2012

A Primer on Us. Taxation of International Transactions (Slides)

William B. Sherman

Holland & Knight

A PRIMER ON U.S. TAXATION OF INTERNATIONAL TRANSACTIONS

Presented by

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Income Taxation of U.S. Persons

- Income Tax
  - Maximum Rates
    - Citizens and Resident Aliens
      - Ordinary Income - 35% (39.6%)*
      - Capital Gains -
        - » Long Term – 15% (20%)*
        - » Short Term - 35% (39.6%)*
      - Qualified Dividend Income – 15% (no preference)*
    - Corporations
      - Ordinary Income and Capital Gains – 35%
  - Worldwide Income Subject to Tax
    - Source Irrelevant
    - Character Irrelevant
    - Includes Income Earned by Certain Foreign Corporations

* Numbers in parentheses represent rates for 2013

Estate and Gift Taxation of U.S. Citizens And Domiciled Aliens

- Estate and Gift Tax
  - Worldwide Assets Subject to Estate or Gift Tax*
  - Gifts in excess of $13,000 Per Year, Per Donee Subject to Gift Tax

* Ignores 2010 repeal of estate tax

Taxation of Non-Resident Aliens (“NRAs”) and Foreign Corporations

- Income Tax
  - Only Certain Income Subject to Tax
    - Income Effectively Connected with a U.S. Business (“ECI”)
    - Fixed, Determinable, Annual or Periodical Income (“FDAP”) from U.S. Sources
    - Capital Gains not FDAP, but taxable if NRA in U.S. for 183 Days or More
    - Gain from disposition of U.S. real property interests (“FIRPTA”)

Taxation of NRAs and Foreign Corporations (cont'd)

- Maximum Rates
  - ECI - Same as for a U.S. Person
    - Branch Profits Tax applicable to Foreign Corporations
  - U.S. Source FDAP - 30% Withholding Tax Unless Reduced by Income Tax Treaty
  - FIRPTA gains treated as ECI

Taxation of NRAs (cont'd)

- Estate and Gift Taxes
  - Only U.S. Situs Assets Subject to Tax
  - U.S. Situs Assets Include:
    - Real Property Located in the U.S.
    - Shares of Stock in a U.S. Corporation (for Estate Tax Purposes ONLY)
    - Tangible Personal Property Located in the U.S.
    - Certain Debt Obligations of U.S. Persons and the U.S. Government (and its subdivisions, including states)
    - Intangible Property

Determination of U.S. Residence Status of Individuals

- Different Tests for Income Tax vs. Estate and Gift Tax
- Income Tax - Two Objective Tests
  - Green Card Test
  - Substantial Presence Test
    - 183 Days Based on Weighted Formula for Current and Prior Two Years
    - Current year: 1 day = 1 day
    - First preceding year: 1 day = 1/3 day
    - Second preceding year: 1 day = 1/6 day
    - Effectively Limits Presence to 121 Days per Year

Determination of U.S. Residence Status of Individuals (Cont'd)

- Estate and Gift Tax – Subjective Test
  - Domicile Test – Place Where Person Resides with Intention to Remain Indefinitely
  - Similar to State residency tests

Entity Characterization Rules-Foreign Entities

- Foreign Corporation
  - Per se corporation – list provided in regulations
  - Default rule – different than for domestic entities
    - If no member has unlimited liability, entity defaults to corporate status– compare to domestic LLC where opposite results
  - “Check the Box” on non-default corporation
- Foreign Partnership (more than one member) or Disregarded Entity (only one member)
  - Default rule
    - At least one member has unlimited liability
  - “Check the Box” on non-per se corporation

Use Form 8832 to file Check the Box Election

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U.S. Taxation of ECI

Effectively Connected Income Analysis

ECI Analysis

- Do you have a trade or business?
- Is the trade or business in the United States?
- What income and expenses are effectively connected to the U.S. trade or business?
- Is there a treaty exemption?

