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# Subpart F Rules on Taxation of Controlled Foreign Corporations

## Navigating the Complexities in Tax Planning for Multinational Companies

**A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Daniel L. Gottfried, Partner, **Rogin Nassau**, Hartford, Conn.  
Jeff Rubinger, Partner, **Holland & Knight**, Fort Lauderdale, Fla.  
Michael J. Miller, Partner, **Roberts & Holland**, New York

**Tuesday, March 9, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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*Subpart F Rules on Taxation of Controlled  
Foreign Corporations: Navigating the  
Complexities in Tax Planning for  
Multinational Companies*

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# *Overview*

Discuss relevant issues under Subpart F including:

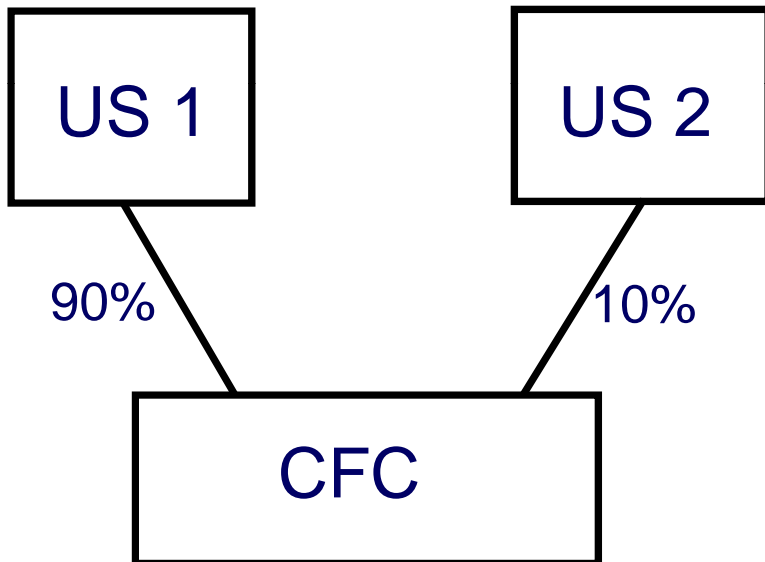
- What is a CFC
- Who is a US shareholder
- What is Subpart F Income
- Planning opportunities
- Recent Developments
- Reporting Requirements

**What is a CFC?  
Who is a US shareholder?**

## *Definition of CFC*

- A foreign corporation is a CFC if “US shareholders” own:
  - More than 50% total voting power, or
  - More than 50% total value
- US shareholder is
  - A US person (including a US LLC or US limited partnership)
  - With a 10%-or-greater voting interest
- Indirect and constructive ownership rules apply for purposes of both CFC and US shareholder status

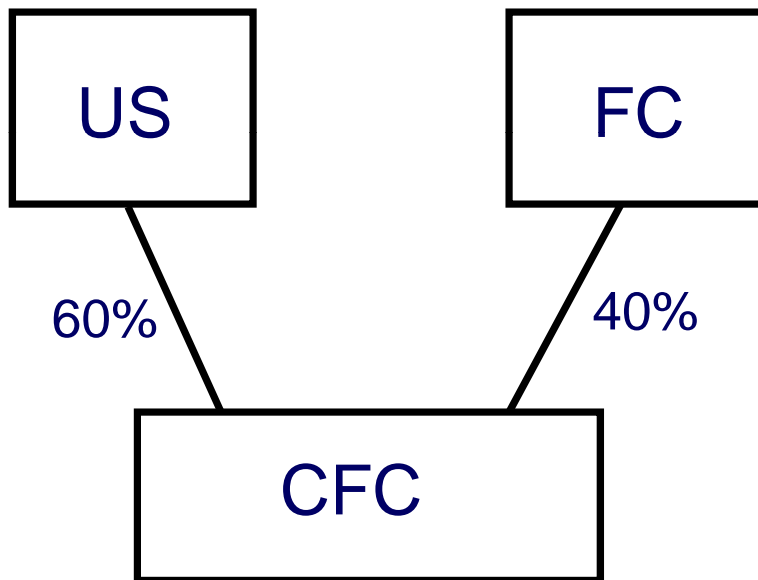
# *US Shareholder Status*



**What Can US 2 Do To Avoid US Shareholder Status?**

- **Reduce to 9.9%**
- **Different Classes of Stock**
- **Options?**
- **Careful of the PFIC rules!**

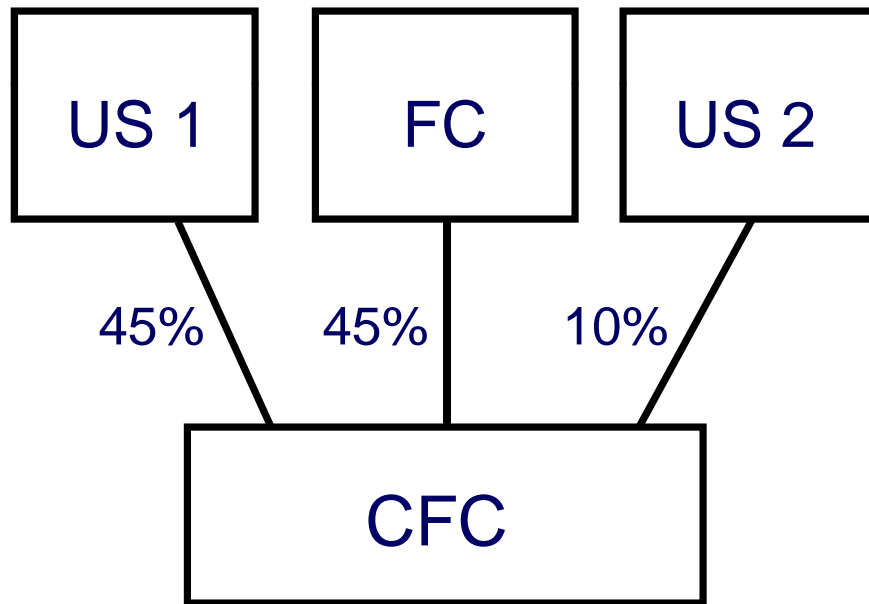
# *CFC Status*



**What Can US Do To Avoid CFC Status?**

- **Reduce to 50%**
- **Different Classes of Stock?**
- **Options?**
- **What if FC sells to a domestic person?**

