Foreign Entity Selection for U.S. Owners of Offshore Businesses: Avoiding Tax and Reporting Traps

THURSDAY, JANUARY 17, 2019, 1:00-2:50 pm Eastern

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Foreign Entity Selection for U.S. Owners of Foreign Interests

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INTRODUCTION

- United States taxpayers increasingly engage in foreign investments and maintain foreign holdings
  - Classification of these foreign interests for U.S. tax purposes is critical, as it dictates U.S. tax ramifications
    - U.S. classification does not rely on foreign laws/foreign nomenclature for classification purposes
      - Initial evaluation of an interest independent of foreign classification is thus critical
  - Default U.S. classification rules exist, but elections can be available to alter them
    - Allows the U.S. taxpayer to dictate how an interest is taxed for United States purposes

INTRODUCTION

- Why does classification matter?
  - Both reporting requirements and the need for income recognition are largely dictated by entity classification
    - Where an interest is maintained in an entity treated as a flowthrough, income immediately is recognized for U.S. tax purposes
    - Conversely, where a corporate structure is found for U.S. purposes, some level of tax deferral is available (with deferral opportunities shrinking based on GILTI!)
      - **Critical:** must be cognizant of how an entity is classified in its home jurisdiction, as both planning opportunities and punitive consequences can result from mismatches

THRESHOLD CONSIDERATIONS

- First question for United States entity classification purposes: Is there a United States person with an interest in a foreign entity?
  - If there is no U.S. taxpayer, there is no U.S. tax issue (assuming the entity has no U.S.-sourced income)
    - Information reporting requirements mostly only apply to U.S. persons (primary exception – Form 5472)
  - If a foreign entity does not exist, then there is no classification of the holding
    - Examples: foreign checking/savings accounts, foreign real property holdings held directly by a taxpayer

THRESHOLD CONSIDERATIONS

- United States person defined under Sec. 7701
  - United States – 50 states and D.C.
  - Person: individual, trust, estate, partnership, association, company or corporation
    - United States “individual” – either a U.S. citizen or a U.S. resident
      - Resident – primarily a green card holder or an individual meeting substantial presence requirements
        - Under default rules – treaties can modify!

THRESHOLD CONSIDERATIONS

- Entity – Regs. 1.1471-1(b)(39) defines an entity as “any non-individual taxpayer”
  - Organization – an entity separate from its owners
  - Critically, whether an “entity” separate from a taxpayer exists for U.S. purposes is determined under U.S. rules, rather than analyzing whether there is an entity for foreign purposes
    - An undertaking by multiple parties is normally classified as an organization
      - Functionally, some type of formal structure/agreement will be needed for an entity to be found

INTEREST IN A FOREIGN ENTITY – IS THE ENTITY A TRUST?

- Two types of entities can generally exist under U.S. rules: (1) trusts and (2) business entities
  - “Trust” defined in the regulations – arrangement whereby trustees take title to property for the purpose of protecting or conserving it for beneficiaries, with the beneficiaries not sharing in the responsibility to protect/conserve the situs
    - CANNOT rely on nominally forming a “trust” – can have reclassifications where trust requirements not met (i.e. beneficiaries having sufficient control/management to constitute a business entity)
- Business trusts and commercial trusts - two examples of structures not typically classified as trusts under the Code
  - Macro-level takeaway – evaluate foreign “trusts” to see how they are classified!

INTEREST IN A FOREIGN ENTITY – IS THE ENTITY A TRUST?

- How are foreign trusts taxed?
  - Foreign grantor trust – income is taxable to the trust creator
    - NOTE: nonresident aliens cannot establish trusts treated under U.S. rules as foreign grantor trusts except under narrow circumstances
  - Foreign nongrantor trust – treated as an entity separate from its creator
    - Subject to direct tax only on its U.S. sourced income
    - Special rules apply to foreign nongrantor trusts with U.S. beneficiaries – including the “throwback” rule

INTEREST IN A FOREIGN ENTITY – IS THE ENTITY A TRUST?

- United States beneficiaries of foreign nongrantor trust are subject to tax via the “throwback” rule on accumulated distributions
  - Where foreign trust has United States beneficiaries and accumulates income, distributions in excess of current year income amounts carry severe consequences
    - Income classified as ordinary, interest applies from date income originally earned, can be taxed at prior year rates
- Often better to avoid foreign nongrantor trusts where there will be U.S. beneficiaries, but can mitigate throwback rule ramifications by making current distributions

INTEREST IN A FOREIGN ENTITY – IS THE ENTITY A TRUST?

