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subject: Application of Section 245A(a) to Dividends Received by a CFC

This memorandum provides non-taxpayer-specific legal advice regarding the application of section 245A(a) of the Internal Revenue Code (the "Code"). This advice may not be used or cited as precedent.

FACTS

USP is a domestic corporation, and FC1 and FC2 are foreign corporations. USP wholly owns FC1. FC1 is a controlled foreign corporation (within the meaning of section 957(a)) ("CFC"). FC1 owns 45% of the single class of stock of FC2, and the remaining stock of FC2 is owned by a nonresident alien individual. FC2 is not a CFC but is a specified 10-percent owned foreign corporation (within the meaning of section 245A(b)) ("SFC").

FC1 receives a dividend from FC2 (the "FC2 Dividend"). FC1 would be allowed the deduction under section 245A(a) with respect to the FC2 Dividend if FC1 were a domestic corporation.

ISSUE

Is FC1 allowed a deduction under section 245A(a) for the FC2 Dividend?

CONCLUSION

No, section 245A(a) does not allow a deduction to FC1 for the FC2 Dividend.

LAW AND ANALYSIS

A. Application of plain language of section 245A(a) to foreign corporations

Section 245A(a) generally allows a deduction (the "section 245A DRD") for the foreign-source portion of a dividend received "from [an SFC] by a domestic corporation which is a United States shareholder with respect to such foreign corporation." Section 951(b) provides that, for purposes of the Code, the term United States shareholder means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) that satisfies certain ownership requirements. Thus, the plain language of section 245A(a) requires that (i) the recipient of the dividend from an SFC be a domestic corporation, and (ii) the domestic corporation be a United States shareholder with respect to the SFC.[1]

Because FC1 is neither a domestic corporation nor a United States shareholder with respect to FC2, the analysis of the issue ends there and FC1 is not allowed the section 245A DRD for the FC2 Dividend.

In fact, the reading of section 245A(a) to allow a section 245A DRD for a CFC would render the use of the word "domestic" in the statute surplusage, and under a "cardinal principle of statutory construction," statutes are to be interpreted to give effect to every word of the statute.[2] The use of the word "domestic" in section 245A(a) contrasts with the language of sections 243(a) and 245(a), each of which allows a deduction for a dividend received by a "corporation" without specifying that the corporation need be domestic. Thus, unlike section 245A(a), sections 243(a) and 245(a) provide dividends received deductions to both domestic and foreign corporations.[3] Had Congress wanted to provide a section 245A DRD to both domestic and foreign corporations, it could have used language analogous to sections 243 and 245.[4] Instead, section 245A(a) specifically requires a *domestic* corporation that is a United States shareholder, and that word must be given its plain meaning.

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[1] These are not the only requirements to qualify for a section 245A DRD, but these are the requirements relevant to the analysis of the issue addressed in this Memorandum.

[2] *Williams v. Taylor*, 529 U.S. 362, 364 (2000). *See also Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991) ("But of course we construe statutes, where possible, so as to avoid rendering superfluous any parts thereof.")

[3] Section 245(b) also provides special rules for certain dividends received by a "domestic corporation" from a "foreign corporation."

[4] *See BFP v. Resolution Trust Corp*., 511 U.S. 531, 537 (1994) ("[I]t is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another…") (quoting *City of Chicago v. Envtl Def. Fund*, 511 U.S. 328, 338 (1994)).

Arguments have been raised, however, that the broader statutory context that includes section 245A(a) or the legislative history of section 245A – in particular, Footnote 1486 (as defined and discussed in section C) – either alone or in connection with §1.952-2, changes this conclusion and permits a CFC to claim the section 245A DRD. The remainder of this Memorandum addresses these potential arguments, none of which is sufficient to override the statutory language of section 245A(a).

B. Whether other statutory provisions change the plain language interpretation of section 245A(a)

In general, courts may use the context of a statutory provision to interpret the words of that statute, with a view towards a reading creating a "harmonious whole."[5] A potential line of argument therefore could assert that the broader statutory framework that includes section 245A(a) indicates that a CFC is allowed the section 245A DRD and thus that section 245A(a) should be read to create this result. This potential argument looks to the language of sections 245A(e)(2) and 964(e)(4), two provisions that were enacted at the same time as section 245A(a), to imply that section 245A(a) should be interpreted contrary to its plain language. However, neither of these sections changes the reading of section 245A(a) described in section A.