U.S. Trade or Business (“USTB”)

- Not defined in the Internal Revenue Code
- Facts and circumstances test
- No bright line rules
- Generally requires regular and continuous activity in U.S.
- Determined on annual basis

U.S. Trade or Business

- May engage in USTB directly or indirectly
  - Branch
  - Partner in partnership that is ETB
- Statutory USTB exceptions
  - *De Minimis* services

    Less than 90 days and $3,000 compensation
  - Securities and commodities traders

USTB Exception for Stock, Securities and Commodities Traders

- Code § 864(b)(2)
  - Trading through independent broker
    - N/A if taxpayer's U.S. office participates in effecting transaction
  - Trading for own account
    - N/A if dealer

Determining if Gross Income is Effectively Connected

- Rules differ depending on whether U.S. or foreign source income
  - If ***U.S.*** source income, different rules for
    - FDAP-type income
    - Other income
  - If ***foreign*** source, only specified types are ECI

    IRC § 864(c)
- Special rules for inventory sales

U.S. Source FDAP Income as ECI

- U.S. source FDAP income is ECI if satisfy either
  - Asset use test
    - Income derived from assets used in the conduct of a USTB
  - Material factor test
    - Activities of USTB were a material factor in the realization of income

IRC § 864(c)(2)

U.S. Source “Other” Income as ECI

- ECI if satisfy “unlimited force of attraction rule”
  - – If ETB, all U.S. source non-FDAP type income is ECI
    - IRC § 864(c)(3)
- Treaties have higher threshold
  - – Income must be “attributable to” US permanent establishment

Foreign Source Income as ECI

- Generally, not ECI
- ECI if
  - Maintain U.S. office or other fixed place of business ("FPB") &
  - Foreign source income consists of
    - Certain rents or royalties
    - Certain dividends and interest;
    - Certain gains or losses from sales of inventory-type property
    - Economic "equivalent" of such income

IRC § 864(c)(4)

Sale of Inventory as ECI

- Title passage rule generally applies
- If foreign title passage, ECI if sale “attributable to” U.S. office
  - Attributable to U.S. office if
    - U.S. office is a “material factor” in the production of the income AND
    - U.S. office regularly carries on such business activities
  - But, not ECI if foreign office also materially participates and non-U.S. destination

Effectively Connected Deductions & Credits

- Allocated and apportioned under Reg. § 1.861-8
  - Special rules for Interest: Reg. § 1.882-5
- Deductions and credits allowed only if return timely filed

  Reg. § 1.882-4

  - Foreign person does not have to file a tax return if no ECI and tax liability on U.S. source FDAP satisfied by withholding

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U.S. Taxation of FDAP

Taxation of FDAP Income

- 30% tax imposed on gross amount
  - Tax collected by withholding
  - Tax and withholding may be reduced or eliminated by treaty
- Only U.S. source FDAP income subject to tax
- ECI trumps FDAP

What is FDAP Income?

- Fixed – paid in amounts definitely predetermined
- Determinable – basis by which amount to be paid may be ascertained
- Annual – paid on same date every year
- Periodical – paid from time to time, whether or not at regular intervals

Types of FDAP Income

- Interest
- Dividends
- Royalties
- Rents
- Salaries and wages

Effectively any income other than from sale or exchange of property

When is FDAP-Type Income ECI?

- Asset Use Test
  - Is income derived from assets used in the conduct of a USTB?
- Material Factor Test
  - Were business activities of USTB a material factor in the realization of income?
- Rents – special election to treat rental income as ECI §§ 871(d), 882(d)
  - Useful when rental income does not satisfy the asset use or material factor test

Source Rules

Depend on character of income

- Interest - Residence of payor (generally)
- Dividends - Place of incorporation of payor (generally)
- Royalties - Place of use of intangible property
- Rents - Place of use of tangible property
- Salaries/Wages - Place of performance of services

Exceptions to Interest Source Rule

- U.S. source
  - Interest paid by U.S. branch of foreign corporation
- Foreign source
  - Interest on deposit in foreign branch of U.S. bank
- Cross-border securities lending transactions

Tax Exemptions for U.S. Source Interest

- Portfolio interest (Code § 871(h))
- Bank deposit interest (Code § 871(i)(2))
- Short-term original issue discount obligations (Code § 871(g))
  - Due 183 days or less from date of issue
  - Rollover problem