- United States information reporting requirements: primarily look to Form 3520
  - Require to be filed by the following:
    - Responsible party for reporting a reportable event that occurred during tax year or transferred property to a foreign trust in exchange for an obligation
    - U.S. person who is treated as the owner of any part of the assets of a foreign trust
    - U.S. person receiving distributions from a foreign trust
  - Form 3520-A can also be required – filed by a foreign trust which has a United States owner

FOREIGN BUSINESS ENTITIES

- Business entity - any entity recognized for federal tax purposes that is not classified as a trust or otherwise subject to special treatment
  - Three types of business entities: (1) disregarded entities, (2) partnerships, and (3) associations taxable as corporations
    - Entities with single owners are either disregarded entities or corporations; when multiple owners exist, an entity can be classified as either a partnership or corporation
      - Partnerships and disregarded entities are jointly referenced as “flowthroughs”

FOREIGN ENTITIES – ENTITY CLASSIFICATION

- Foreign-domiciled entities generally are able to elect their entity classification for United States tax purposes
  - EXCEPTION: Per-se corporations (as listed in the Regulations)
  - Default rules for classification exist, which hinge on the limited liability of owners/members
    - If limited liability for owner/owners – association taxable as a corporation
    - If no limited liability for at least one owner – partnership if multiple members, disregarded entity if one

RELEVANCE DETERMINATION FOR FOREIGN ENTITIES

- Elections out of default rules are available - can elect to be a partnership, corporation, or disregarded entity
  - Entity with single owner can either by taxed as a corporation or a DRE; entity with multiple owners can be a partnership or corporation
  - Election made on Form 8832 – initial election required within 75 days of entity becoming “relevant”
    - A foreign entity becomes “relevant” when its classification affects the liability of any person for federal tax or information purposes
      - i.e. when a United States filing obligation of some sort (either tax or information return) is created

RELEVANCE DETERMINATION FOR FOREIGN ENTITIES

- When is obligation to file created?
  - Generally, a foreign corporation engaged in a trade or business within the United States during the taxable year is taxable on income effectively connected with the conduct of that trade or business.
    - Foreign corporations engaged in a United States trade or business at any time during the taxable year must file Form 1120-F.
  - Information reporting obligations can also exist for U.S. owners of foreign entities:
    - Form 5471 (for foreign corporations)
    - Form 8865 (for foreign partnerships)
    - Form 8858 (for foreign DREs)

RELEVANCE DETERMINATION FOR FOREIGN ENTITIES

- Who can make the election?
  - Form 8832 must be filed by either:
    - Each member of the electing entity who is an owner at the time the election is filed; or
    - Any officer, manager, or member of the electing entity who is authorized (under local law or the organizational documents) to make the election.
  - Often, for United States persons with minority interests in foreign corporations, they will not have authority/power to make an election
    - United States entity classification elections thus functionally unavailable as a result!
    - Need to be cognizant of default classification/ramifications as a result where minority interests will exist

RELEVANCE DETERMINATION FOR FOREIGN ENTITIES

- Late election relief is available under narrow circumstances.
- Prospective elections can also be made for existing entities.
  - Where a prospective election is made, tax ramifications can occur (based upon the deemed change in entity).
- If an eligible entity elects to change its classification, the entity cannot change its classification by election for sixty months after the election's effective date.

TAXATION OF FOREIGN ENTITIES

- Activities of foreign flowthroughs create immediate income recognition requirements for their U.S. owner/partner
- Activities of foreign corporations have historically been exempt from U.S. tax, subject to exceptions
  - System incentivizes income-shifting efforts in order to delay U.S. tax imposition
    - Historically, the primary exception has been Subpart F, though others – like the passive foreign investment company rules – also existed
  - Under the Tax Cuts and Jobs Act, there has been a shift in the tax of foreign subsidiary distributions, but an increase in anti-deferral mechanisms

FOREIGN CORPORATIONS – SUBPART F INCOME

- Subpart F imposes a direct tax on a U.S. shareholder of a controlled foreign corporation (“CFC”) as to the CFC’s Subpart F income
  - Tax imposed directly on shareholders, regardless of whether distributions of income are made
    - For future distributions which previously were taxed under Subpart F, Sec. 959 prevents double taxation of the same income
    - Indirect foreign tax credits available under Sec. 960 – however, only available for domestic corporations!
  - Look to (1) whether a U.S. shareholder exists, (2) whether there is a CFC, and (3) whether the CFC has Subpart F income
    - U.S. shareholder – United States person owning at least 10% of the foreign corporation’s voting stock or value
    - Controlled foreign corporation if on any day during a given year U.S. shareholders own more than 50% of the stock

FOREIGN CORPORATIONS – SUBPART F INCOME

Subpart F income is primarily comprised of “movable income” – income that can be shifted to foreign jurisdictions more easily

- Foreign base company income is the largest component
  - Includes foreign personal holding company income, foreign base company sales income, foreign base company services income, etc.
    - Foreign personal holding company income: dividends, interests, rents, royalties, and annuities
      - Also includes certain net gains from sale of property which generates passive income
      - Exceptions exist, i.e. for active trade or business rents

