

Treatment as Qualified Dividend Income for Purposes of Section 1(h)(11) of the Internal Revenue Code of Distributions, Inclusions, and Other Amounts From Foreign Corporations Subject to Certain Anti-Deferral Regimes

Notice 2004-70

SECTION 1. PURPOSE

This notice provides guidance regarding the extent to which distributions, inclusions and other amounts received by, or included in the income of, individual shareholders as ordinary income from foreign corporations subject to certain anti-deferral regimes may be treated as qualified dividend income for purposes of section 1(h)(11) of the Internal Revenue Code (Code). This guidance is necessary to reflect the provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, 117 Stat. 752) (2003 Act) that provided for reduced rates of tax on certain dividends for taxable years beginning after December 31, 2002. The Treasury Department and the Internal Revenue Service intend to issue regulations under section 1(h)(11) of the Code that incorporate the guidance set forth in this notice.

SECTION 2. OVERVIEW

The 2003 Act provides that qualified dividend income received by an individual shareholder is subject to tax at reduced rates. This notice provides guidance regarding the extent to which distributions, inclusions, and other amounts received by, or included in the income of, individual shareholders as ordinary income from foreign corporations subject to certain anti-deferral regimes may be treated as qualified dividend income for purposes of section 1(h)(11) of the Code. Section 3 of this notice describes the statutory rules for determining whether income is

qualified dividend income and describes in general the anti-deferral regimes applicable to controlled foreign corporations (as defined in sections 957(a) and (b) and 953(c)(1)(B)) (CFCs), foreign personal holding companies (as defined in section 552(a)) (FPHCs), foreign investment companies (as defined in section 1246(b)) (FICs), and passive foreign investment companies (as defined in section 1297(a)) (PFICs). These rules are relevant principally because section 1(h)(11)(C)(iii) provides that dividends from a foreign corporation which for the taxable year of the corporation in which the dividend is paid, or the preceding taxable year, is an FPHC, a FIC, or a PFIC, are not qualified dividend income. Section 4 of this notice provides guidance with respect to distributions, inclusions, and other amounts from a CFC that is not also an FPHC, a FIC, or a PFIC. Section 5 of this notice provides guidance with respect to FPHCs, including FPHCs that are also CFCs. Section 6 of this notice provides guidance with respect to FICs, including FICs that are also CFCs. Section 7 of this notice provides guidance with respect to PFICs, including PFICs that are also CFCs.

This notice provides that distributions of non-previously taxed earnings and profits from a CFC to an individual are qualified dividend income, and therefore are eligible for the reduced rates of tax applicable to certain capital gains under section 1(h)(1) of the Code, provided that the CFC is otherwise a qualified foreign corporation. This notice also provides that section 951(a)(1) inclusions from a CFC and deemed or actual distributions from an FPHC, a FIC or a PFIC are not qualified dividend income under section 1(h)(11)(B)(i)(II) and therefore are not eligible for the reduced rates of tax applicable to certain capital gains under section 1(h)(1). In addition, this notice provides that, for purposes of section 1(h)(11), the determination of whether a foreign corporation is a PFIC is made on a shareholder-by-shareholder basis. Accordingly, distributions of non-previously taxed earnings and profits received by an individual

from a CFC that would be a PFIC with respect to that individual but for the application of section 1297(e) are qualified dividend income if the CFC is otherwise a qualified foreign corporation.

SECTION 3. BACKGROUND

.01 *The 2003 Act*

In general, section 1(h)(1) of the Code provides that an individual taxpayer's net capital gain for any taxable year is subject to a maximum tax rate of 15 percent (or 5 percent in the case of certain taxpayers). Section 1(h)(11) provides that, for purposes of section 1(h), the term "net capital gain" means net capital gain increased by qualified dividend income.

"Qualified dividend income" is defined as dividends received during the taxable year from domestic corporations and qualified foreign corporations. Section 1(h)(11)(B)(i) of the Code. The term "qualified foreign corporation" does not include any foreign corporation that, for the taxable year of the corporation in which the dividend is paid, or the preceding taxable year, is an FPHC, a FIC, or a PFIC. Section 1(h)(11)(C)(iii). Subject to this limitation, the term "qualified foreign corporation" means any foreign corporation that is incorporated in a possession of the United States or that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program.¹ Section 1(h)(11)(C)(i). In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.² Section 1(h)(11)(C)(ii).