# *CFC Status - Variation*



**What Can US 2 Do To Avoid CFC Status?**

**What effect on US 1?**

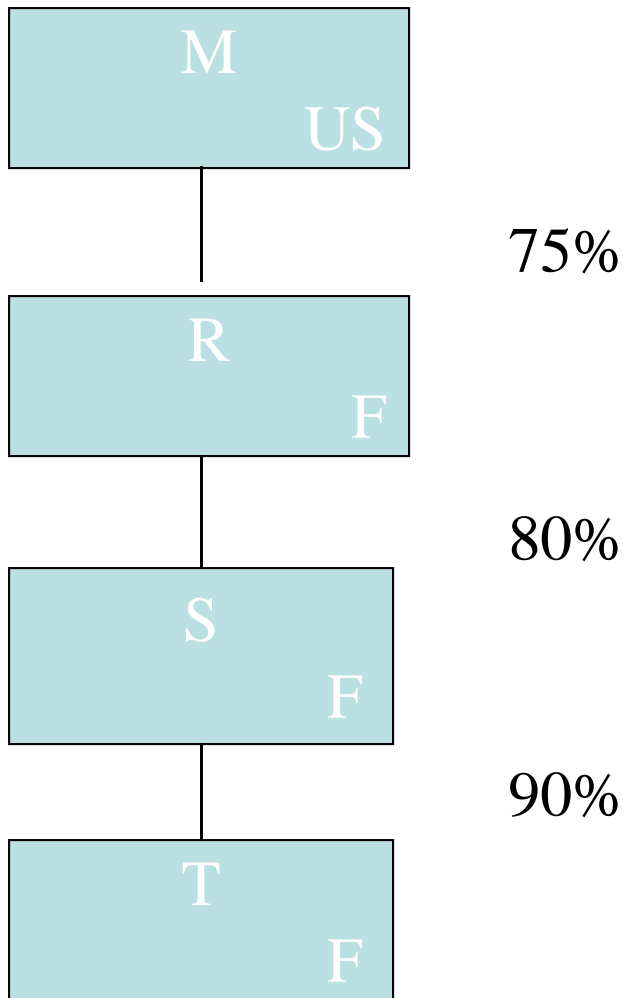
# *What is Voting Power?*

- Generally, power to elect the Board of Directors
- Be wary of “understandings”
- Be wary of “tie-breaker” provisions, special powers, and other arrangements that may shift voting power
- See Garlock, Alumax

# *Indirect Stock Ownership*

- Stock owned by a foreign corporation, partnership, trust or estate, is considered to be owned “proportionately” by its shareholders, partners, or beneficiaries.

# Indirect Stock Ownership - Example

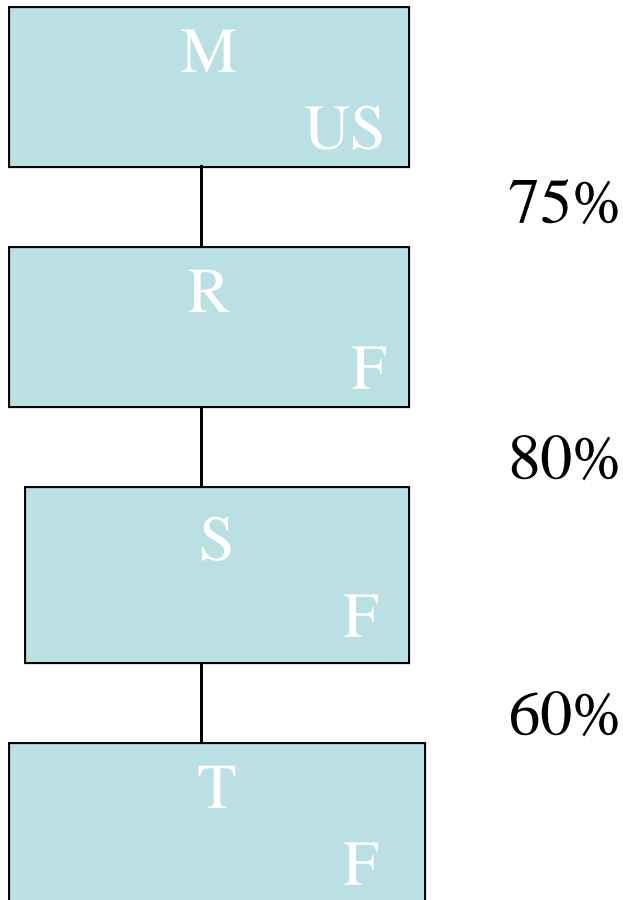


- R owns 72% of T  
(80% X 90% = 72%)
- M owns 54% of T  
(75% X 72% = 54%)

# *Constructive Ownership*

- Family
- From Entity to Owner
- From Owner to Entity
- Deemed Exercise of Options
- Special Rules
  - No attribution from non-US person to US person
  - If entity owns > 50%, treated as owning 100%