FOREIGN CORPORATIONS – SUBPART F INCOME

Foreign base company sales income - CFC buys or sells tangible personal property from/to a related person where property is manufactured/produced outside the CFC's country of incorporation and purchased/sold for use outside the country of incorporation

- Person is a related person if they control/are controlled by the CFC or are a entity which is controlled by the same persons who control the CFC
  - Control generally classified as a >50% interest

FOREIGN CORPORATIONS – SUBPART F INCOME

Foreign base company services income - income from personal services performed for/on behalf of any related person and performed outside the CFC's country of organization

- Compensation, commissions, fees, etc. derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial services
- For both foreign base company sales income and foreign base company services income, look to activities outside the corporation's country of domicile and the transactions with related persons

FOREIGN CORPORATIONS – SUBPART F INCOME

Tax Cuts and Jobs Act made significant modifications in Subpart F context

- U.S. shareholder definition changed – pre-TCJA, only looked to voting power (rather than value)
- Sec. 958(b)(4) repealed – previously prevented “downward attribution” for U.S. shareholder/CFC purposes
  - Post-TCJA, can now have attribution of a foreign subsidiary owned by a foreign parent to a U.S. subsidiary!
    - Importantly, Subpart F inclusion occurs only to the extent of direct ownership and stock indirectly held via foreign entities under Sec. 958(a)

FOREIGN CORPORATIONS – PASSIVE FOREIGN INVESTMENT COMPANIES

- Passive foreign investment company ("PFIC") is a foreign corporation where either:
  - 75% or more of the gross income of such corporation for the taxable year is passive income, or
  - The average percentage of assets held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50%

Passive income for these purposes is any income which is of a kind which would be foreign personal holding company income

  - Unlike with Subpart F, no minimum ownership requirements exist for rules to apply
    - Where an entity meets both PFIC and CFC definitions, the CFC rules apply and the PFIC ones do not

FOREIGN CORPORATIONS – PASSIVE FOREIGN INVESTMENT COMPANIES

- Separate regimes can apply to PFICs for United States tax purposes; default rules exist in lieu of alternate elections
  - Default rules: punitive tax repercussions exist on excess distributions or dispositions
    - Holders of PFICs are subject to tax on any excess distribution or disposition at the top marginal tax rates for individual taxpayers, plus interest amounts calculated based on their holding period
  - Elections outside default rules available to modify tax ramifications
    - Qualified electing fund ("QEF") election: include ordinary earnings as ordinary income and net capital gain as long-term capital gain
    - Mark-to-market ("MTM") election: recognition of gain or loss on shares' fair market value on an annual basis

FOREIGN CORPORATIONS - GILTI

- Under Sec. 951A, U.S shareholders of a controlled foreign corporation must include their share of global intangible low-taxed income in US tax
  - GILTI: Excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return
  - U.S. shareholder and controlled foreign corporation concepts mirror Subpart F
    - GILTI inclusion treated similarly to Subpart F in many ways, but not technically a component of Subpart F
  - 50% deduction available for GILTI, but ONLY for C-Corporations!
    - Makes the effective tax rate for corporate shareholders 10.5%
    - For non-corporate U.S. shareholders, rate can be 37%

FOREIGN CORPORATIONS - GILTI

- GILTI Application
  - Functionally, GILTI essentially is tax imposed on U.S. shareholders of a CFC on the excess of an assumed 10% rate of return on tangible business assets of the CFC
    - GILTI imposes a minimum tax on foreign earnings that exceed a standard rate of return amount
  - No direct reference to intangibles is made in Sec. 951A
    - Aim may have been intangible income, but application will be significantly more far-reaching, and not limited to one type of income (i.e. movable income)

ANTI-DEFERRAL REGIMES

- Historical anti-deferral rules targeted specific types of income – mainly, movable income (including passive income)
  - GILTI expands the scope – now, all income exceeding a set rate of return is immediately includable
    - Functional interplay exists between GILTI and Subpart F – Subpart F addresses passive income of a foreign entity, with GILTI looking towards its operational income
  - **NOTE: Subpart F/GILTI apply only where there is a U.S. shareholder and a CFC!**
    - If either requirement not met, then GILTI/Subpart F will not apply – but PFIC rules might

IMPACT OF TAX TREATIES

- Tax treaties function to reduce a country's taxing authority in situations covered by treaty terms
  - Under treaties, residents of a treaty country can be taxed at a reduced rate, or even exempted from tax, on specified items of income from the other country
    - i.e. dividends can be subject to reduced rates of tax
    - Goal with treaties is to facilitate global activities
  - Savings clause prevents a United States citizen or resident from using a tax treaty to alter tax on US-source income
  - Treaty-based positions generally must be disclosed
    - Subject to exemptions under the Regulations