.02 *Anti-deferral Regimes under the Code*

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax when such income

¹ See Notice 2003-69, 2003-42 I.R.B. 851 (providing the current list of U.S. tax treaties meeting these requirements).

² See Notice 2003-71, 2003-43 I.R.B. 922 (defining "readily tradable" on an established securities market in the United States with respect to dividends received on or after January 1, 2003); Notice 2003-79, 2003-50 I.R.B. 1206 (defining "readily tradable" for securities other than ordinary or common stock).

is distributed to a U.S. person that holds stock in such foreign corporation. Accordingly, a U.S. person that is a shareholder of a foreign corporation generally is not subject to U.S. tax on the income earned by the foreign corporation until that income is distributed to the shareholder as a dividend. However, a variety of anti-deferral regimes apply to subject the U.S. shareholder to U.S. tax on that income even if the income is not actually distributed to the shareholder.

A brief summary of the rules applicable to foreign corporations subject to each of the anti-deferral regimes addressed in this notice is provided below.

(1) *CFCs*. In general, a CFC is any foreign corporation with respect to which U.S. shareholders own more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of such corporation. Under section 951(b) of the Code, a “United States shareholder” is a U.S. person (as defined in section 957(c)) that owns ten percent or more of the total combined voting power of all classes of stock entitled to vote.

United States shareholders of CFCs are required to include in gross income currently their *pro rata* share of certain income of the CFC (referred to as “subpart F income”), without regard to whether the income is distributed by the CFC to its shareholders in the year the income is earned. Section 951(a)(1)(A) of the Code. Subpart F income includes foreign base company income, including foreign personal holding company income (e.g., dividends, interest, annuities and other specified passive income), and certain insurance income. Sections 952, 953, and 954. United States shareholders of a CFC also are required to include currently in income their *pro rata* share of the CFC’s earnings to the extent invested by the CFC in U.S. property. Section 951(a)(1)(B). The amounts so included in income under section 951(a)(1) are limited to the shareholder’s *pro rata* share of the current earnings and profits of the CFC. Section 951(a)(2) and (c)(1)(A).

Income of a CFC that has been included in the gross income of its United States shareholders as an inclusion under section 951(a)(1) of the Code is not included in gross income again when it actually is distributed to the United States shareholders.

Section 959(a)(1). Any income of a CFC that is not included in the gross income of its United States shareholders under section 951(a)(1) is not subject to U.S. tax as income of the United States shareholders until actually distributed as a dividend. A United States shareholder of a CFC that sells its stock in the CFC generally is required to report any recognized gain from the sale of the stock as a dividend to the extent of the untaxed undistributed earnings and profits of the CFC and certain subsidiaries that are attributable to the United States shareholder. Section 1248(a) and (c)(2).

(2) *FPHCs*. A foreign corporation is an FPHC if (1) at any time during the taxable year more than 50 percent of the stock of the corporation, determined by vote or value, is owned by five or fewer individuals who are U.S. citizens or residents; and (2) at least 60 percent of the corporation’s gross income for the taxable year is foreign personal holding company income (e.g., dividends, interest, annuities and other specified passive income). Once a foreign corporation qualifies as an FPHC, however, the gross income threshold for each subsequent year is only 50 percent, until the expiration of either one taxable year during which the stock ownership requirement is not satisfied or three consecutive taxable years in each of which the gross income requirement is not satisfied at the 50 percent threshold. Section 552(a) of the Code.

All individual shareholders of an FPHC who are U.S. persons must include in gross income their distributive shares of undistributed foreign personal holding company income (as defined in section 556(a) of the Code) without regard to whether the income is distributed by the FPHC to its shareholders in the taxable year the income is earned. The undistributed foreign personal holding company income of an FPHC is the taxable income of the FPHC with adjustments minus the amount of the dividends paid deduction determined under section 561. Section 556(a). The undistributed foreign personal holding company income of an FPHC is treated as a dividend under section 551(b). Amounts that are deemed distributed as a dividend are treated as recontributed by the U.S. individual shareholders to the FPHC as a contribution to capital.