# Constructive Stock Ownership - Example



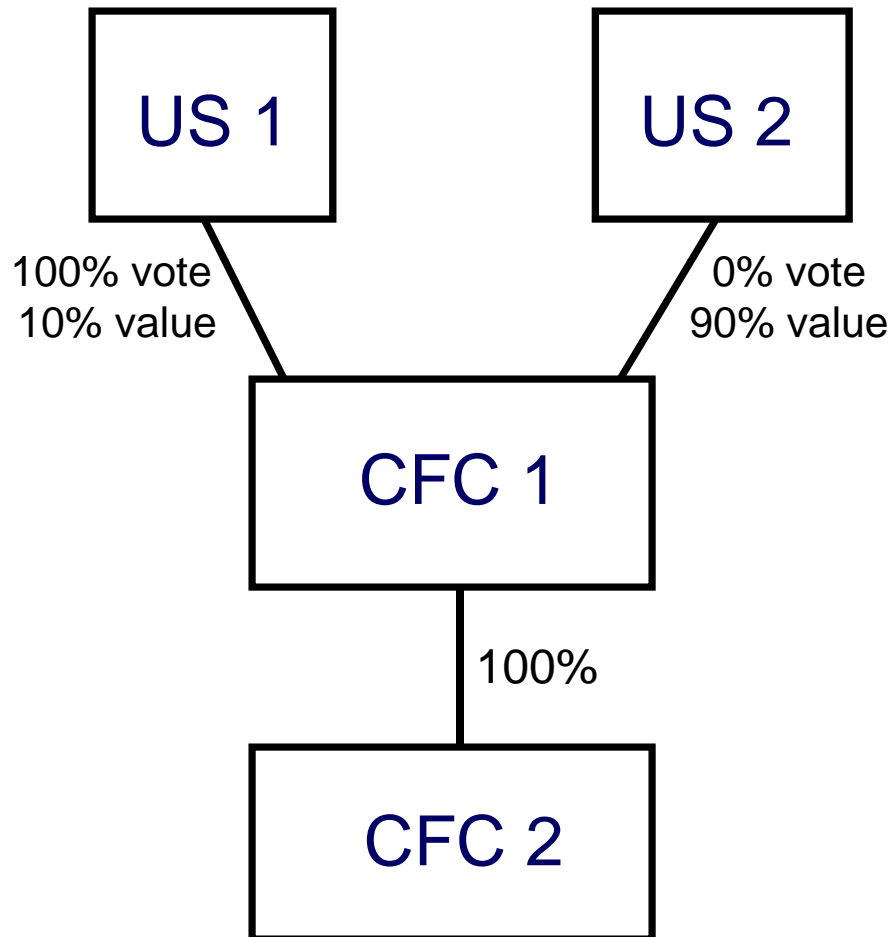
## Indirect Ownership

- M owns 36% of T  
(75% \* 80% \* 60% = 36%)

## Constructive Ownership

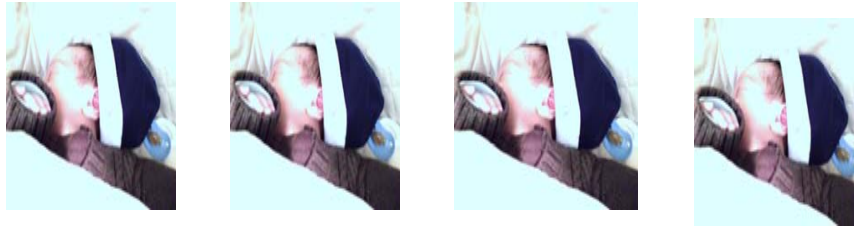
- M owns 100% of T

# Constructive Ownership – Surprising Example



- **US 2 is a US shareholder of CFC 2, but not CFC 1!**
- **CFC 2 voting stock attributed to shareholders of CFC 1 based on value of CFC 1 stock owned.**

# Constructive Ownership – Planning Opportunity



Grandpa:  
100% vote  
12% value

Four grandchildren. Each has:  
0% vote  
22% value



- Grandpa is a US shareholder; includes 12% of the CFC's Subpart F income
- No attribution from grandparent to grandchild
- Grandchildren are not US shareholders, so do not include any Subpart F income
- However, they must worry about PFIC issues

# What is Subpart F Income?

# *What is Subpart F Income*

- In general
- Insurance income
- Foreign base company income
- International boycott income
- Illegal bribes and kickbacks
- Income from blacklist countries

## *Subpart F Income; In General*

US shareholder includes its pro rata share of Subpart F income in its gross income

- Pro rata share is hypothetical dividend on Subpart F income
- Pro rata share is based on shares owned, directly or indirectly, by US shareholder
- Subpart F income is ordinary income

# *Insurance Income*

- Includes income from
  - insuring or reinsuring any insurance or annuity contract where risks are in country other than country where CFC is organized
  - intra-country risks where counterparty receives same premiums for risks arising in other countries
- Risks include property/casualty, life and health
- Subchapter L limitation
- Other rules/exceptions

# *Foreign Base Company Income*

Most common types of foreign base company income (FBCI):

- Foreign personal holding company income
- Foreign base company sales income
- Foreign base company services income

# *Foreign Personal Holding Company Income*

- Foreign personal holding company income (FPHCI) is generally passive income
  - Dividends, interest, rents, royalties and annuities
  - Gains from sale of property that produces passive income
  - Gains from commodity transactions, foreign currency transactions, notional principal contracts, etc.
- Exceptions for active business

# *Foreign Base Company Sales Income*

- Foreign base company sales income is:
  - Income from sales to or on behalf of a related person, or purchased from or on behalf of a related person
  - Does not include sale of property for use, consumption or disposition in CFC's country of organization
- Includes commissions, profits, fees, etc.

