KPMG

TaxNewsFlash

United States

No. 2018-376
September 18, 2018

U.S. Tax Court: CFC's distribution not "qualified dividend income," but taxable at ordinary rates

The U.S. Tax Court today granted motions for summary judgment for the IRS, finding the taxpayers' controlled foreign corporation (CFC) in Hong Kong was not a domestic corporation or a qualified foreign corporation and thus that the CFC's distribution to the taxpayers was not "qualified dividend income" but was taxable to the taxpayers at ordinary income rates. The Tax Court also found that the taxpayers had received a constructive dividend from a Cypriot CFC on the cancellation of an account receivable balance owned to that CFC.

The case is: *Smith v. Commissioner,* 151 T.C. No. 5 (September 18, 2018). Read the 53-page **Tax Court opinion** [PDF 189 KB]

The purpose of this report is to provide text of the Tax Court's opinion.

Summary

The taxpayers, during 2008 and 2009 owned (through a pair of domestic grantor trusts and an S corporation) controlled foreign corporations (CFCs) incorporated in Hong Kong and later in Cyprus.

- In 2008, the Hong Kong CFC paid the taxpayers a dividend of $12.3 million.
- In 2009, the Cypriot CFC paid the taxpayers a dividend of $57.1 million.
- In 2009, the Cypriot CFC cancelled an account receivable owned by the taxpayers' S corporation. The account receivable had an outstanding balance of $21.1 million when it was cancelled.

The IRS determined deficiencies for the 2008 and 2009 tax years of approximately $6.3 million and $18.7 million, respectively, based on findings that:

- The dividend paid by the Hong Kong CFC in 2008 was taxable as ordinary dividend income under section 962(d) to the extent of the difference between the amount of earnings and profit (E&P) the Hong Kong CFC had distributed to the taxpayers in 2008 and the tax that they had previously paid on account of prior section 951(a) inclusions to which that E&P was attributable.

- The Cypriot CFC was not a "qualified foreign corporation" and that the $57.1 million dividend was taxable as ordinary dividend income (and not as "qualified dividend income" eligible for a reduced rate of tax).

- Cancellation of the account receivable balance owned to the Cypriot CFC was taxable to the taxpayers in 2009 as a constructive dividend.

The Tax Court today, on cross-motions for summary judgment concluded that:

- The Hong Kong CFC was neither a domestic corporation nor a "qualified foreign corporation" and that its 2008 distribution of $12.3 million was not "qualified dividend income" but was taxable to the taxpayers under section 962(d) at ordinary income rates.

- The taxpayers received from the Cypriot CFC a constructive distribution of $21.1 million that was taxable to them as a dividend.

The Tax Court found that one issue—whether the Cypriot CFC was a "qualified foreign corporation" based on a residency certificate issued by the Cyprus Ministry of Finance—was not appropriate for summary judgment because there were "genuine disputes of material fact concerning the CFC's residency" and thus whether the $57.1 million dividend paid in 2009 was "qualified dividend income."