(3) *FICs*. A foreign corporation is a FIC if (1) it is registered under the Investment Company Act of 1940, either as a management company or as a unit investment trust; or (2) it is engaged primarily in the business of investing, reinvesting, or trading in securities or commodities, or in any interest in securities or commodities, at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the value of all classes of stock, is held by U.S. persons. Section 1246(b) of the Code. Under the FIC rules, in general, gain on the sale or exchange (or a distribution that is treated as an exchange) of stock in a FIC is treated as ordinary income to the extent of the taxpayer’s ratable share of the post-1962 undistributed earnings and profits of the FIC. Section 1246(a). Any amount previously included in the gross income of the shareholder under section 951 is excluded from the shareholder’s ratable share of the post-1962 undistributed earnings and profits of the FIC (but only to the extent the inclusion of such amount did not result in the exclusion of any other amount from gross income under section 959). A FIC that elected before 1963 to distribute annually 90 percent of its taxable income (other than capital gains) is not subject to the general rules of section 1246(a) with respect to any year in which the election applies. Section 1247(a)(1); Section 1.1247-1(c)(1) of the Income Tax Regulations. Qualified shareholders (as defined in section 1247(c)) who invest in FICs that elected this treatment under section 1247 and for which the election is currently in effect are required to include in income currently their share of the net long term capital gains of the FIC whether or not actually distributed.

(4) *PFICs*. In general, a foreign corporation is a PFIC if (1) 75 percent or more of its gross income for the taxable year consists of passive income; or (2) the average percentage of assets held by the corporation during the taxable year that produce, or are held for the production of, passive income is 50 percent or more. Section 1297(a) of the Code. Subject to certain exceptions, passive income generally means income of a kind that would be foreign personal holding company income under section 954(c). Section 1297(b).

In general, gain recognized by a U.S. person on the disposition of stock of a

PFIC, or the amount of any excess distribution (as defined under section 1291(b)), is treated as ordinary income earned *pro rata* over the shareholder's holding period with respect to the PFIC stock. Amounts attributed to the current taxable year are included as ordinary income. Amounts attributed to prior years are subject to tax at the highest applicable tax rate in effect for each respective year of the holding period, and interest is imposed at the underpayment rate on the tax liability with respect to such amounts.

As an alternative to being taxed under the rules of section 1291(a) of the Code, a shareholder that is a U.S. person may make a qualified electing fund (QEF) election under section 1295 of the Code or a mark to market election under section 1296. In general, a U.S. shareholder that makes a QEF election must include in gross income its *pro rata* share of the QEF's ordinary income and net capital gain for the taxable year. Section 1293(a). A U.S. shareholder of a PFIC that makes a mark to market election must include in gross income for its taxable year as ordinary income the excess of the fair market value of the PFIC stock over its adjusted basis. Section 1296(c)(1). The adjusted basis of the shareholder's stock is increased by the amount included in the gross income of the shareholder with respect to the stock.

A foreign corporation may be treated as a PFIC with respect to some shareholders but not others. Under section 1298(b)(1), a foreign corporation generally is treated as a PFIC with respect to a shareholder even if the corporation does not meet the income or asset tests for the current year if the corporation met either the income test or the asset test during any portion of the shareholder's holding period of the stock of the foreign corporation and the shareholder has not made a QEF election.³ Under section 1297(e), a foreign corporation is not treated as a PFIC with respect to a shareholder even if the corporation meets the income test or the asset test if the corporation is a CFC, the shareholder

is a United States shareholder, and certain other conditions are met.

SECTION 4. CONTROLLED FOREIGN CORPORATIONS

This section provides guidance with respect to distributions, inclusions, and other amounts received by individual shareholders from a CFC that is not also an FPHC, a FIC, or a PFIC (and that was not an FPHC, a FIC, or a PFIC in the preceding taxable year). The treatment of distributions, inclusions, and other amounts received by individual shareholders of a CFC that is also an FPHC, a FIC, or a PFIC is addressed in sections 5, 6, and 7 of this notice, respectively.

Individual United States shareholders of CFCs may have amounts included in income under section 951(a)(1) of the Code, distributions of amounts previously taxed under section 951(a)(1), or distributions of amounts that have not been previously taxed under section 951(a)(1). The tax treatment of these amounts in the context of section 1(h)(11) is discussed below.