Section 245A(e)(2) provides that, in the case of a "hybrid dividend" received by a CFC from another CFC where the same domestic corporation is a United States shareholder of each CFC, the hybrid dividend gives rise to subpart F income of the receiving CFC, and the domestic corporate United States shareholder includes its pro rata share of that amount in its gross income. Section 245A(e)(4) defines a hybrid dividend as an amount received from a CFC "for which a deduction would be allowed under [section 245A(a)]" but for section 245A(e). Thus, the argument would assert that the reference to "hybrid dividend" in section 245A(e)(2), which is defined in part as an amount received for which a deduction would be allowed under section 245A(a), means that a CFC must be allowed the section 245A DRD.

Section 245A(e)(2), however, does not depend on the application of section 245A(a) to a CFC.[6] The better interpretation of section 245A(e)(2) is that it applies based on whether a section 245A DRD would be allowed if the recipient were a domestic corporation. Indeed, regulatory guidance clarifies this interpretation of "hybrid dividend" for purposes of section 245A(e)(2) and gives effect to section 245A(e)(2) by treating the hybrid dividend as subpart F income for the recipient CFC without requiring that CFC be allowed the section 245A DRD.[7] The statutory language of section 245A(e), therefore,

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[5] *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) (quoting *FTC v. Mandel Bros., Inc.*, 359 U.S. 385, 389 (1959)).

[6] Indeed, the legislative history describes section 245A(e)(2) as an exception to the application of section 954(c)(6) and makes no mention of section 245A(a). H.R. Rep. No. 115-466, at 600 (2017).

[7] Section 1.245A(e)-1(c)(2) defines a tiered hybrid dividend as an amount received by a CFC from another CFC that would be a hybrid dividend if "the receiving CFC were a domestic corporation."

does not have any implications for interpreting section 245A(a), which should be read consistently with its plain language.

Section 964(e)(1) provides that if a CFC sells or exchanges stock in another foreign corporation, any resulting gain is included in the CFC's gross income as a dividend to the same extent that it would have been so included under section 1248(a) if the CFC were a United States person. Section 964(e)(4)(A) treats the foreign-source portion of the gain treated as a dividend under section 964(e)(1) as subpart F income of the selling CFC for purposes of section 951(a)(1)(A). A United States shareholder of such a selling CFC includes in gross income under section 951(a)(1)(A) its pro rata share of such subpart F income and may be allowed a section 245A DRD for that amount "in the same manner as if such subpart F income were a dividend received by the shareholder from the selling [CFC]." Thus, a potential argument would assert that it would be incongruous for Congress not to have provided a section 245A DRD for actual dividends received by a CFC from a non-CFC SFC while allowing a section 245A DRD to a United States shareholder for an amount treated as a dividend by reason of section 964(e)(4)(A) in the case of a sale or exchange by a CFC of stock of a foreign corporation.

This argument is incorrect: there is no incongruity between the application of sections 964(e)(4)(A) and 245A(a) in these types of fact patterns, and the comparison asserted is asymmetrical and flawed. That is, section 964(e) does not apply to sales or exchanges of the stock of foreign corporations that are not and never were CFCs, meaning that gain recognized on such a sale or exchange would not produce a section 245A DRD, which is consistent with not treating dividends received by a CFC from such entities as giving rise to a section 245A DRD. The text and application of section 964(e)(4)(A), therefore, does not have any implications for interpreting section 245A(a), which should be read consistent with its plain language.[8]

Another potential argument would focus on section 964(e)(4)(B), which provides that rules similar to the rules of section 961(d) shall apply to the sale by a CFC of stock in another foreign corporation. Section 961(d) provides a special rule that, in general, reduces basis of stock of an SFC held by a domestic corporation, solely for purposes of determining loss on a disposition of such stock, if the domestic corporation received a section 245A DRD with respect to the stock. Thus, this argument would assert that

[8] Even in cases where a DRD would be allowed under 964(e)(4), such as a CFC selling the stock of another CFC, the treatment under 964(e)(4) would not affect the interpretation of section 245A(a). While there are some similarities between the two provisions, the text and application of section 964(e)(4) cannot be interpreted as changing the clear general operation of section 245A(a). These are different Code sections that apply to different transactions and have different mechanics (a deduction to the recipient of a dividend in the case of section 245A versus a deduction to the U.S. shareholder of the recipient of a deemed dividend in the case of section 964(e)(4)), and therefore may appropriately give rise to different results. Congress may have simply intended different results for an actual dividend as compared to a deemed dividend as is the case, for example, for an actual dividend being eligible for the same-country exception under section 954(c)(3)(A), whereas a deemed dividend under section 964(e) cannot qualify for this exception as provided under section 964(e)(2).

section 961(d) applies directly to the selling CFC and, logically, the CFC must be allowed the section 245A DRD for "rules similar to the rules of section 961(d)" to apply.