# *Foreign Base Company Services Income*

Foreign base company services income is:

- Income derived from services performed for or on behalf of a related person
- Does not include:
  - Income from services performed for unrelated persons
  - Income from services performed in CFC's country of organization

## *Other Subpart F Inclusions*

- International boycott income
- Illegal bribes and kickbacks
- Income from blacklist countries

# What are Some Subpart F Exceptions?

## *Subpart F Income -- Exclusions and Limitations*

- De minimis/Full Inclusion rules for FBICI
- High-Tax Exception
- Exclusion of Effectively Connected Income
- E&P Limit on Subpart F Income

## *De minimis and Full Inclusion Rules*

- If Subpart F income is less than the lesser of:
  - 5% of the gross income, or
  - \$1,000,000then Subpart F income deemed to be zero.
- If  $> 70\%$  of gross income is Subpart F income, then all of the CFC's gross income is considered Subpart F income

## *High Tax Exception*

Item of income  $\neq$  Subpart F income, if effective rate of tax imposed on the income by a foreign country  $>$  90% of the maximum rate US tax (31.5%).

- The exception is applied separately to each item of income.
- Effective rate determined under US tax principles (can't just look up the rate).

# *Earnings and Profits Limitation*

- Subpart F income may not exceed current E&P.
- Current E&P not reduced by distributions made during the year.
- Certain accumulated E&P deficits reduce E&P in later years.

# *Distributions of Previously Taxed Income*

Previously taxed income (PTI) not:

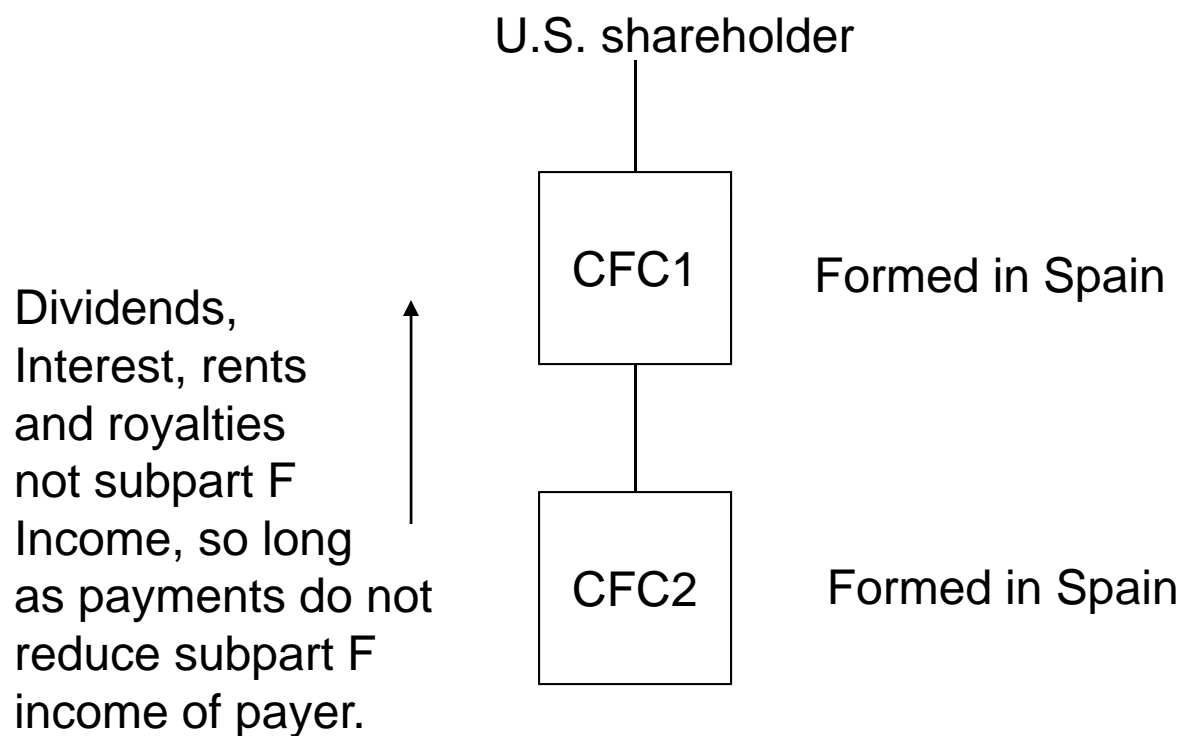
- Subpart F income when distributed
- Section 956 inclusion when invested in US property

# Planning with Management and Control

## *Exception from Subpart F Income – Same Country Exception*

- Foreign personal holding company income
  - Does not include:
    - Dividends and interest received from a related person that (i) is a corporation created or organized in the same foreign country as the CFC is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in the same foreign country;
    - Rents and royalties received from a corporation which is a related person for the use of property within the country under the laws of which the CFC is created or organized.
  - Related person for this purpose is defined using a more than 50 percent vote or value test.

## *Exceptions from Subpart F Income – Same Country Exception (cont.)*



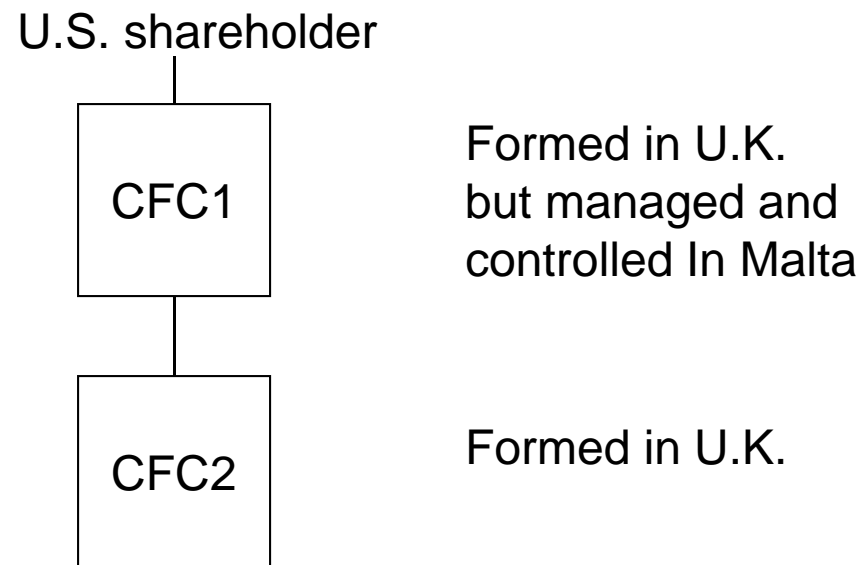
## *Exceptions from Subpart F Income (cont.)*

