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# Subpart F Income Planning

# Transnational Tax Network - Miami

# May 3, 2013

Jeffrey L. Rubinger
Bilzin Sumberg

# Agenda

- Using High-Tax Exception and Malta to Avoid Subpart F Income
- Use of Section 962 Election for High-Taxed Subpart F Income
- Planning for Sale of Lower-Tier Subsidiaries

# Subpart F – Basic Mechanics

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- Subpart F inclusion applies to U.S. shareholder holding stock on last day in taxable year on which FC is a CFC
- CFC defined as foreign corporation that is more than 50 percent owned (directly, indirectly, or constructively) by "U.S. shareholders."
- “U.S. shareholder” – U.S. person that owns (directly, indirectly, or constructively) 10 percent or more of voting  power of CFC.
- Pro rata share of subpart F income – based on direct and indirect ownership. Not constructive ownership
- FC must have CFC status for 30 days or more during the taxable year

# Using Malta to Avoid Subpart F Income Under High Tax Exception

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- Under Section 954(b)(4), a U.S. shareholder of a CFC is able to exclude from foreign base company income an item of income earned by a CFC if the taxpayer can show that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum federal income tax rate specified in Section 11.
- The maximum rate of tax specified in Section 11 is currently 35 percent.
- Therefore, the high-tax exception will apply to income earned by a CFC that is subject to an effective foreign tax rate of at least 31.5 percent.

# High-Tax Exception and Malta (cont.)

- For purposes of this provision, the effective tax rate equals (1) the foreign income taxes paid, accrued, or deemed accrued with respect to the net item of income, divided by (2) the net item of FBC income (increased by the income taxes on the item).
- The amount of foreign income taxes paid, accrued, or deemed accrued with respect to an item of income is generally the amount a taxpayer would be deemed to have paid under Section 960 if the item of income were included in gross income under Subpart F.
- In the case of an individual, this amount is determined as if an election under Section 962 has been made to treat the individual as a corporation for the purposes of Section 960.

# High-Tax Exception and Malta (cont.)

- Regulation Section 1.954-1(d)(3)(i) specifically provides that the amount of foreign income taxes paid, accrued, or deemed accrued with respect to an item of income will <u>not</u> be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholder of all or part of such income.
- Further, Regulation Section 1.904-4(c)(7)(iii) (dealing with the "high-tax kick out" exception under the foreign tax credit rules) specifies that if the effective foreign tax rate imposed on a foreign corporation is reduced under foreign law upon the distribution of that income, the rules of Section 954(b)(4) are applied <u>without regard to the possibility of a subsequent foreign tax reduction</u>.

# High-Tax Exception and Malta (cont.)

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- An example in the Section 904(d) regulations (1.904-4(c)(8), Ex. 7) illustrates this concept:
- S, a CFC, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of $200 of passive income that is FPCHI that is earned in foreign country X.
- Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed.
- In 1987, S pays $100 of foreign tax. P elects to apply the Section 954(b)(4) high-tax exception to S's passive income that is subpart F income.
- In 1988, S distributes $150 to P. The distribution is a dividend to P because S has $150 of accumulated earnings and profits (the $100 of earnings in 1987 and the $50 refund in 1988).
- The example concludes that the $200 of FPHCI will be eligible for the Section 954(b)(4) high-tax exception to subpart F income, even though the effective foreign tax rate is reduced from 50 percent to 25 percent (which is less than the 31.5 percent generally needed to qualify) as a result of the $50 tax refund received in 1988.

# High-Tax Exception and Malta (cont.)

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- A similar result may be accomplished by forming a CFC that is tax resident in Malta.
- In general, Malta has a corporate income tax rate of 35 percent. Malta, however, applies an "imputation system" whereby the corporate income tax paid by the company is refunded to the shareholders when distributions are made to them. The amount of the refund depends on the type of income earned by the company.
- When dividends are paid by a Maltese company earning active income, the shareholders become entitled to claim refunds of 6/7 of the Maltese corporate income tax paid. This results in an effective corporate income tax rate of 5 percent.
- If, on the other hand, dividends are paid by Maltese companies out of profits earned from passive interest and royalties, the shareholders are entitled to claim a refund of 5/7 of the Maltese corporate income tax paid. This results in an effective corporate income tax of 10 percent on these types of passive income.
- The refunds are payable within 14 days from the last day of the month in which the request is made to the Maltese tax authorities.