.01 Distributions of Amounts Not Previously Taxed

Section 1(h)(11) of the Code does not exclude CFCs from the definition of "qualified foreign corporations." Thus, actual dividends from a CFC's non-previously taxed earnings and profits to an individual shareholder are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met. Similarly, amounts treated as dividends under section 1248(a) are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met.⁴ See section 1248(a) (stating gain recognized on the sale or exchange of stock in certain foreign corporations shall be included in the gross income of a shareholder as a divi-

dent). In addition, amounts treated as dividends under section 1.367(b)-2(e)(2) of the regulations (*i.e.*, section 1248 amounts and all earnings and profits amounts) are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met.⁵

.02 Section 951(a)(1) Inclusions

Neither section 951(a)(1) nor the corresponding regulations characterize a section 951(a)(1) inclusion as a dividend. In contrast, deemed inclusions under the FPHC and PFIC regimes are characterized as dividends throughout the statutory provisions governing these regimes. *See, e.g.*, section 551(b) (stating that undistributed foreign personal holding company income is included in a foreign personal holding company shareholder's gross income as a dividend). Moreover, while section 1248 requires inclusions in gross income as a dividend, section 951 simply requires inclusions in gross income.⁶ Accordingly, for purposes of section 1(h)(11), section 951(a)(1) inclusions are not dividends and therefore cannot constitute qualified dividend income.

.03 Distributions of Previously Taxed Income

Distributions of previously taxed income excluded from gross income under section 959(a) of the Code are not qualified dividend income because they are not subject to U.S. tax and are not dividends. *See* section 959(a) and (d).

SECTION 5. FOREIGN PERSONAL HOLDING COMPANIES

.01 In General

Section 1(h)(11)(C)(iii) of the Code excludes FPHCs from the definition of qualified foreign corporation. Therefore, actual dividends received by U.S. individ-

³ Section 1298(b)(1) also may not apply to a shareholder that has obtained a new holding period under section 1.1296-1(f) of the regulations by reason of a mark-to-market election.

⁴ Amounts treated as dividends under section 1248(a) in the case of gain with respect to stock of a foreign corporation that was a CFC during the 5-year period prior to the disposition also may be qualified dividend income provided that the foreign corporation is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met. Future guidance may address the treatment of section 304 amounts and section 306(a)(2) amounts under section 1(h)(11).

⁵ Amounts treated as dividends under section 1.367(b)-2(e)(2) of the regulations with respect to foreign corporations that are not CFCs also may be qualified dividend income provided that the foreign corporation is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met. Section 1.367(b)-3(c)(3).

⁶ It should be noted that, while section 951(a) was not modified by the 2003 Act, section 306(a)(1)(D) was modified to provide that, for purposes of section 1(h)(11), amounts treated as ordinary income under section 306 shall be treated as a dividend received from the corporation.

uals who are shareholders of an FPHC are not qualified dividend income. Similarly, undistributed foreign personal holding company income that is treated as distributed to individual U.S. shareholders as a dividend is not qualified dividend income. Further, a dividend from a foreign corporation that is not an FPHC but was an FPHC in the preceding taxable year is not qualified dividend income.

.02 FPHCs that are also CFCs

A foreign corporation may be both an FPHC and a CFC. Because a foreign corporation that is both an FPHC and a CFC continues to be an FPHC, any dividends (both actual dividends and amounts treated as a dividend) received by an individual shareholder from that corporation are not qualified dividend income.

SECTION 6. FOREIGN INVESTMENT COMPANIES

.01 In General

Section 1(h)(11)(C)(iii) of the Code excludes FICs from the definition of qualified foreign corporation. Therefore, actual dividends received by U.S. individuals who are shareholders of a FIC are not qualified dividend income. Likewise, a shareholder's *pro rata* share of a FIC's post-1962 accumulated earnings and profits following the sale of FIC stock is not qualified dividend income. Similarly, amounts distributed as ordinary income by a FIC that has a section 1247 election in effect also are not qualified dividend income. Further, a dividend from a foreign corporation that is not a FIC but was a FIC in the preceding taxable year is not qualified dividend income.

.02 FICs that are also CFCs

A foreign corporation may be both a FIC and a CFC. Because a foreign corporation that is both a FIC and a CFC continues to be a FIC, any dividends or other distributions taxable as ordinary income from that corporation are not qualified dividend income.