- Use of same country exception can be made even more beneficial by moving the “management and control” of parent CFC to a more favorable taxing jurisdiction.
- Management and control generally can be moved by appointing local director in another jurisdiction and holding board meetings in that jurisdiction.
- Once foreign corporation is formed in one jurisdiction but managed and controlled in another jurisdiction, it will be considered a “dual resident” corporation.
- If treaty exists between both foreign jurisdictions, place of management and control will determine residency for foreign tax purposes.

## *Example of Using Same Country Exception for Non-Domiciled Company*

- U.S. parent owns 100-percent of the stock of a foreign corporation (“FC1”). FC1 owns 100-percent of the stock of another foreign corporation (“FC2”). Both FC1 and FC2 are CFCs. FC1 was formed under the laws of the U.K., but is managed and controlled in Malta; FC2 was formed under the laws of the U.K., and is managed and controlled in the U.K. FC1 makes a loan to FC2 so that FC2 can expand its U.K. business. The interest paid by FC2 to FC1 reduces FC2’s U.K. tax base, but is not subpart F income under the same country exception for interest because both FC1 and FC2 have both been formed under the laws of the U.K.
- Thus, avoid subpart F income, and avoid local tax in the U.K. because FC1 is not treated as U.K. resident under U.K.-Malta treaty tie breaker provision.
- Gain favorable tax benefits in Malta because resident but non-domiciled Maltese companies are subject to very low tax rates.

# *Example of Using Same Country Exception for Non-Domiciled Company (cont.)*



## *Section 954(c)(6) Look-Through Rule*

- Section 954(c)(6) provides temporary look-through rule for related CFCs.
- Interest, dividends, rents, royalties received or accrued from related CFC will not be treated as subpart F income, regardless of where payor CFC is formed, so long as payments are not attributable to subpart F income of paying CFC.
- However, this look-through rule expired December 31, 2009 (although part of an “extender” bill). Thus, use of same country exception more beneficial since it results in long-term structures.

## *Foreign Base Company Services Income – In General*

- Foreign base company services income defined as income derived from the performance of services for, or on behalf of, a related person, if those services are performed outside the CFC's place of formation.
- Also includes services income derived by CFC from the performance of services to or on behalf of unrelated person, if related person provides “substantial assistance.”

## *Example of Substantial Assistance Test*

- U.S. person has offer to perform services for foreign employer in the U.K. Instead of performing services directly (and being subject to current U.S. tax), U.S. person sets up CFC in the Cayman Islands and has CFC sign contract with foreign employer to perform services.
- CFC then signs employment contract with U.S. shareholder appointing U.S. shareholder as the actual service provider.
- Income derived by Cayman Islands entity will be treated as subpart F income, even though services are performed for unrelated U.K. employer because related person (*i.e.*, U.S. shareholder) provided “substantial assistance.”

## *Planning to Avoid Foreign Base Company Services Income by Moving Management and Control*

- U.S. person has offer to provide services to U.K. employer. Instead of performing services directly, U.S. person forms U.K. company and has U.K. company sign service contract with U.K. employer. The management and control of U.K. entity is located in Malta. Under U.K.-Malta treaty tie breaker test, entity treated as resident of Malta.
- U.S. person then signs employment contract with U.K. entity to agree to provide services on the company's behalf in the U.K.
- Income derived by U.K. entity not subpart F income because services are performed in place where CFC is formed (*i.e.*, the U.K.).

## *Planning to Avoid Foreign Base Company Services Income by Moving Management and Control*

- In addition to services being performed in place where CFC is created or organized, in order to avoid subpart F income also need to worry about Section 954(c)(1)(H) - income from personal service contracts, which is now treated as category of subpart F income.
- Can avoid if (i) the individual who is to perform the services is not listed in the corporation's employment contract and (ii) only the corporation has the right to designate who is to perform the services.
  - This will be the case regardless if all parties are aware that U.S. shareholder will be performing the service.

