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Funaro Confirms Tax Reporting Rules for Controlled Foreign Corporations

Repeal of Internal Revenue Code Section 958(b)(4)

The Tax Cut and Jobs Act (the **"TCJA"**) of 2017 greatly expanded the potential scope of the controlled foreign corporation (**"CFC"**) regime. A CFC is a foreign corporation in which US shareholders own, directly, indirectly, or constructively, more than 50% of the stock of such foreign corporation. Generally, a US person, including a corporation, who owns 10% or more of the stock of a foreign corporation (a "US shareholder") is required to file Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*) to report their ownership interest in, and certain tax and financial information about, any CFC in which they are a US shareholder. Failure to file Form 5471 in a timely manner can result in a penalty of $10,000 per Form 5471 and cause the statute of limitations not to run on the US shareholder's Federal income tax return.

In particular, the TCJA repealed Internal Revenue Code ("**IRC**") Section 958(b)(4), which had prevented "downward" ownership attribution of stock from foreign corporations to United States ("**US**") corporations. As a result of this repeal, a US subsidiary of a foreign corporation is deemed to own stock owned by its foreign parent, including the stock of the foreign parent's foreign subsidiaries. Under the TCJA, a foreign affiliate with no direct US ownership, may be treated as a CFC of its US affiliate.

Impact of the Repeal

The impact of TCJA's repeal of IRC §958(b)(4), is reflected in the following example:

If an Italian corporation ("**ITCO**") directly owns (i) 100% of a US corporation ("**USCO**"); (ii) 100% of a Luxembourg corporation ("**LUXCO**"); and (iii) 30% of a Singapore corporation ("**SINGCO**"), then USCO, through its Italian parent, is now deemed to own 100% of LUXCO and 30% of SINGCO. As a result, USCO in this example is considered a US shareholder of both of its foreign affiliates, and LUXCO would be considered a CFC (i.e., because ITCO owns more than 50% of LUXCO). Assume further, that no US person owns any stock of ITCO. This would mean that if there was no exemption, USCO would have to prepare and file a Form 5471 for LUXCO.

Consider a foreign parent that has subsidiaries throughout the world, including a US subsidiary. Without an exemption, the US subsidiary would be required to obtain voluminous financial information from its foreign parent and prepare a substantial number of Forms 5471. As indicated above the cost of not filing required Forms 5471 in a timely manner can be significant.

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Internal Revenue Service Attempts at Relief

The US tax community heavily criticized the new "downward attribution" regime resulting in several Internal Revenue Service ("**IRS**") efforts to mitigate the harshness of the new rules. In Notice 2018-13, the IRS exempted US corporations from having to file Form 5471 with respect to foreign corporations that are CFCs solely because of downward attribution and where there is no US shareholder that directly or indirectly owns stock of the CFC (the **"Exemption"**). For instance, in the example above, USCO would qualify for the Exemption and would not have to prepare and file Form 5471. In Rev. Proc. 2019-40, the IRS provided other limited relief from filing Form 5471 (i.e., filling out only designated parts of the Form 5471) if such US persons are US shareholders because of Downward Attribution, but the requirements of the Exemption are not met (the **"Limited Relief"**).

Internal Revenue Service Practice Unit Causes Concern

While the coordination between the Limited Relief and Exemption provisions arguably has been vague and even confusing, an IRS Practice Unit ("**IPU**") issued in August 2022 seemed to undermine the application of the Exemption provision. Although an IPU is not an official pronouncement of law, nor can it be cited as precedent, it does provide insight as to the training tax auditors are receiving or, in this case, the application of the downward attribution rules for purposes of the Form 5471 filing requirements.

The IPU included an example where a foreign parent corporation owned a chain of foreign subsidiaries and also a US subsidiary (basically the fact pattern of the Example above). The US subsidiary did not directly, or indirectly, own any interest in any of the foreign corporations in the chain, but due to downward attribution, the US subsidiary was a "US shareholder" and therefore, as the result of downward attribution, all of the foreign subsidiaries were CFCs.

The IPU example made no mention of the Exemption. The IPU indicated that the US subsidiary must file IRS Form 5471 for each of the CFCs, but only on a Limited Relief basis. However, nowhere in the example was it indicated whether the foreign parent had any US shareholders suggesting either: (i) the example assumes the presence of US shareholders of the foreign parent, or (ii) the presence or absence of US shareholders of the foreign parent is irrelevant to the analysis.

Funaro Confers with Internal Revenue Service Expert

Funaro contacted the Subject Matter Expert ("**Expert**") at the IRS to discuss our concerns about the IPU example. The Expert agreed and mentioned that several other members of the US tax community voiced similar concerns. The Expert agreed that if in the example there was no US shareholder that there would be no requirements to prepare and file a Form 5471 (i.e., the Exemption would apply). The Expert also indicated that the IPU example would be corrected, and the Form 5471 Instructions would clarify that the Limited Relief provision applies where the Exemption does not apply.

We will continue to monitor both the Form 5471 Instructions and the IPU to confirm that such changes are indeed made.

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If you have any questions or would like additional information on the topics covered in this alert, please contact your engagement partner.

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