However, section 964(e)(4)(B) does not depend on the application of section 245A(a) to a CFC. That is, section 964(e)(4)(B) operates to limit a loss with respect to the stock of a selling CFC that may otherwise benefit its United States shareholders when such United States shareholders have benefitted from a section 245A DRD under section 964(e)(4)(A)(iii). Section 964(e)(4)(B), therefore, does not require interpreting section 245A(a) contrary to its plain language.

C. Legislative History

1. Conference Report and footnote 1486

Potential arguments for allowing the section 245A DRD for dividends received by CFCs may also look to the legislative history of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2208 (December 22, 2017) (the "Act"). The Act's conference report (the "Conference Report") explains that section 245A, which was added to the Code by the Act, allows an "exemption for certain foreign income by means of a 100-percent deduction for the foreign-source portion of dividends received from [SFCs] by domestic corporations."[9] A footnote ("Footnote 1486") to the phrase "domestic corporations" then adds the following:

> Including a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See Treas. Reg. sec. 1.952-2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income.[10]

Footnote 1486, therefore, suggests that CFCs are allowed a section 245A DRD; but that result is contrary to the statutory language of section 245A(a). The starting point for interpreting a statute is the statute itself, and when that statutory language is clear and unambiguous, a court will apply the plain meaning of that language.[11] Section 245A(a) is clear and unambiguous in identifying the type of taxpayer to which it applies.

Additionally, Footnote 1486, as noted above, cites to §1.952-2(b)(1) in support of its conclusion that "a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect

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[9] H.R. Rep. No. 115-466, at 598-99 (2017).
[10] *Id*., at 599, fn. 1486.
[11] *Connecticut National Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("In any event, canons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one, cardinal canon before all others. We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there.").

to such income." But this conclusion appears to rest on a misapplication of §1.952-2. Although §1.952-2(b) provides a basis for treating a CFC receiving a dividend as a domestic corporation for purposes of calculating its taxable income, that treatment is not absolute, and further, §1.952-2(c) specifically provides that the CFC is *not* treated as a United States shareholder, thereby precluding the CFC from meeting the requirements of section 245A(a).

2. Section 1.952-2

a. In general

Section 952 defines "subpart F income", which is certain income of a CFC that gives rise to an inclusion in a United States shareholder's gross income on an annual basis under section 951. Section 952 enumerates categories of income (that are further defined in other sections, such as sections 953 and 954) that comprise subpart F income but does not provide specific computational rules for determining the amounts of these categories of income. For purposes of computing the different types of foreign base company income (one of the categories of subpart F income), section 954(b)(5) provides regulatory authority to take into account deductions properly allocable to the types of income.[12] Notably, section 952 does not provide that a foreign corporation be treated as a domestic corporation in determining its subpart F income.

Section 1.952-2 thus provides rules for determining a foreign corporation's gross income and taxable income, which are relevant for purposes of determining the foreign corporation's subpart F income. For these purposes, §1.952-2(a)(1) and (b)(1) provide that a foreign corporation is generally treated as a domestic corporation taxable under section 11 and by applying the principles of sections 61 (defining gross income) and 63 (defining taxable income). The application of each of these provisions, however, is subject to the special rules of paragraph §1.952-2(c). Under §1.952-2(c)(1), the provisions of various subchapters of chapter 1 of the Code, including subchapter N, do not apply "except where otherwise distinctly expressed." Subchapter N of Chapter 1 of the Code contains the definition of a United States shareholder in section 951(b).