SECTION 7. PASSIVE FOREIGN INVESTMENT COMPANIES

.01 In General

Section 1(h)(11)(C)(iii) of the Code excludes PFICs from the definition of qualified foreign corporation. As a result, a dividend (including an excess distribution) from a foreign corporation that is a PFIC or that is not a PFIC in the current taxable year but was a PFIC in the preceding taxable year is not qualified dividend income.

Similarly, amounts included in a shareholder's gross income under sections 1293(a) (in the case of a shareholder that has made a QEF election) or 1296 (in the case of a shareholder that has made a mark to market election) are not qualified dividend income.

.02 Determination of PFIC Status

As noted above in Section 3.02(4), some of the rules for determining whether a foreign corporation is a PFIC operate on a shareholder-by-shareholder basis. Therefore, a foreign corporation may be treated as a PFIC with respect to some shareholders but not others. Thus, for purposes of section 1(h)(11), the result of an analysis of whether a foreign corporation is a PFIC, and therefore whether dividends from that corporation are for that reason excluded from qualified dividend income, may be different for shareholders of the same foreign corporation.

A determination of whether a foreign corporation was a PFIC in the previous taxable year also should be made on a shareholder-by-shareholder basis if the shareholder of the foreign corporation was a shareholder in the previous taxable year. For example, a foreign corporation that was a PFIC under the income test or the asset test of section 1297(a) of the Code for one year of a shareholder's holding period under certain circumstances may be a PFIC with respect to that shareholder even though it may not meet the income or asset tests in subsequent years and notwithstanding that the foreign corporation may not be a PFIC with respect to other shareholders. Section 1298(b)(1). To the extent a foreign corporation is a PFIC with respect to a shareholder, dividends received by that shareholder are not qualified dividend income.

.03 PFICs that are also CFCs

A foreign corporation may be both a PFIC and a CFC. Except where section 1297(e) of the Code applies to certain shareholders as described below, in cases where a foreign corporation is both a PFIC and a CFC an amount received by a shareholder from such a corporation is not qualified dividend income.

Where a foreign corporation is a CFC, section 1297(e)(1) of the Code provides that the foreign corporation generally is not treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period in the stock of the foreign corporation even if the corporation meets the income test or the asset test. The qualified portion generally is the portion of the shareholder's holding period that is after December 31, 1997, and during which the shareholder is a United States shareholder and the foreign corporation is a CFC. This overlap elimination rule does not apply if the foreign corporation otherwise is treated as a PFIC under section 1298(b)(1) because there is a portion of the shareholder's holding period prior to the application of this rule when the foreign corporation was a PFIC. H.R. Rep. No. 105-148, 105th Cong., 1st Sess., at 534 (1997).

In cases where a foreign corporation would qualify as a PFIC with respect to a shareholder but for the application of section 1297(e) of the Code, for purposes of section 1(h)(11), distributions, inclusions, or amounts received by, or included in the income of, that shareholder from that foreign corporation are subject to the same analysis as amounts from foreign corporations that are CFCs and are not PFICs. Thus, in accordance with the guidance provided for CFCs in Section 4 above, distributions of non-previously taxed earnings and profits received by an individual from a CFC that would be treated as a PFIC with respect to such individual but for the rule of section 1297(e) are qualified dividend income provided that the CFC is otherwise a qualified foreign corporation under section 1(h)(11)(C) and the other requirements of section 1(h)(11) are met.

SECTION 8. EFFECTIVE DATE

Regulations to be issued relating to the guidance set forth in this notice will be

effective for amounts included in income on or after October 8, 2004. Until such regulations are issued, taxpayers may rely on this notice.

SECTION 9. COMMENTS

Comments should be submitted in writing and should include a reference to **Notice 2004-70**.

Written comments may be submitted to CC:PA:LPD (**Notice 2004-70**), Room 5207, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washing-

ton, D.C. 20044. Alternatively, interested parties may submit comments electronically via the following e-mail address: *Notice.Comments@irsounsel.treas.gov*. Please include “**Notice 2004-70**” in the subject line of any electronic communications.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD (**Notice 2004-70**), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

VI. CONTACT INFORMATION

The principal author of this notice is Alexandra K. Helou of the Office of Associate Chief Counsel (International). However, other personnel from the Service and the Treasury participated in its development. For further information regarding this notice, contact Phyllis Marcus at (202) 622-3840 (not a toll-free call).