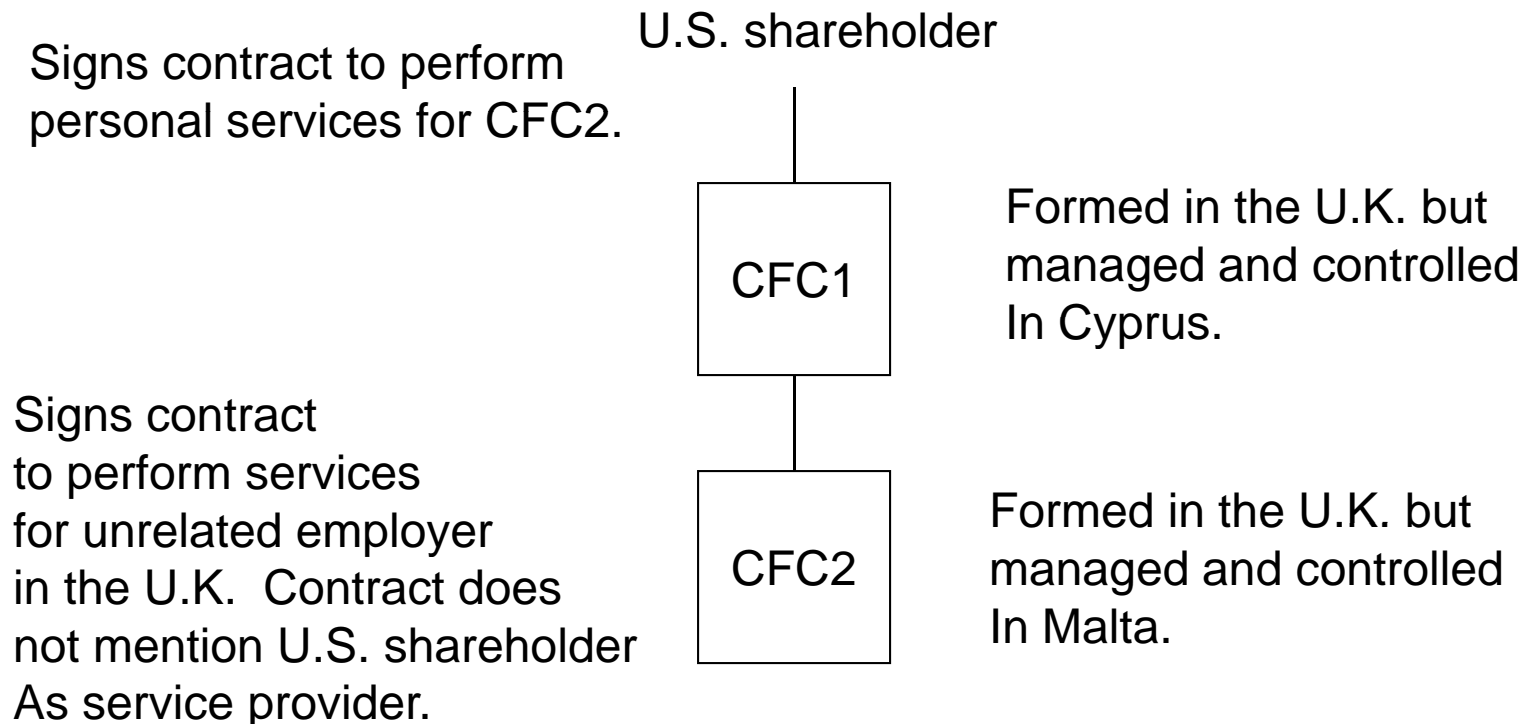
## *Planning to Avoid Foreign Base Company Services Income by Moving Management and Control (cont.)*

- Foreign tax consequences of structure:
  - Companies that are resident but non-domiciled in Malta are only taxed on income remitted to Malta.
  - Thus, so long as service income is not remitted to Maltese bank account, no taxation in Malta.
  - In addition, likely no taxation in the U.K. because no permanent establishment in the U.K. if services last for limited duration and Maltese company has no employees in the U.K.

## *Planning to Avoid Foreign Base Company Services Income by Moving Management and Control (cont.)*

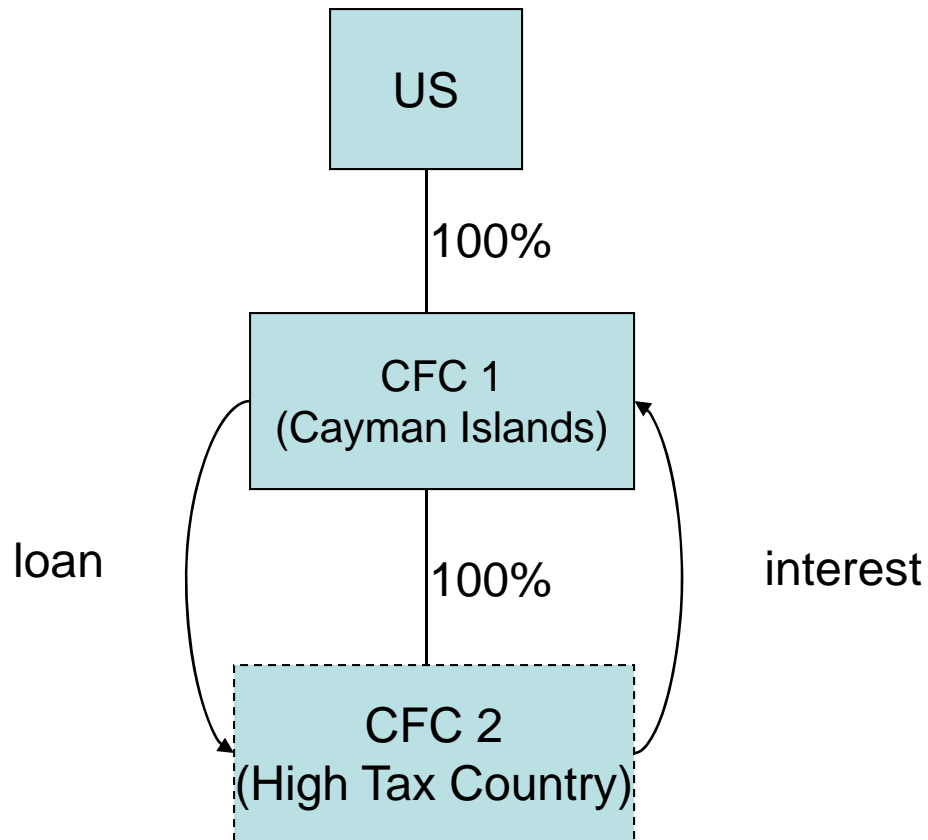
- In addition, if ownership of U.K./Maltese entity is structured correctly, U.S. individual shareholder should be able to obtain qualified dividend income.
- For example, if U.K. entity (which is treated as Maltese resident, and thus not treated as qualified foreign corporation for Section 1(h)(11) purposes) is owned by entity formed in U.K. but managed and controlled in Cyprus, dividends paid by U.K. subsidiary entity to U.K./Cypriot parent entity would not be treated as subpart F income (under same country exception), would be exempt from tax in the U.K. (since non-resident of U.K. under treaty) and exempt from tax in Cyprus (under participation exemption).
- Also, would be eligible for 15 percent tax rate in the U.S. when repatriated.