Sections 1.952-2(a)(1) and (b)(1) treat a foreign corporation as a domestic corporation in certain respects for a limited purpose: to calculate a measure of its gross income and taxable income to determine the foreign corporation's subpart F income and, thus, its United States shareholders' associated subpart F inclusions.[13]

[12] For example, §1.954-1 computes a CFC's foreign base company income, in part, based on categories of gross income and deductions allocated against such income.
[13] Section 1.952-2 is also used to determine tested income and tested loss for purposes of section 951A. *See* §1.951A-2(c)(2).

b. Effect of §1.952-2 on requirement that only domestic corporations are allowed a section 245A DRD

In light of the limited function of §1.952-2(b)(1) set forth above, the provision cannot override an express statutory limitation of a deduction to only domestic corporations. Because section 245A(a) expressly limits its application to domestic corporations, §1.952-2(b)(1) cannot override that statutory result to permit a foreign corporation to claim a section 245A DRD. A contrary interpretation (such as the one asserted by Footnote 1486) could create untenable results, including: (i) allowing a foreign corporation a deduction under section 250(a), which like the section 245A DRD is restricted to only domestic corporations, or (ii) causing a foreign corporation to be treated as an includible corporation (within the meaning of section 1504) for purposes of applying the consolidated return regulations to determine the foreign corporation's income, despite the specific exclusion for foreign corporations from that definition under section 1504(b)(3). These results are obviously incorrect and further demonstrate why the interpretation of §1.952-2(b)(1) suggested in Footnote 1486 is similarly incorrect.

c. Application of §1.952-2 given that only United States shareholders of an SFC are allowed a section 245A DRD

Section 245A(a), in addition to requiring that the recipient of a dividend from an SFC be a domestic corporation, also requires that the recipient be a United States shareholder of the SFC. Nothing in §1.952-2 allows a CFC that receives a dividend from an SFC to meet the United States shareholder requirement of section 245A(a). First, as described in section C.2.b, §1.952-2(b)(1) cannot override an express statutory limitation of a deduction to United States shareholders. Second, §1.952-2(c) explicitly provides that a foreign corporation is not treated as a United States shareholder for purposes of §1.952-2(b)(1).

As noted above, the special rule of §1.952-2(c)(1) provides that subchapter N (which includes section 951(b)) does not apply for purposes of calculating taxable income of a foreign corporation pursuant to §1.952-2(b)(1). Section 1.952-2(c)(1) thus precludes a CFC from being treated as a United States shareholder, and for section 245A(a) to apply, the recipient of the dividend must be a domestic corporation that is a United States shareholder.[14] Therefore, Footnote 1486 is incorrect in indicating that §1.952-2(b)(1), which is subject to §1.952-2(c)(1), would cause a CFC to be allowed the section 245A DRD.

Section 1.952-2(c)(1) contemplates that exceptions to the nonapplication of subchapter N may be provided where "distinctly expressed." One example of such a distinct expression may be found in section 964(e), which, as described above, provides that

[14] As noted above, section 951(b) defines a United States shareholder for purposes of "this title," and Congress has modified that term where appropriate (for example, in sections 898(b)(3) and 953(c)(1)(A)). Congress did not modify that term with respect to section 245A(a).

gain on certain sales or exchanges of stock of a foreign corporation by a CFC is recharacterized as a dividend to the same extent it would have been under section 1248(a) if the CFC were a United States person. Section 1248(a) is in subchapter P of Chapter 1 of the Code, and it applies only to United States persons who own, within the meaning of section 958, stock of a CFC or former CFC, as defined in section 957. Both sections 957 and 958 are in subchapter N of Chapter 1 of the Code. Thus, in the absence of section 964(e), section 1248(a) would not apply in determining the income of a CFC under §1.952-2. To change that result, Congress enacted section 964(e) (that is, a distinct expression) to provide that the principles of section 1248(a) apply to such a sale or exchange by a CFC.

In contrast, Footnote 1486 cannot reasonably be read as an authoritative distinct expression of congressional intent to allow the section 245A DRD for a CFC by overriding the normal application of §1.952-2(c)(1). It provides a conclusion both contrary to the statutory language and to the regulation it cites for support.

D. Conclusion

As a general matter, a deduction is allowed as a matter of "legislative grace" clearly reflected in the applicable statute.[15] Under the statute, a dividend received by a CFC from an SFC does not meet the terms of section 245A(a) because section 245A(a) limits the section 245A DRD to a dividend received from an SFC by a domestic corporation that is a United States shareholder of the SFC. None of section 245A(e)(2), section 964(e)(4), Footnote 1486, or §1.952-2 changes that result. Thus, FC1 is not allowed a section 245A DRD for the FC2 Dividend.

Please call Karen Li at 202-317-6937 if you have any further questions.

[15] *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed.").