Foreign Tax Credit Planning With Losses
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High Basis—Low Value Stock
Granite Trust Transaction

**Facts**

USP’s basis in the shares of CFC1 exceeds the FMV of CFC1. Thus, there is a $100 built-in-loss in the CFC1 shares.

USP transfers 25% of the CFC1 stock to CFC2 in exchange for NQPS.

CFC1 liquidates (actual or CTB liquidation).

**Anticipated Results**

USP realizes $25 capital loss on the transfer of the CFC1 shares to CFC2 in exchange for NQPS. This loss is deferred under §267(f). TD 9583 (4/20/2012).

USP realizes and recognizes a $75 capital loss on the taxable liquidation of CFC1. See, e.g., Granite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1956) (concluding that §332 is elective in nature).
Technical Considerations

Is the liquidation of CFC1 an upstream “C” reorganization into USP?

Does USP acquire “substantially all” of CFC1’s assets? Does the nature of the CFC1 assets transferred to CFC2 impact this analysis?

What ownership percentage in CFC1 does USP need to transfer to CFC2 in order to ensure the substantially all requirement is not satisfied? The greater amount of stock transferred results in more loss being deferred under §267(f).

If CFC1 is a holding company owning stock in more than one controlled subsidiary, can §355 apply to disallow the loss (tax-free split-up)?

Does the nature of USP’s divesture of the CFC1 shares to bust the §332 control requirement impact the analysis?

If CFC uses cash, does the application of §304 matter (NQPS avoids the application of §304)?

Can the economic substance doctrine apply to disallow the loss?
Stock Loss Transactions: Foreign Owner

Facts

Same basic facts as the previous example except that the transferor is also a CFC.

Anticipated Results

Loss is recognized for E&P purposes.

Loss may reduce current year E&P or otherwise result in an overall E&P deficit that can be used in later years (see, e.g., deficit planning opportunities in later slides).

Watch for §952(c) recapture potential.

E&P in CFC1 is eliminated because the liquidation is not described in §381.

Granite Trust Transaction

CFC-P

① 25% S1 Stock

FV: $100
AB: $200*

CFC2

CFC1

Liquidation

②

* Assumes each share has uniform basis.
E&P Deficit Planning for CFCs
The E&P deficit planning addressed herein is focused on the following two common scenarios:

1. **A CFC with an accumulated E&P deficit begins to generate positive E&P**
   - This may happen because the CFC’s business has become profitable or because U.S. E&P deductions (e.g., amortization or interest deductions) have expired
   - Foreign taxes paid on the CFC’s earnings are “trapped” because Post-86 Undistributed Earnings are negative
   - Distributions by the CFC could give rise to taxable dividends (i.e., a nimble dividend) with no foreign tax credit offset
   - Deficit planning could allow “trapped” taxes to become accessible

2. **A CFC has an accumulated E&P deficit with no current expectation the E&P deficit will reverse in the future**
   - The CFC’s E&P deficit may be available to offset earnings generated in related companies, optimizing the overall FTC position of the group
Hovering Deficit Rules

- A hovering deficit arises when two foreign corporations engage in a transaction in which E&P and taxes carry over under §381 and either corporation has a deficit in Post-86 Undistributed Earnings in one or more FTC baskets
  - The deficit and associated taxes hover and can only be offset by earnings “accumulated” after the §381 transaction in the same basket; taxes are released proportionately as the deficit is earned out
  - There may be a hovering deficit in a basket even if overall E&P available for distribution under §316 is positive
  - Earnings are treated as being “accumulated” if the earnings are not distributed or deemed distributed (e.g., under subpart F) during the taxable year earned
  - Hovering deficit rules apply even if both corporations have a deficit in the same FTC basket
  - Certain exceptions for qualified deficits and chain deficits under §952(c)
Nimble Dividends and Trapped Taxes

**Facts**
- CFC1 is expected to generate $20 of U.S. E&P each year
- Due to the pre-existing accumulated E&P deficit, it will take 6-years to earn out of the accumulated deficit
- CFC1’s earnings are subject to foreign tax (e.g., the prior E&P deficit resulted from deductions for U.S. E&P purposes only)

**Expected Results**
- In 2013, a distribution from CFC1 would result in a taxable dividend to the extent of current year E&P (i.e., a nimble dividend)
- Post-86 Undistributed Earnings has a deficit balance (($100)). As such, distributions by CFC1 will not carry foreign taxes
- Based on the assumed earnings of $20 each year, USP could not access foreign tax credits in CFC1 until 2019 (or later, if current E&P is distributed)

As of 12/31/13
AEP ($120)
CEP $20
Post-86 E&P ($100)
Post-86 Taxes $40

As of 12/31/13
AEP $200
CEP $100
Post-86 E&P $300
Post-86 Taxes $0

All E&P is assumed to be general limitation earnings.
Nimble Dividends and Trapped Taxes – Movement of E&P into CFC1

Facts

- CFC2 has Post-86 Undistributed Earnings of $300, which is equal to its E&P available for distribution under §316
- CFC2 incurs no foreign taxes on its earnings
- CFC2 distributes $110 to CFC1. This distribution does not result in subpart F income (e.g., §954(c)(6))

Expected Results

- The $110 distribution from CFC2 increases CFC1’s current year E&P to $130
- Likewise, the current year E&P of $130 offsets the deficit in Post-86 Undistributed Earnings, resulting in a positive balance of $10
- CFC1 can make a distribution of $10, equal to the amount of its Post-86 Undistributed Earnings, which will carry all $40 of Post-86 Taxes
- Going forward, because CFC1 no longer has a deficit in Post-86 Undistributed Earnings, CFC1 can make annual distributions that carry foreign taxes
- Planning is more difficult if CFC2 is not directly held by CFC1 (e.g., step transaction risks)
Facts

- Over the next 5-years, CFC1 expects to earn $20 of E&P and pay $5 of foreign taxes annually.
- On January 1, 2014, for valid business reasons, CFC2 merges into CFC1 in a transaction that qualifies as a reorganization under §368(a).