Portfolio Interest Obligation

- Interest exempt from U.S. tax if derived from
  - Bearer obligation arranged to ensure that only non-U.S. persons will hold*, or
  - Registered obligation where U.S. payor has received a statement that beneficial owner is not a U.S. person
    - Form W-8BEN

* repealed by FATCA for instruments issued after March 12, 2012

Exceptions to Portfolio Interest Exemption

- 10% shareholder/partner
- Contingent interest
- Recipient is foreign bank on ordinary business loan
- Recipient is CFC and payor is related person

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FIRPTA

FIRPTA: Foreign Investment in U.S. Real Property Tax Act § 897

- Gain from disposition of U.S. real property interest ("USRPI") treated as ECI
- USRPI includes:
  - any direct interest in U.S. real property
    - except solely as a creditor
  - stock in a domestic U.S. real property holding corporation ("USRPHC")

U.S. Real Property Holding Corporation

- A USRPHC is any corporation if:
  - – FMV of its USRPIs is at least 50% of
  - – Sum of fair market values of
    - its USRPIs
    - its real property interests outside the U.S.
    - other trade or business assets

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Withholding

Types of Withholding

- Disposition of USRPI
- U.S. source FDAP income
- U.S. source services income
- Foreign partner’s share of partnership income
- FATCA

FIRPTA Withholding § 1445

- Transferee must withhold 10% of **amount realized** on disposition of USRPI by a foreign person
- Limited exemptions
  - – non-foreign affidavit
  - – non-USRPHC affidavit
  - – transferee receives a qualifying statement from the IRS
    - Procedures for applying to IRS for reduction or elimination of withholding
  - – transferee to use as a residence and amount realized does not exceed $300,000
  - – publicly traded stock

FDAP Withholding

- No withholding required unless U.S. source
- Withholding at 30% rate unless payor receives appropriate Form W-8 from beneficial owner or intermediary
  - Form W-8BEN
  - Form W-8ECI
  - Form W-8IMY

Service Income Withholding

- Paid to a foreign corporation
  - Generally, no withholding because it is ECI

    IRC §§1442(a), 1441(c1)
- Paid to a nonresident alien
  - Independent contractor
    - IRC § 1441 FDAP withholding
  - Employee
    - IRC § 3401 Employee withholding

Withholding by Partnership

- Domestic Partnership
  - Distributions of U.S. source FDAP
    Reg. § 1.1441-3(f)
  - Distributive share of
    - U.S. source FDAP income
      Reg. § 1.1441-3(f)
    - ECI
      IRC § 1446
- Foreign Partnership
  - Distributive share of ECI only
    IRC § 1446

Foreign Account Tax Compliance Act ("FATCA") Provisions of HIRE Act

Adds new "Chapter 4" withholding requirements: Sections 1471 – 1474.

Basic Concept: Any payor of U.S. source FDAP **or gross proceeds** related to U.S. source FDAP securities (defined as "withholdable payments") must withhold 30% from such amount paid to a non-U.S. payee UNLESS the payee agrees to provide information on its U.S. customers or owners.

New rules will apply not just to financial institutions but to all U.S. payers.

All withholding agents must apply Chapter 4 before applying the current FDAP withholding rules.

Effective for payments made after December 31, 2012 (subject to certain grandfathering rules). Notice 2011-53 extends the effective date for certain payments by 1 or 2 years.

Reporting Obligations

- Payor
  - Must file Form 1042 and 1042S
- Recipient
  - If engaged in a USTB
    - Must file return
    - Loss of deductions if return not timely filed
  - If not engaged in a USTB
    - No return required if all tax due withheld at source
    - File return to claim refund or pay additional tax due

Treaties

Treaty Benefits for ECI and FDAP Income

- To claim benefits, must be
  - “Resident” of treaty country and
  - Satisfy treaty’s limitation on benefits provision

Treaty Benefits for ECI

- No tax on business profits unless “permanent establishment” in US
- Preparatory or auxiliary activities do not constitute permanent establishment
- Only ECI type income attributable to a permanent establishment is subject tax
  - Overrides force of attraction principle

Treaty Benefits for FDAP

- May reduce or eliminate U.S. tax
  - Interest and royalties – rate may be 0%
  - Dividends – rate is 5%-15%
    - Some new treaties have 0% rate
    - Lowest rates apply to intercorporate dividends with certain minimum stock ownership thresholds
- To claim, recipient must provide Form W-8 BEN: Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding

