anti-deferral regime,[34] the extent of the applicability of the net investment income tax, impact on the USI's basis in his or her stock of the foreign corporation and so on. Needless to say, this article is obviously not a treatise on this subject and should certainly not be relied upon as a practice guide. Of course, any tax practitioner intending to serve a U.S. owner of a foreign business must necessarily develop a firm understanding of the U.S. international tax regime. This piece is simply an elucidation of the two most common issues that mystify general tax practitioners with the goal of helping them to develop an appreciation for, and inspiring them to further their understanding about, the practice of international taxation.

ENDNOTES

1 Under the current default rules, foreign business entities are automatically classified as corporations if their owners enjoy limited liability. Reg. §301.7701-3(b)(2)(i).

2 The foreign corporations referred to herein should be construed as "controlled foreign corporations" within the meaning of Code Sec. 957(a).

3 This article explores the taxation of U.S. individual shareholders—not U.S. parent business entity shareholders, the taxation of which could be altogether different.

4 Form 1099-DIV, in a domestic context, characterizes dividends as ***ordinary dividends*** and ***qualified dividends***. The term "ordinary dividends" includes both qualified and nonqualified dividends. It is highly unlikely for foreign corporations to issue Forms 1099-DIV to their U.S. shareholders.

5 Net capital gains are the excess of net long-term capital gains over net short-term capital

losses. Code Sec. 1(h)(1).

[6] Code Sec. 1(h)(11).

[7] The net capital gains tax rate for individuals is 20 percent for taxpayers in the 39.6-percent regular income tax bracket; 15 percent for the 25-, 28-, 33- or 35-percent regular income tax brackets; and zero percent for the 10- or 15-percent regular income tax brackets. Code Sec. 1(h)(1).

[8] Beyond the two requirements discussed herein, there are two additional requirements that will not be discussed as they pertain to foreign stock ownership *vis-à-vis* portfolio investment, and not as a consequence of business ownership. The first requirement mandates that dividends must be paid by a foreign corporation whose stock is publicly listed on an established U.S. securities exchange. The second requirement is that dividends must be paid to shareholders who do not hold long and short positions in the stock. Code Secs. 1(h)(11)(C)(ii) and 1(h)(11)(B)(iii)(II).

[9] Code Sec. 1(h)(11)(B)(iii).

[10] *Id.*

[11] Code Sec. 246(c)(3)(A).

[12] Code Sec. 1(h)(11)(B)(i).

[13] Code Sec. 1(h)(11)(C)(i)(I).

[14] Code Sec. 1(h)(11)(C)(i)(II).

[15] Notice 2011-64, 2011-37 IRB 231.

[16] *Id.*

[17] *Id.*

[18] Code Sec. 901, subject to certain limitations, allows for a direct foreign tax credit in such situations.

[19] U.S. individual, partnership and S-corporation shareholders are not entitled to claim the indirect foreign tax credit allowable only to C-corporation shareholders upon the receipt of a dividend under Code Sec. 902. The indirect foreign tax credit essentially enables a domestic C-corporation shareholder to claim a credit for taxes paid by the foreign subsidiary with respect to the income used to make the dividend payment.

[20] Code Sec. 904(d).

[21] Code Sec. 904(d)(2)(A)(i).

[22] Code Sec. 904(d)(3).

[23] *Id.*

[24] Code Sec. 904.

[25] Code Sec. 904(a).

[26] A USI's taxable income is computed without any deduction for personal exemptions. Code Sec. 904(b)(1).

[27] The regulations provide a safe harbor for certain noncorporate taxpayers with a limited amount of foreign qualified dividend and net capital gains income. *See* Reg. §1.904(b)-1(b)(3).

[28] Code Sec. 904(b)(2)(B)(i); Reg. §1.904(b)-1(c)(1).

[29] Instructions, Form 1116 (2015), at 7.

[30] *Id.*

[31] Code Sec. 904(b)(2)(B)(ii); Reg. §1.904(b)-1(c)(2).

[32] Suringa, 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904*.

[33] Arriving at a precise FTC limitation would require taxpayers to first separately calculate their U.S. tax liability on both their ordinary income and foreign qualified dividends. They would then have to calculate their unique rate differential to appropriately adjust the numerator and denominator of their FTC limitation formula.

[34] The anti-deferral regime applicable to CFCs is subpart F. *See* Code Sec. 952.

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