

Fifth Circuit confirms that subpart F inclusions are not dividends

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In brief

Subpart F income inclusions are not dividends and thus, are not qualified dividend income for purposes of Section 1(h)(11), the Court of Appeals for the Fifth Circuit held on July 5, 2013. This affirms the US Tax Court's decision in *Osvaldo and Ana Rodriguez v. Commissioner*. Accordingly, the tax rate applicable to subpart F income inclusions is the ordinary income rate, not the reduced rate for qualified dividend income.

The holding in *Rodriguez* could have broader relevance for individuals earning income through foreign corporations. Although the opinion addresses an inclusion under Section 951(a)(1)(B) with respect to a CFC's investment in US property, the opinion is equally applicable to subpart F inclusions under Section 951(a)(1)(A) and may also inform the final analysis of the proper application of the net investment income tax under Section 1411.

In detail

Background

Osvaldo and Ana Rodriguez, Mexican citizens and permanent residents of the United States, owned 100% of a Mexican company that had a US branch. The Mexican company was a controlled foreign corporation (CFC), and the US branch had investments in real and tangible personal property in the United States. For tax years 2003 and 2004, the Rodriguezes included in gross income, under Section 951, the Section 956 amounts relating to the CFC's investments in US property. The Rodriguezes reported the subpart F inclusions as qualified dividend income, subject to US federal income tax at the

reduced 15% rate under Section 1(h)(11)(B), rather than their otherwise-applicable 35% ordinary income rate.

The IRS issued a notice of deficiency based on the position that the subpart F inclusions should be subject to tax as ordinary income rather than qualified dividend income.

The taxpayers challenged the deficiency in the US Tax Court. The facts of the case were not in dispute. The only issue for the Tax Court was one of statutory interpretation: whether the Rodriguezes' Section 951(a)(1)(B) inclusions constituted qualified dividend income under Section 1(h)(11). The Tax Court ruled for the IRS.

What did the case address?

As in the Tax Court, the only issue for the Fifth Circuit was whether the Rodriguezes' income attributable to the CFC's investment in US property constituted qualified dividend income. The determination would turn on whether subpart F inclusions are treated as dividends for all US federal income tax purposes or only to the extent expressly provided in the Code.

The appellants' position

The Rodriguezes claimed that their Section 951 inclusions should be considered deemed dividends. In addition, they pointed out that they could have caused the CFC to pay a

dividend at any time. Had they done so, the income at issue would have unquestionably qualified as dividend income subject to the lower tax rate under Section 1(h)(11). Thus, they argued as a matter of policy that it would be unjust to tax the income at the ordinary rate. The Rodriguezes buttressed this policy argument with references to language in Section 956 legislative history that they believed appeared to create an equivalence between Section 956 inclusions and dividends.

The government's position

The government noted in its appellate brief that the Rodriguezes could have caused the CFC to distribute earnings to them as dividends, which would have constituted qualified dividend income under Section 1(h)(11). However, since they did not cause the CFC to distribute actual dividends, they should not be taxed under Section 1(h)(11) as if they had received dividends from the CFC.

The government emphasized that qualified dividend income could arise only where a corporation has made an actual distribution of property to its shareholders that is treated as a dividend as described in Section 316(a). The government also argued that a Section 951 inclusion is not a dividend for purposes of Section 1(h)(11) where Congress has, in other limited cases not including Section 1(h)(11), expressly provided that Section 951 inclusions should be treated as dividends. The government also explained that treating Section 951 inclusions as qualified dividends for purposes of Section 1(h)(11) would be inconsistent with the purpose of that provision, *i.e.*, a favorable rate of tax on dividends from certain foreign corporations was intended to have a stimulative effect on the US economy

by encouraging corporations to distribute their earnings to shareholders, whereas Section 951 inclusions are undistributed amounts of a corporation's earnings.

The Fifth Circuit decision

The Fifth Circuit agreed with the Tax Court and the government that Section 956 amounts included in current income under Section 951 do not constitute dividends. The court accepted the government's argument based on the definition of 'dividend' under Section 316(a). The Fifth Circuit followed the Tax Court in quoting the 1968 Supreme Court case of *Commissioner v. Gordon*: "in determining when a dividend has issued, [t]he question is not whether a shareholder ends up with 'more' but *whether the change in the form of his ownership represents a transfer to him, by the corporation.*" (emphasis in original). Thus, the Fifth Circuit reasoned that Section 951 inclusions are not actual dividends, because no change in the ownership of corporate property occurs. In effect, if there is no actual distribution, there is no actual dividend.

The court noted that Congress specifically directed that Section 951 inclusions be treated as dividends for certain purposes, such as the Section 904 foreign tax credit limitation rules. The court concluded that there would be no reason to make dividend treatment explicit in those contexts if Section 951 inclusions constituted dividends for all US federal income tax purposes.

The court also rejected the Rodriguezes' policy arguments regarding the disparate treatment of actual dividends and subpart F inclusions, agreeing with the government's position that the

taxpayers cannot avoid the tax consequences of a specific decision they made simply because, with hindsight, they may regret that decision.

Finally, the Fifth Circuit rejected the Rodriguezes' references to legislative history as unpersuasive, because those references dated from a period before the qualified dividend income regime, when there was no particular reason to distinguish actual dividends from subpart F amounts that US federal income tax law treated in a similar fashion.

Observation: This opinion may determine the application of Section 1411 to subpart F inclusions under final regulations. Section 1411 imposes Medicare tax on net investment income. The proposed regulations governing what constitutes 'net investment income' cited the Tax Court *Rodriguez* decision in stating that subpart F inclusions are not dividends for purposes of the Section 1411 tax. The Fifth Circuit decision thus is consistent with the IRS's position in the proposed regulations.

The takeaway

The Fifth Circuit's *Rodriguez* decision supports the IRS position that subpart F inclusions are not treated as dividends except to the extent specified in statutory language. More generally, the decision reminds us that taxpayers are very limited in their ability to rescind or recharacterize, for US federal income tax purposes, the transactions they undertake. Thus, taxpayers and their advisers need to be mindful of the implications of decisions that they cannot change retroactively, such as the payment (or nonpayment) of dividends.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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