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Provisions Affecting U.S. Persons

Provisions Affecting U.S. Persons

- Foreign Tax Credit
  - allows a credit against U.S. tax for certain foreign taxes
- Anti-deferral Regimes
  - taxes certain U.S. shareholders on income of certain foreign corporations
- Section 367
  - overlay on subchapter C nonrecognition provisions
- Dividends from Qualified Foreign Corporations
  - allows reduced U.S. tax rate for certain dividends from foreign corporations received by a non-corporate taxpayer
- Limitations on deductible payments to foreign persons

Foreign Tax Credit

- U.S. gives a credit against U.S. tax liability for foreign taxes paid by U.S. taxpayer
  - Direct foreign taxes
  - Deemed paid foreign taxes
- Only certain taxes—those based on net income—are eligible for the foreign tax credit
- Foreign Tax Credit Limitation
  - Credit is limited to U.S. tax on net foreign source income
  - Limitation is determined separately for various categories of income

Deemed Paid Foreign Taxes

- A U.S. C corporation is deemed to have paid its share of the foreign taxes paid by a 10% owned foreign corporation when:
  - it receives a dividend from the foreign corporation
  - it includes income or earnings of the foreign corporation under subpart F
  - it recognizes gain on the sale of stock of a CFC
- Taxes deemed paid are determined by reference to the portion of the foreign corporation's earnings and profits included by the U.S. corporation
- Taxpayers other than a C corporation not entitled to deemed paid amount

Foreign Tax Credit Limitation

Formula =

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \quad X \quad \text{U.S. Tax Before Credits}$$

Example:

FSTI = $200

WWTI = $1,000

U.S. Tax Rate = 35%

$$\frac{\$200}{\$1{,}000} \quad X \quad 350 \quad = \quad \$70 \text{ (FTC Limit)}$$

Separate Baskets

- The foreign tax credit limitation formula used to be applied separately to each of nine categories (baskets)
- for post 2006 tax years
  - Only 2 baskets
    - Passive
    - General limitation

ANTI-DEFERRAL REGIMES

General Taxation of Foreign Corporate Earnings

- Foreign Corporation
  - not subject to U.S. tax unless U.S. source FDAP Income or ECI
- U.S. Shareholder of a Foreign Corporation Subject to U.S. tax
  - when earnings are repatriated to U.S. (dividend)
  - upon sale of shares of the foreign corporation
- Thus, U.S. tax on foreign corporate earnings may be deferred

Special Provisions of U.S. Tax Law Aimed at U.S. Shareholders of Foreign Corporations

Anti-deferral rules:

- Subpart F-deals with controlled foreign corporations (“CFC”)
- Passive foreign investment company (“PFIC”)

SUBPART F

Basic Rules of Subpart F

– Certain income of a controlled foreign corporation ("CFC"), is includible in the income of its “U.S. shareholders” in the year earned.
– Earnings of a CFC invested in U.S. property treated as distributed to its U.S. shareholders.
– Ordering rules eliminate double inclusion.
– A U.S. Shareholder's basis in stock of the CFC adjusted for inclusions and distributions.
– A Corporate U.S. Shareholder deemed to have paid the foreign taxes paid by the CFC.

Definition of Controlled Foreign Corporations ("CFC") Section 957(a)