# High-Tax Exception and Malta (cont.)

- Therefore, if a Maltese CFC earns, for example, passive income that would otherwise be characterized as foreign personal holding company income, that income should not be treated as subpart F income since the income initially will be subject to corporate income tax in Malta at a 35 percent rate.
- Based on the regulations previously discussed, this result should not be affected by a subsequent distribution of the earnings of the Maltese company that causes a reduction in the effective corporate income tax paid in Malta to a rate as low as 5 percent.
- Accordingly, if successful, this structure would allow a U.S. taxpayer to earn passive income or other types of potential subpart F income (foreign base company sales or services income) and have that income be deferred from U.S. federal income tax without incurring much in the way of foreign income taxes.

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

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- 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

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- A German CFC is wholly owned by one U.S. individual. The CFC earns $1 million of 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 <u>currently</u> $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 treated as being made from qualified foreign corporation (or a domestic 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 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.
  - High tax exception (i.e., foreign tax rate at least 90 percent of U.S. tax rate - 31.5 percent) may make this election irrelevant. Section 956 inclusions not eligible for high tax exception.
- 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 potentially qualified dividend income, currently taxed at 20 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 potentially only be taxed at 20 percent.

# Section 962 Election - How is Actual Distribution Treated?

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- Is actual distribution treated as coming from hypothetical C corporation?  If so, taxed currently at 20 percent.
- Or is actual distribution treated as coming from actual foreign corporation?
- If so, does that mean that is election is only beneficial when distribution coming from "qualified foreign corporations"?
- Legislative history indicates that the purpose of the provision  is to give "such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in [a domestic] corporation doing business abroad."

# Planning for Sale of Lower Tier Subsidiaries by CFC

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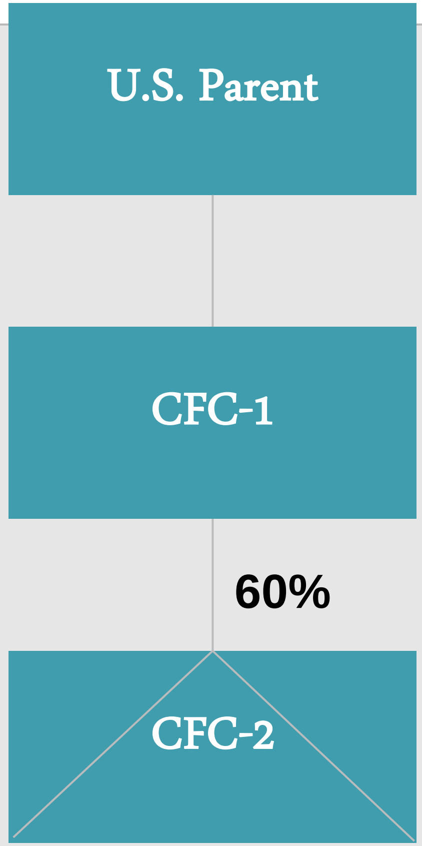
- Property transactions – FPHCI includes net gains from the sale or exchange of:
  - Property that gives rise to FPHCI
    - Capital gains by CFC from sale of shares in subsidiary
    - "Check and sell" planning (Dover case) - treated as asset sale versus stock sale. Available when CFC owns 80 percent or more of lower-tier subsidiary.
  - An interest in a trust, partnership or REMIC
    - Exception for sale by CFC of 25% or greater capital or profits interest in partnership (look-through treatment)

# Extension of "CFC look-through" rule – Section 954(c)(6)

- The 2005 Act provided a *temporary* "CFC look-through" exception from subpart F FPHCI for dividends, interest, rents, and royalties received by a CFC from another CFC that is a related person within the meaning of §954(d)(3)
- To the extent such items (of dividends, interest, rents, or royalty) are attributable or properly allocable to income of the related CFC (i.e., the paying CFC) that is not subpart F income, they are not treated as FPHCI to the recipient CFC
- Effective for tax years of CFCs beginning after December 31, 2005 and before January 1, 2012 (as further extended by the Unemployment Insurance Reauthorization and Job Creation Act of 2010).
- Although §954(c)(6) had legislatively expired, Congress re-instated it retroactively to taxable years beginning after December 31, 2011.
- Now scheduled to sunset for taxable years beginning after January 1, 2014.