# *Planning to Avoid Foreign Base Company Services Income by Moving Management and Control (cont.)*



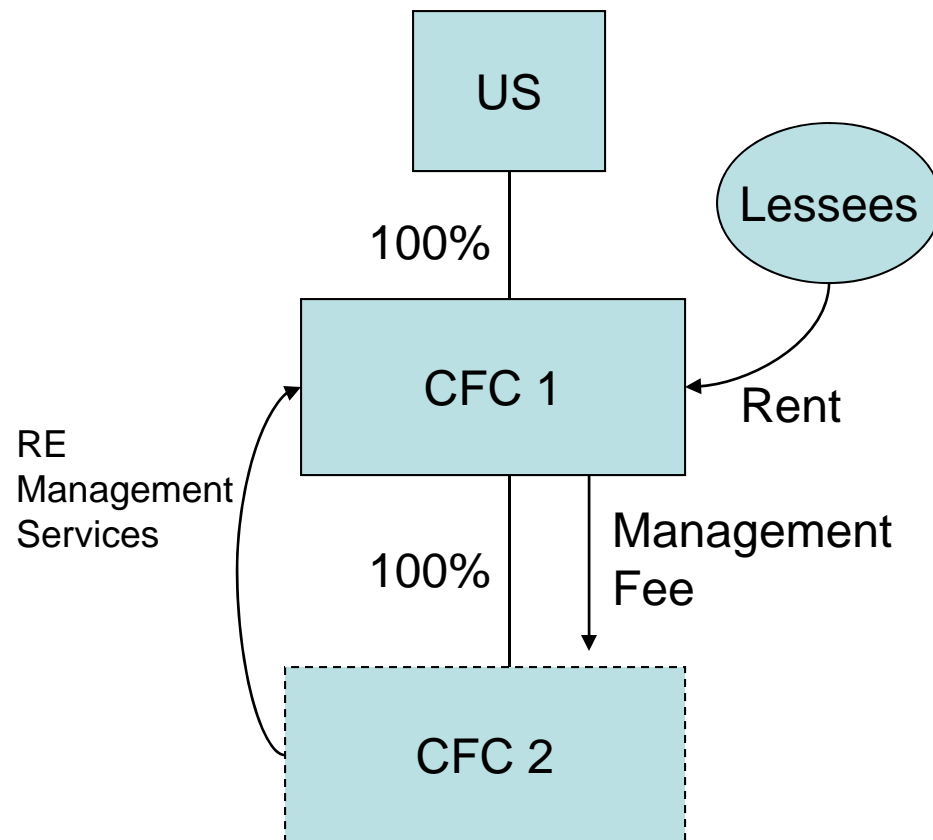
# Check-the-Box Planning

# Subpart F – Planning Example 1



- Interest is subpart F income to CFC 1
- CFC 2 “checks the box” to eliminate the interest income
- No more subpart F!
- But watch out for proposed legislation

# Subpart F – Planning Example 2



- Rent is subpart F income to CFC 1
- Active rent exception requires own officers or employees
- CFC 2 “checks the box” so that CFC 2 employees attributed to CFC 1
- But watch out for proposed legislation

# Investment in US Property

# *Investment in US Property*

- Subpart F accelerates tax on CFC earnings that are invested in US property
- US shareholder taxed on pro rata share of CFC's increase in earnings invested in US property ("956 amount")
- Otherwise, effectively repatriate earnings in nontaxable transactions (e.g., loans)

# *What is US Property*

- Tangible property (real and personal) located in the US
- Stock of a US corporation
- Obligation of a US person
- Guarantee of an obligation of a US person
- Right to use intellectual property in the US

# *Excluded Property*

- Property temporarily in the US
  - In transit between foreign countries
  - Purchased in US for export
- Stock and obligations of unrelated US corporations
- Short term obligations
- Obligations of the United States
- Bank deposits
- US property acquired before foreign corporation was treated as CFC

# Section 962 Planning

# *Use of Section 962 Election for CFC in High-Tax Jurisdiction*

- Individual shareholders of CFCs are not eligible to claim foreign tax credits for foreign income taxes paid or incurred at corporate level.
  - Can only claim FTC for foreign withholding taxes.
- Section 962 treats individual shareholders of CFCs as domestic corporations for Section 951(a) inclusion purposes (i.e., subpart F and Section 956 inclusions) only, which allows them to claim indirect foreign tax credit on those inclusions.
- When actual distributions out of the E&P of the CFC are made, those amounts are included in the gross income (notwithstanding Section 959(a)) of the individual U.S. shareholders hands, minus the tax that was paid as a result of making the Section 962 election.

## *Section 962 Election - Example*

- A German CFC is wholly owned by one U.S. individual. The CFC earns \$1 million of foreign currency gain (characterized as subpart F income) and pays U.S. \$300,000 in foreign income taxes to the German tax authorities.
- Without a Section 962 election, the U.S. shareholder would pay \$300,000 of German tax and \$245,000 of U.S. taxes (\$1 million of subpart F income (limited to \$700,000 of E&P) x 35 percent U.S. tax rate), for effective tax rate of 54.5 percent.
- If shareholder makes Section 962 election, U.S. individual treated as domestic corporation for subpart F inclusion purposes and thus eligible to claim foreign tax credit of \$300,000. Therefore, only pay currently \$50,000 of U.S. taxes, for effective tax rate of 35 percent.
- When actual distribution of \$700,000 is made, \$650,000 of that will be taxable. However, taxpayer has ability to defer that distribution and if distribution is from qualified foreign corporation, amount should be taxed at qualified dividend rate.
  - Subsequent distribution is not treated as PTI under Section 959(a).