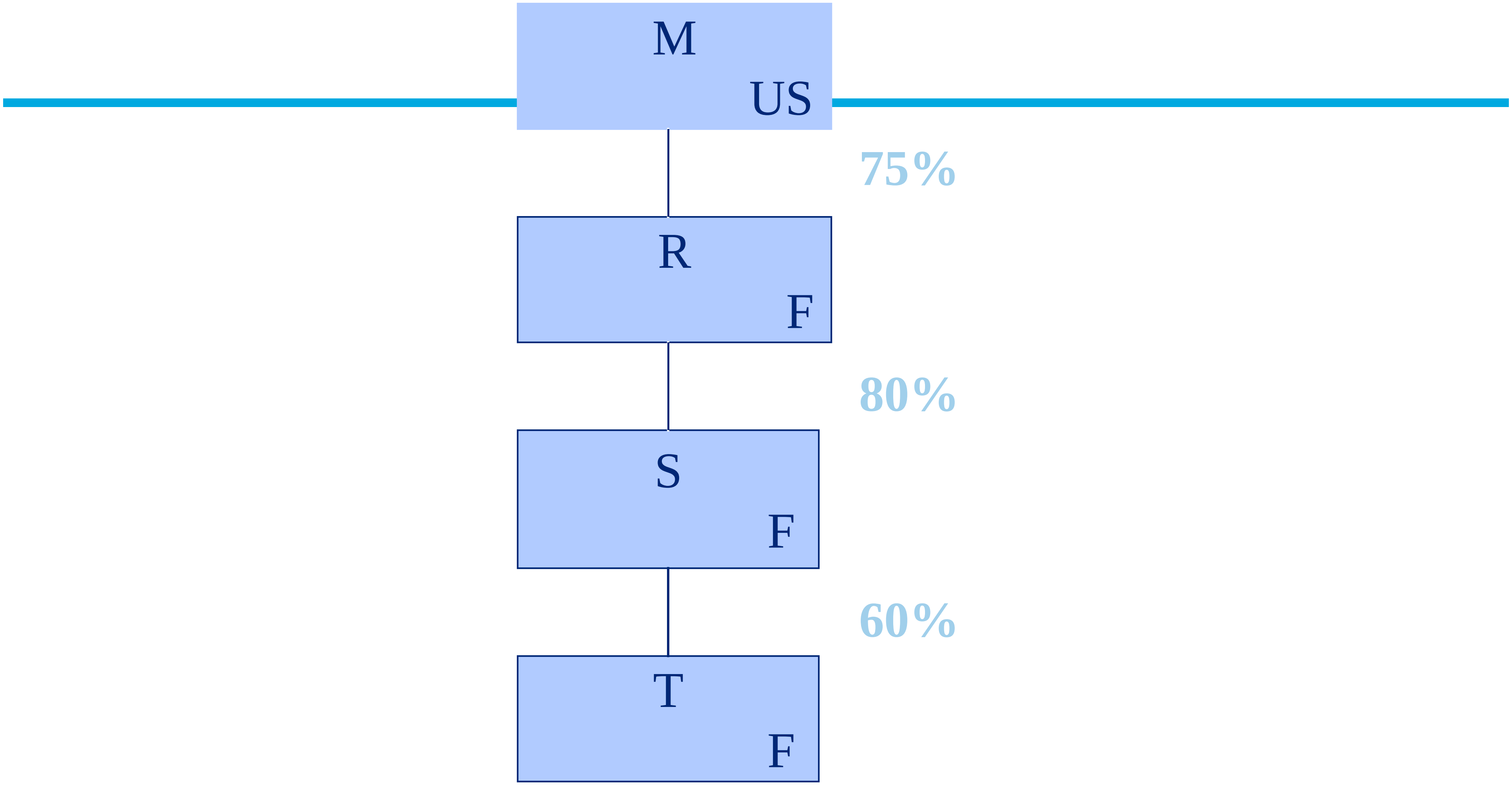
- A foreign corporation
- More than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of the stock
- Owned directly, indirectly, or constructively by U.S. shareholders
- On any day during the taxable year of such corporation.

Definition of United States Shareholder. Section 951(b)

- A United States person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation.

Stock Ownership Rules

- Determine both U.S. shareholder and CFC status.
  - **Three types:**
    - Direct,
    - Indirect – proportionate through all foreign entities
    - Constructive
      - § 318 with modifications
      - No attributions from non-U.S. person to U.S. person
      - If entity owns > 50%, treated as owning 100%
- Same rules apply to determine "related person" status



Indirect Ownership
- R owns 48% of T (80% x 60% = 48%)
- M owns 36% of T (75% x 48% = 36%)

Constructive Ownership
- R owns 100% of T (100% x 100% = 100%)
- M owns 100% of T (100% x 100% = 100%)

Taxation of U.S. Shareholders of a CFC

- A U.S. shareholder of a CFC on the last day of the CFC's taxable year during which it was a CFC for an uninterrupted period of 30 days or more must include in gross income its pro rata share of the CFC's:

  a. subpart F income;

  b. previously excluded Subpart F income withdrawn from less developed countries;

  c. previously excluded Subpart F income withdrawn from shipping operations; and

  d. increase in earnings invested in U.S. property.