Expected Results

- As of January 1, 2014, CFC1 has an accumulated E&P deficit of ($100) and a deficit in Post-86 Undistributed Earnings of ($100).
- CFC1’s ($100) deficit in Post-86 Undistributed Earnings hovers and is excluded from Post-86 Undistributed Earnings and §316 E&P. CFC1’s $40 of Post-86 Taxes also hover and is released proportionally as the ($100) deficit is earned out.
- The reorganization results in a “fresh start” for CFC1’s Post-86 Undistributed Earnings, allowing CFC1 to make post-merger distributions that carry foreign taxes.
- The hovering deficit only solves for taxes incurred post-merger that would otherwise have been trapped due to a deficit in Post-86 Undistributed Earnings. The $40 of historic taxes remain trapped until the hovering deficit is earned out.
### E&P Deficit Offset

**Facts**
- CFC2 has Post-86 Undistributed Earnings of $250, which is equal to its E&P available for distribution under §316.
- CFC2’s E&P has an ETR of approximately 23%.
- CFC1 has an E&P deficit of ($200) and it is not expected to earn out of the deficit.
- CFC2 distributes $250 to CFC1. This distribution does not result in subpart F income (e.g., §954(c)(6)).

**Expected Results**
- The $250 distribution from CFC2 increases CFC1’s current year E&P to $250.
- Likewise, the current year E&P of $250 offsets the deficit in Post-86 Undistributed Earnings, resulting in a positive balance of $50.
- CFC1 can make a distribution of $50, equal to the amount of its Post-86 Undistributed Earnings, which will carry all $75 of Post-86 Taxes (which moved from CFC2 to CFC1).
- A $50 distribution from CFC1 will carry foreign taxes with an ETR of approximately 60%.
- Planning is more difficult if CFC2 is not directly held by CFC1 (e.g., step transaction risks).

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**USP**

**As of 12/31/13**
- AEP ($200)
- CEP $0
- Post-86 E&P ($200)
- Post-86 Taxes $0

**CFC1**

**As of 12/31/13**
- AEP $200
- CEP $50
- Post-86 E&P $250
- Post-86 Taxes $75

**CFC2**

$250

All E&P is assumed to be general limitation earnings.
Hovering Deficit Traps for the Unwary
### Facts
- On December 31, 2013, for valid business reasons, CFC1 merges into CFC2 in a transaction that qualifies as a reorganization under §368(a).
- Prior to the merger, the maximum dividend USP could receive, from both CFC1 and CFC2, is $200, equal to the $200 of §316 E&P in CFC1.

### Expected Results
- Under §381, there would be no hovering deficit created because neither CFC1 nor CFC2 has a deficit in §316 E&P. Generally, CFC1’s $200 of E&P would be inherited by CFC2.
- However, under Reg. §1.367(b)-7, the hovering deficit rules are applied by basket. Because CFC1 has a ($100) deficit in the general basket, this amount becomes a hovering deficit and is removed from Post-86 Undistributed Earnings and §316 E&P.
- CFC2 inherits $300 of E&P from CFC1 (all in the passive basket), causing $100 of “springing” E&P because of the removal of the general basket deficit from E&P.
- The total E&P available for distribution becomes $300.
Facts

- On December 31, 2013, for valid business reasons, CFC1 merges into CFC2 in a transaction that qualifies as a reorganization under §368(a)

Expected Results

- If CFC1 distributed $200 to USP prior to the merger, the ($100) deficit in its passive basket would offset the positive balance in the general basket, leaving a balance of $200. See Reg. §1.960-1(i)(4)
- Because the $200 dividend is sourced entirely from the general basket E&P, the distribution carries all $60 of taxes
- The ($100) passive deficit would carry over, as a passive deficit, to the next taxable year
- As a result of the merger, the passive basket deficit becomes a hovering deficit and is removed from Post-86 Undistributed Earnings and §316 E&P, leaving CFC with §316 E&P of $300
- In order to access all $60 of Post-86 Taxes, CFC2 would need to distribute $300. This is because the ($100) passive deficit is not available to “offset” the general basket E&P under Reg. 1.960-1(i)(4)
Facts
• CFC2 liquidates into CFC1 on 6/30/13. CFC2’s ($500) E&P deficit hovers and can only be offset by earnings accumulated after the liquidation.
• CFC3 distributes $500 to CFC1 on 9/30/13, which brings up $200 of §902 taxes. Assume the distribution is CFC1’s only current year income and is not subpart F income.

Expected Results
• Under Reg. §1.367(b)-7(f)(5)(i), earnings in the year of the §381 transaction are deemed to accumulate ratably over the entire year.
• Thus, although the $500 dividend is received after the §332 liquidation on 6/30/13, only 50% (because the liquidation was mid-way through the year) of the earnings are treated as accumulated after the §381 transaction and available to be offset by the hovering deficit.
• As of the beginning of 2014, CFC1 has a ($250) hovering deficit (in the general basket) and $50 of hovering taxes.
Thank you