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – “HYBRID” ENTITIES

- Entity classification rules permit the utilization of “hybrid” entities (i.e. an entity treated as a “corporation” for foreign tax purposes and a disregarded entity for United States purposes), which can provide benefits from a global planning perspective.
  - Planning opportunities based on “mismatches” between how an entity/transaction is classified in different jurisdictions is referenced as “tax arbitrage”

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – “HYBRID” ENTITIES

- “Hybrid” entities are entities which are fiscally transparent for United States tax purposes (i.e. a partnership) but not fiscally transparent for foreign tax purposes (i.e. a corporation).
- A “reverse hybrid entity” is one which is fiscally transparent for foreign tax purposes but not fiscally transparent for United States tax purposes.
- Different types of these entities can exist:
  - An entity can be a “corporation” for foreign tax purposes but a partnership or disregarded entity for United States purposes.
  - An entity can be a “partnership” or “branch” for foreign tax purposes but a corporation for United States tax purposes.

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – “HYBRID” ENTITIES

- Planning through hybrid entities provides significant opportunities.
  - Can create situations where a transaction is deductible in country A without creating taxable income in Country B
  - Can exploit different tax rules of relevant jurisdictions to reduce/eliminate tax
    - On a macro level, use of hybrid entities provides planning opportunities; consideration should be provided to planning opportunities in the entity classification context

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – "HYBRID" ENTITIES

- Examples of hybrid planning opportunities:
  - Earnings stripping transactions – incorporates use of a loan with interest received by a US DRE (so no Subpart F inclusion) but payments made to a foreign corporation (so interest expense deductible in payor's home jurisdiction)
  - Foreign tax credit mismatches – income earned by an entity viewed by the US as a corporation but by its home country as a flowthrough
    - Income then attributed to a foreign corporation which is disregarded for U.S. purposes – with U.S. parent receiving a FTC without income recognition!
- Given the ability to reduce/eliminate tax as a result of structuring transactions, the Service has put barriers to hybrid transactions in place

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – "HYBRID" ENTITIES

- Code Sec. 894(c)(1) denies treaty benefits for specified payments from the United States made to hybrid entities.
- Under the provision, foreign persons are not entitled to any reduced withholding tax rate under any United States income tax treaty on income derived through an entity that is treated as fiscally transparent for purposes of United States taxes if:
  - The income is not treated as income of the person for purposes of the tax laws in the foreign country,
  - The treaty contains no provision relating to the applicability of the treaty to income derived through a partnership, and
  - The foreign country imposes no tax on the distribution of the income from the entity to the person.

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – "HYBRID" ENTITIES

- Code Sec. 894(c)(2) authorized the Service to promulgate regulations to further limit benefits from hybrid structures
- The relevant Regulations set forth additional limitations for certain transactions involving hybrid entities (limiting potential for "double non-taxation" of items of income).
  - "[Withholding taxes imposed] on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction."

PLANNING OPPORTUNITIES FOR FOREIGN ENTITIES – "HYBRID" ENTITIES

- In late 2018, further regulations were issued under Sec. 267A to limit hybrid benefits
- A specified party's deduction for any interest or royalty paid or accrued is disallowed to the extent it is treated as:
  - A disqualified hybrid amount (requires a deduction without a corresponding income inclusion);
  - A disqualified imported mismatch amount (requires a U.S. deduction and foreign income being offset by a hybrid deduction); or
  - A payment subject to anti-avoidance rules.

WHICH ENTITY CLASSIFICATION IS BEST?

- Proper entity classification for United States purposes is inherently fact-specific, and hinges on a number of variables
  - One crucial variable is home country classification, as disparities can create U.S. tax repercussions
    - Entities classified as passthroughs in their home jurisdiction but as corporations (whether by default or by election) in the United States are an example
      - Can create income inclusion (by virtue of passthrough status) without a corresponding U.S. foreign tax credit!

WHICH ENTITY CLASSIFICATION IS BEST?

- Anti-deferral rules apply only to foreign corporations – can elect non-corporate entity classification to avoid regimes and their impact on U.S. shareholders
  - BUT when making such a classification election, lose the ability to defer any income!
    - Anti-deferral rules aren't applicable to flowthroughs because there is no deferral!
    - GILTI has an impact in this context – severely curtails the ability to defer income from U.S. perspective

WHICH ENTITY CLASSIFICATION IS BEST?

- Classification decisions often require weighing the burden of reporting requirements for foreign corporations (i.e. Form 5471) and deferral availability with the eschewal of deferral for flowthroughs
  - Information reporting still required for flowthroughs – Forms 8865 (partnerships) and 8858 (DREs)
  - Treaty provisions also provide an important variable where applicable
  - Vital to evaluate all relevant facts – no universal best option!

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