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Minimizing Tax on Gain from the Sale of Stock of Latin American Controlled Foreign Corporations

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The United States currently has only two income tax treaties in effect with Latin American jurisdictions: Mexico and Venezuela. As a result, most individual taxpayers who recognize gain from the sale of stock of a controlled foreign corporation (CFC)[1] located in Latin America (other than in Mexico or Venezuela) assume that such gain will be subject to U.S. federal tax at the "non-qualified dividend" rate of 43.4 percent. Because the corporate income tax rates are so high in most Latin American countries, however, this typically will not be the case. An important limitation is provided on the amount of tax that an individual U.S. shareholder will pay when it sells stock of a CFC. This limitation is based on the amount of corporate income tax that the CFC pays in its home country, as well as a hypothetical corporate income tax that would apply if the CFC were a domestic corporation. As illustrated below, with careful analysis, this limitation can provide an individual U.S. shareholder with significant tax savings if the shareholder recognizes gain on the sale of stock of a CFC located in a high-tax jurisdiction.

Section 1248, in General

Under Section 1248(a),[2] gain recognized on a U.S. shareholder's [3] disposition of stock in a CFC is treated as dividend income to the extent of the relevant earnings and profits accumulated while such person held the stock. Where the U.S. seller is a C corporation, this conversion of gain into a dividend does not trigger any tax rate differential, because corporations, unlike individuals, are not entitled to reduced rates of tax on long-term capital gains or "qualified dividends."[4] In the case of such corporate sellers, however, the principal effect of Section 1248(a) is to permit the seller to claim an indirect foreign tax credit under Section 902 for a relevant portion of the corporate income taxes paid by the CFC.

With respect to individual U.S. shareholders who sell stock in a CFC, on the other hand, recharacterization under Section 1248(a) potentially is more significant. While long-term capital gain is taxable to such shareholders at a maximum federal income tax rate of 23.8 percent, dividends may be taxable at either that same 23.8 percent rate (in the case of "qualified dividends" from treaty-resident CFCs) or at a higher 43.4 percent ordinary income tax rate (in the case of non-qualified dividends from CFCs not resident in treaty countries). Because of this clear tax rate differential, most taxpayers expect that where individual U.S. shareholders sell stock of a CFC that is resident in a non-treaty country that those shareholders will be subject to a potential 43.4 percent tax rate on the “nonqualified” dividends when Section 1248(a) is applied.

Section 1248(b), however, provides for a ceiling on the tax liability that may be imposed on the shareholder receiving a Section 1248(a) dividend if the taxpayer is an individual and the stock disposed of is a long-term capital gain asset (i.e., a capital asset that the taxpayer has held for more than one year). The Section 1248(b) ceiling consists of the sum of two amounts. The first amount is the U.S. income tax that the CFC would have paid if the CFC had been taxed as a domestic corporation, after permitting a credit for all foreign and U.S. tax actually paid by the CFC on the same income (the “hypothetical corporate tax”). For example, if a CFC has $100 of income and pays $5 of foreign taxes, and assuming the CFC would be in the 35 percent income tax bracket for U.S. federal income tax purposes under Section 11 based on its taxable income levels, the hypothetical corporate tax would be $30 ($35 U.S. tax minus a $5 foreign tax credit).

The second amount is the addition to the taxpayer’s U.S. federal income tax for the year that results from including in gross income as long-term capital gain an amount equal to the excess of the Section 1248(a) amount over the hypothetical corporate tax (the “hypothetical shareholder tax”). Continuing with the same example and assuming the shareholder’s gain on the sale is $100, this hypothetical shareholder tax would be 23.8 percent of $65 ($95 Section 1248(a) dividend [after reducing earnings and profits by the $5 foreign taxes] less the hypothetical corporate tax of $30), or $15.47.

Adding together the hypothetical corporate tax and the hypothetical shareholder tax in this example thus yields $45.47 in U.S. tax on the $100 Section 1248 “dividend.” Assuming the CFC in this example is not resident in a treaty country, the $100 dividend triggered by Section 1248(a) would be taxable as ordinary income, at a maximum federal rate of 43.4 percent, resulting in $43.40 of tax. Because this is less than the Section 1248(b) ceiling of $45.47, the ceiling does not apply, and the U.S. shareholder pays U.S. tax of $43.40.

As illustrated in the above example, where little or no foreign corporate income taxes are paid, Section 1248(b) has no impact, because the Section 1248(a) amount is less than the ceiling computed under Section 1248(b). As the foreign tax burden increases, however, the Section 1248(b) limitation becomes relevant.