The subpart F inclusion "hopscotches" over intervening foreign corporations.

U.S. Shareholder’s Pro Rata Share

- Amount that would have been distributed with respect to the stock owned by the shareholder, directly or indirectly.

Subpart F Income

The Sum of:

1. Certain income derived from the insurance of risks determined under Section 953);
2. “Foreign Base Company Income” (determined under Section 954);
3. Boycott income (determined under Sections 952(a)(3) and 999);
4. Certain illegal bribes and kickbacks (determined under Section 162(c) and 952(a)(4); and
5. Income from unrecognized foreign countries (determined under Sections 901(j) and 952(a)(5)).

Foreign Base Company Income (“FBCI”)

The largest and therefore the most significant category of Subpart F income

1. Foreign Personal Holding Company Income;
2. Foreign Base Company Sales Income;
3. Foreign Base Company Services Income;
4. Foreign Base Company Oil Related Income.

Foreign Personal Holding Company Income (“FPHCI”) Section 954(c)

1. Dividends, interest, royalties, rents and annuities.
2. Net gains from the sale of property which either:
   a. generates passive types of income listed in 1 above.
   b. is an interest in a trust, partnership or REMIC, or
   c. generates no income.
3. Net gains from commodity transactions except
   a. Bona fide hedging transactions
   b. Active business gains from the sale of commodities

Foreign Personal Holding Company Income ("FPHCI") Cont'd.

4. Net foreign currency gains, (except directly related to the business needs of the CFC.)
5. Income equivalent to interest.
6. Net income from notional principal contracts (except to hedge inventory property).
7. Certain payments in lieu of dividends under equity securities agreements.
8. Income from certain personal service contracts.

Exceptions to FPHCI

Certain types of income that would otherwise constitute FPHCI are excluded.

1. Active trade or business rents and royalties received from an **unrelated person**.
2. Export financing interest.
3. Same country related person dividends and interest.
4. Special rules for active banking, financing or similar business
5. Special rules for investment income of certain insurance companies

Look through Rule for Related CFCs

- Dividends, interest, rents, and royalties received from a related CFC are not treated as FPHCI to the extent attributable to non-Subpart F income of the related CFC.

  Section 954(c)(6)

- Applicable to tax years of CFCs beginning after 2005 and before 2012.

Foreign Base Company Sales Income (“FBCSI”) Section 954(d)

- Income in the form of profits, commissions, fees or otherwise
- Derived by a CFC in connection with
- A purchase/sale transaction with a related person
- But only if the goods originate outside of and are used outside of the CFC’s country of incorporation

Definition of Related Person

A person is a related person with respect to a CFC if:

- Such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the CFC; or
- Such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the CFC.

Control

- More than 50% of the vote or value of stock of a corporation.
- More than 50% of the value of the beneficial interests in a partnership, trust, or estate.

Determining if Property is Manufactured

- Why relevant
  - If CFC is a manufacturer, place of manufacture and use not relevant, and transaction with related person does not trigger FBCSI
- What constitutes manufacturing
  - Substantial Transformation
  - Substantial Operations-Generally Considered Manufacturing
  - Contract Manufacturing

Substantial Transformation

- Substantial Transformation Examples
  - Conversion of wood pulp to paper
  - The machining of steel rods to screws and bolts
  - The processing of raw tuna fish into canned fish

Substantial Operations- Generally Considered Manufacturing

- If the operations of the CFC are substantial in nature and generally considered to constitute manufacture, production, or construction.
- Presumption - if conversion costs (direct labor and factory burden) of the CFC > 20% of the total costs of goods.

Contract Manufacturing

- December 24, 2008-Final 954(d) regulations issued
- For CFC to be considered a manufacturer, it must make a substantial contribution to the manufacturing process through the activities of its own employees
- Physical manufacturing by another (the contract manufacturer) still permitted, provided CFC makes the substantial contribution

FBCSI Branch Rule

Rule: Treats branch of CFC as separate corporation

Test: Income of branch taxed at an effective tax rate less than 90% and 5 percentage points less than the effective tax rate that would apply in the CFC's country of incorporation.