## *Section 962 Election – Example (cont.)*

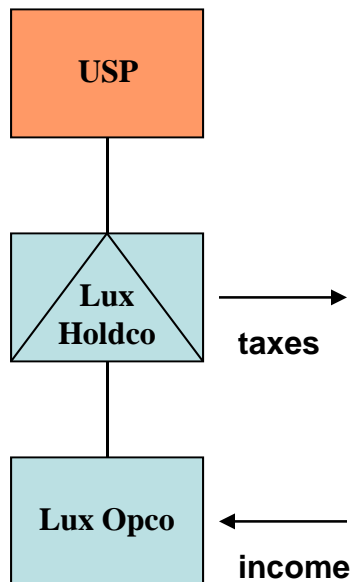
- Section 962 election makes most sense when CFC is qualified foreign corporation and foreign corporation subject to relatively high rates of foreign tax.
- Election available to any category of subpart F income as well as Section 956 inclusions.
- The higher the rate of foreign tax paid, the election will have the effect of converting Section 951(a) inclusions, generally taxed at 35 percent rates, into qualified dividend income, currently taxed at 15 percent rates.
  - For example, if a U.S. individual shareholder owns a qualified foreign corporation (that is subject to foreign income tax at a 35 percent rate), makes a loan to its U.S. parent, Section 956 would require the U.S. shareholder to treat the amount of the loan as ordinary income.
  - The Section 962 election would allow U.S. individual shareholder to claim a foreign tax credit of 35 percent against the U.S. tax of 35 percent. A subsequent distribution would only be taxed at 15 percent.

# Foreign Tax Credit Planning

# *Foreign Tax Credits With Respect to Amounts Included Under Subpart F*

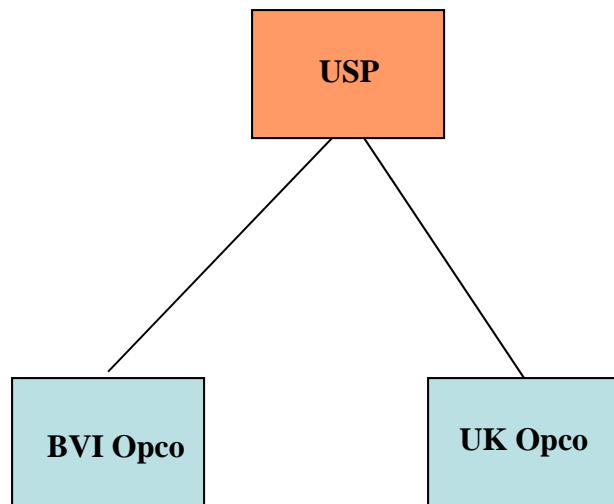
- Deemed paid credit available to corporate US shareholders
- Similar to Section 902 credit
- Adjustments to Section 904 limitation in years when PTI actually distributed
- Section 956 “hopscotch”

# Guardian Industries Planning: Splitting Foreign Income and Foreign Taxes



- Lux taxes paid by Holdco – a DRE – considered to be paid by USP
- Under current law, USP can credit Lux taxes paid by Holdco, even if corresponding income, earned by Opco, not taxable in US, b/c no Subpart F inclusion or dividend
- Only works if USP has excess foreign taxes
- Improper policy result -- proposed legislation would prevent such splitting
- In this particular structure, depends on unusual Lux law, i.e., Opco income solely taxable to Holdco, the Lux parent of the group. Under FTC regs, different result if Holdco and Opco jointly liable
- Other structures do not depend on fortuitous provisions of foreign law, i.e., if Opco were a “reverse hybrid” entity

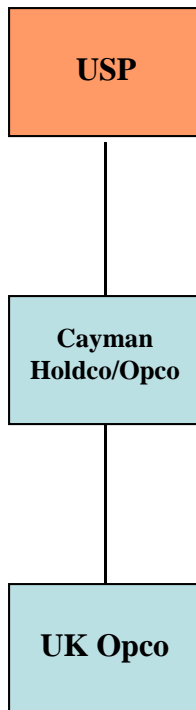
# Cherry Picking Foreign Tax Credits



- BVI Opco pays no foreign tax
- UK Opco pays 30% UK tax

- USP needs to take a \$100MM dividend from its subsidiaries (assume plenty of E&P)
- Dividend from BVI Opco fully taxable: \$35MM
- Dividend from UK Opco results in deemed-paid FTC of \$30MM, so tax is \$5MM
- Current law allows to cherry pick by repatriating solely the high-taxed foreign earnings
- Proposed legislation would prevent, but rationale unclear

# *Using Section 956 to Cherry Pick*



- USP needs to take a \$100MM dividend from its subsidiaries (assume plenty of E&P)
- Cayman co. has low-taxed earnings
- Dividend from UK Opco would cause high-taxed UK earnings to mix with low-taxed Cayman earnings
- Section 956 transaction (e.g., loan from UK Opco to USP or guarantee of USP debt) “hotscoches” over Cayman co.
- Would also be covered by proposed legislation

# Reporting Requirements

# *Reporting Requirements*

- Form 926
  - Transfers to foreign corporations
- Form 5471
  - Operations of foreign corporations
- Form 8858
  - Operations of foreign disregarded entities
- TDF 90-22.1 (FBAR)
  - Foreign financial accounts

# Q&A