For example, assume a U.S. shareholder owns 100 percent of a Brazilian CFC that earns $100 of income for both Brazilian and U.S. tax purposes and pays $35 in Brazilian corporate tax on this income, leaving earnings and profits of $65 available for distribution to the shareholder. The tax on the Section 1248(a) dividend would be 43.4 percent of the $65 deemed dividend, or $28.21. The Section 1248(b) ceiling, on the other hand, would be $15.47, computed as follows: The hypothetical corporate tax in that case would be $0 ($35 US tax minus $35 Brazilian tax actually paid). The hypothetical shareholder tax would be 23.8 percent of $65 (i.e., the Section 1248(a) amount of $65, less the hypothetical corporate tax of zero), or $15.47. In this case the Section 1248(b) amount is indeed significantly lower than the Section 1248(a) amount. Therefore, the 1248(b) ceiling applies to limit the selling shareholder’s US tax to $15.47, in effect treating the shareholder as if he sold shares of a CFC located in a treaty jurisdiction.

Because Section 1248(b) only provides a benefit to taxpayers who own CFCs resident in non-treaty countries, and only where the CFC is subject to a relatively high effective tax rate (a rate of at least 12.5 percent), this provision has particular relevance to U.S. shareholders of CFCs located in Latin American countries. Most such countries, including (but not limited to) Colombia, Brazil, Argentina, Chile, Costa Rica, El Salvador, Guatemala, Nicaragua, Peru, and Uruguay have statutory corporate tax rates of between 25 and 35 percent. And none of these countries has an income tax treaty with the United States. Thus, where a U.S. shareholder of such a “high-taxed” CFC sells his shares at a gain, the U.S. tax due on the Section 1248(a) amount will be more than the Section 1248(b) amount, so that Section 1248(b) will provide the U.S. shareholder with a tax benefit.

In some cases, the benefits to such shareholders under Section 1248(b) may be even more significant. This is due to the ability of such shareholders to take deductions for purposes of the hypothetical U.S. tax computations that may not be available under relevant foreign law. At least one federal court has discussed this issue. In Hoover v. the United States,[5] for purposes of determining the amount of corporate taxes that would have been paid if the CFC had been a domestic corporation, the U.S. District Court for the Central District of California allowed the hypothetical corporation to claim the former deduction available under Section 922 for Western Hemisphere Trade Corporations. This special deduction is available only to domestic corporations all of whose business was conducted in North, Central, or South America, or in the West Indies, if, among other items, at least 95 percent of the company’s gross income was derived from foreign sources during a three-year testing period. Clearly this deduction is not available for U.S. federal income tax purposes when computing the earnings and profits of a CFC, so it is noteworthy that the court allowed the taxpayer in Hoover to claim this special deduction in calculating the hypothetical corporate tax under Section 1248(b).

While the Section 922 deduction for Western Hemisphere Trade Corporations no longer exists, other relevant provisions are available that may provide a benefit to U.S. taxpayers in calculating the hypothetical corporate tax under Section 1248(b). For example, Section 199 currently allows for a 9 percent “domestic manufacturing deduction.” This provision could provide a benefit to a U.S. taxpayer that owns a CFC that conducts manufacturing activities primarily outside of the United States. The Section 199 regulations make it clear that this deduction is available to domestic corporations, so long as a portion of the manufacturing activities takes place within the United States, which could be by unrelated contract manufacturers.[6]

Another interesting issue that arises when calculating the hypothetical corporate tax under Section 1248(b) is whether foreign taxes deemed paid by a Latin American CFC should be factored into the calculation. As noted above, the hypothetical corporate tax is the amount of U.S. income tax the CFC would have paid if it had been taxed as a domestic corporation reduced by a tax credit for any foreign (or U.S.) income taxes paid by the CFC on the same income. Would the foreign taxes paid by the CFC include taxes that the CFC is given credit for under a tax-sparing provision of an income tax treaty concluded by the CFC and a third country? For example, assume a Brazilian CFC earns interest and/or royalties from the lending of funds or licensing of intellectual property to a third party located in Ecuador. Under the Brazil-Ecuador income tax treaty, payments of interest and royalties are subject to only a 15 percent withholding tax in Ecuador, but the CFC in Brazil is given a tax credit of 25 percent.[7] Should the Section 1248(b) calculation only take into account the actual withholding tax of 15 percent or should the CFC be treated as paying 25 percent? No guidance currently exists on this issue.

Conclusion

Given the generally high corporate tax rates in Latin America, individual U.S. taxpayers should not automatically assume that any gain recognized on the sale of a Latin American CFC will be taxed at the non-qualified dividend rate of 43.4 percent. As illustrated above, with thoughtful analysis, Section 1248(b) provides an important limitation that may yield significant tax benefits in the right situations.

[1] In general, a CFC is a foreign corporation that is more than 50 percent owned (by vote or value) by 10 percent (by vote) U.S. shareholders. Section 957.

[2] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury Regulations promulgated under the Code.

[3] For this purpose, "U.S. shareholder" means a U.S shareholder as defined in Section 951(b).

[4] See Section 1(h)(11).

[6] Treas. Reg. Sections 1.199-3(f) and (g). Section 167 is another example of a provision that could provide a benefit to a U.S. taxpayer when calculating the hypothetical corporate tax under Section 1248(b).

[7] Other treaties concluded by Brazil that contain reciprocal tax sparing provisions include those with India, the Philippines, South Korea, and Spain.

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