Foreign Base Company Services Income

Income

- in the form of compensation, commissions, fees, etc.
- derived in connection with the performance of services
- performed for or on behalf of any related person, and
- performed outside the country of organization of the CFC.

Substantial Assistance

- services are considered performed for on behalf of a related person if substantial assistance in the performance of the services by the CFC has been furnished by related person.

Substantial Assistance

- Assistance includes direction, supervision, services, know-how, financial assistance (other than capital contributions) equipment, material or supplies
- Assistance is substantial if:
  - It provides the CFC with skills that are principal element in producing services income; or
  - The cost to the CFC equals 50% or more of total cost to CFC of performing its services
  - Notice 2007-13 – only applicable to assistance from U.S. related person counts and it is substantial if the cost to the CFC equals 80% - not 50% - under the above test

Exclusions From and Limitations on Subpart F Income

- De minimis/Full Inclusion rules for FBCI
- Deductions from Gross FBCI
- High-Tax Exception
- Exclusion of Effectively Connected Income
- Exclusion of Foreign Trade Income of a FSC
- E&P Limit on Subpart F Income

Investment of Earnings in United States Property

U.S. shareholders taxed on pro rata share of CFC's increase in earnings invested in United States property.

- Known as a "Section 956 inclusion."

Section 956 Inclusion

- The **lesser** of
  - U.S. shareholder's pro rata share of CFC's U.S. property and
  - U.S. shareholder's pro rata share of the CFC's current and accumulated E&P ("applicable earnings").
  - Amount of U.S. property = average of quarterly amounts.

What is United States Property

- Tangible property located in the United States.
- Stock of a domestic corporation.
- Obligation of a United States person.
- Guarantee of an obligation of a U.S. person by a CFC.
  - Includes pledge of at least 2/3 of the stock of the CFC by the U.S. shareholder.
- Right to the use intellectual property in the United States.
- Trade or service receivable acquired from related U.S. person if obligor is a U.S. person.

Items Excluded from United States Property

- Obligations of the United States and money and bank deposits.
- Property located in the U.S. which is purchased in the U.S. for export to, or use in, foreign countries.
- Ordinary obligation of a U.S. person arising in connection with the sale of property.
- Service receivable paid within 60 days.
- Obligation held at the end of the CFC's taxable year, if collected within 30 days from the time it is incurred.

Items Excluded from United States Property

Cont'd.

- Certain transportation equipment used in foreign commerce, predominantly outside the United States.
- Insurance company assets (equivalent to an amount of unearned premiums or reserves, which are ordinary and necessary for the proper conduct of its insurance business attributable to certain insurance contracts).
- Stock or obligations of a domestic corporation which is not a U.S. shareholder of the CFC, or which is not 25% or more owned by such U.S. shareholders.

Items Excluded from United States Property Cont'd.

- Movable property other than a vessel or aircraft used on the Continental Shelf of the U.S. Section.
- An amount of assets of the CFC equal to the U.S. source effectively connected income.
- Property which is held by FSC and which is related to the export activities of such FSC.
- Deposits of cash or securities received by a dealer as collateral with respect to a loan or other financial transaction.
- Obligation of a U.S. person obtained by a dealer with respect to a "repo" agreement.
- Securities held by a securities dealer in ordinary course of its business.
- Obligation of a U.S. person that is not a corporation and is not a U.S. Shareholder of the CFC or a related person to the CFC.

Section 1248

- U.S. shareholder of CFC converts long term capital gain on sale of CFC's shares to dividend income to extent of CFC's accumulated E&P (other than PTI)
- Corporate U.S. shareholders
  - No tax rate differential
  - Deemed paid credit
- Individual U.S. shareholders
  - is CFC a "qualified foreign corporation"
  - if yes, no rate differential
  - if no, rate differential

Passive Foreign Investment Company Rules

Definition of a PFIC

- Foreign corporation
- Satisfies either
  - Passive income test
  - Passive asset test
- No stock ownership threshold
  - Attribution rules apply

PFIC Income and Asset Tests

- Income Test
  - 75% or more of gross income is passive income
- Asset Test
  - Quarterly average percentage of passive assets is 50% or more
- Look through 25% owned foreign subsidiaries
  - Look through is only one way

Passive Income

- FPHC income - same as for CFC purposes
- Exceptions for
  - Banking and insurance businesses
  - Interest, dividend, rent or royalty from 25% owned entity
  - Foreign trade income

Passive Assets

- Assets which
  - produce passive income or
  - are held for the production of passive income

Tax Consequences of PFIC Status

- Three Alternative Regimes
  - Excess Distributions (Default Rule)
  - Qualified Electing Fund (“QEF”)
  - Mark-to-Market

Excess Distribution Regime

- Tax upon excess distribution or any disposition
- Deferred tax and interest charge
- Loss of capital gain distinction
- No stepped-up basis at death

Tax Liability Under Excess Distribution Regime

- Calculate total excess distribution
  - >125% of 3-year moving average plus
  - ANY gain on actual or constructive disposition
- Spread across post-1986 holding period
- Compute tax for each year at maximum rate
- Apply underpayment interest rate to each such tax amount
- Add up results

QEF Regime

- Election required
  - Need information from PFIC
- Deemed annual inclusion of income and net capital gain
  - Preservation of capital gains
- Step-up in basis at death

CFC/PFIC Overlap

- CFC rules override PFIC rules for any U.S. Shareholder (10% voting stock) for post 1997 years
- Concurrent CFC/PFIC rules apply if:
  – Pre-1998 the corporation was a PFIC and U.S. Shareholder does not elect to "purge" the PFIC taint; or
  – U.S. owner is not a U.S. Shareholder (10% voting stock)

Overview of § 367

- Tax-free treatment under the Subchapter C rules
- § 367(a): Intended to prevent tax-free transfer of appreciated property by U.S. persons beyond the U.S. tax jurisdiction
- § 367(b): Intended to prevent the accumulated profits of controlled foreign corporations from escaping U.S. tax
- § 367(d): Special rules for outbound transfers of intangible assets; purpose similar to § 367(a)
- § 367(e): Special rules for outbound distributions generally qualifying under § 355 or § 332; purpose similar to § 367(a)

Taxation of U.S. Persons on Dividends from Qualified Foreign Corporations

- A dividend paid to an individual from a qualified foreign corporation ("QFC") is qualified dividend income, i.e., dividend income taxed at a maximum long term capital gains rate - currently 15%
- Scheduled to sunset at end of 2012
- Obama Administration Green Book proposals would retain qualified dividends

Taxation of U.S. Persons on Dividends from Qualified Foreign Corporations (cont'd)

- A QFC is a foreign corporation
  - that is incorporated in a U.S. possession;
  - that is eligible for the benefits of a comprehensive income tax treaty with the U.S., which includes an exchange of information program (*See* Notice 2003-69); or
  - whose stock is readily tradable on an established securities market in the U.S. (*See* Notice 2003-71)
- A foreign corporation is not a QFC if it is a PFIC in the year the dividend is paid or in the previous year
- The foreign corporation must be a QFC for the year the dividend is paid in order for the dividend to qualify for the reduced 15% rate

Limitations on Deductibility

- **Section 163(j)**
  - U.S. corporation paying interest to related foreign person
  - If applicable, results in disallowance of interest deduction
  - Disallowed interest carried forward indefinitely
  - To apply
    - Payor's debt-to-equity must exceed 1.5:1
    - Payor's net interest expense must exceed 50% of adjusted taxable income
- **Section 267**
  - Impacts timing of deduction
  - Deduction delayed until income includible in gross income of foreign recipient

International Transfer Pricing § 482

- Commonly controlled entities
- Arm’s length pricing
  - Intangible property-commensurate with income standard
- Penalties-§ 6662(e)
- Contemporaneous documentation
- Advanced Pricing Agreement

Contact Information

William B. Sherman
Holland & Knight LLP
515 East Las Olas Boulevard
Suite 1200
Fort Lauderdale, FL 33301
Tel: 954-468-7902
Email: bill.sherman@hklaw.com

11466206