# Taxable foreign-to-foreign CTB liquidation under Section 331 – absent Section 954(c)(6) relief






- CTB deemed liquidation of CFC-2 treated as §331/336 liquidation, since CFC-1 does not own at least 80% of CFC-2
- Since §331 treats CFC-1 as selling stock of CFC-2, §964(e) applies to treat gain on the sale as a dividend, to the extent of CFC-1's pro rata share of CFC-2's E&P
- Same country exception will not apply in determining whether the deemed dividend under §964(e) is subpart F income to CFC-1

# Taxable foreign-to-foreign CTB liquidation under Section 331 – result under Section 954(c)(6)

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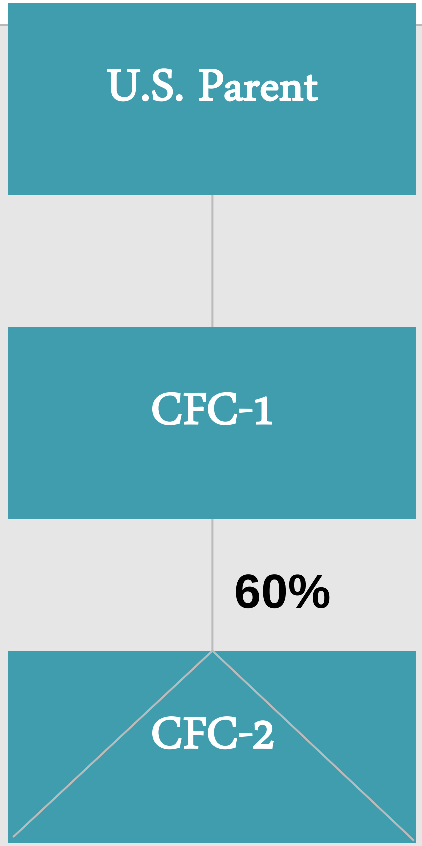
- CTB deemed liquidation of CFC-2 treated as §331/336 liquidation, since CFC-1 does not own at least 80% of CFC-2
- Since §331 treats CFC-1 as selling stock of CFC-2, §964(e) applies to treat gain on the sale as a dividend, to the extent of CFC-1's pro rata share of CFC-2's E&P
- §954(c)(6) generally prevents the §964(e) deemed dividend from being subpart F income to CFC-1



# “Same country exceptions” versus Section 954(c)(6)

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| Same country exceptions | §954(c)(6) – CFC look through rule |
| --- | --- |
| Payor must be created or organized under laws of same foreign country as recipient and have a substantial part of its assets used in its trade or business located there. | Payor can be created or organized in a different country. No requirement as to where it uses its assets. |
| Dividends excluded only if paid out of earnings and profits earned or accumulated when stock of payor was owned by recipient | No requirement as to when earnings and profits are earned or accumulated |
| Interest (and rent/royalties) exception does not apply if the payment reduces the payor CFC’s Subpart F income or creates/increases a deficit that may reduce the Subpart F income of the payor CFC or another CFC | Similar |
| Does not apply to a dividend deemed to be received on the sale of a related CFC under section 964(e)(1) | 954(c)(6) applies to 964(e) dividends. |
| Only applies to income from a related person | Only applies to income from a controlled foreign corporation which is a related person |

# What if CFC owns less than 50 percent of shares of lower-tier subsidiaries?

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- Would not be eligible for either Dover planning (i.e., check and sell) or Section 954(c)(6)/Section 964(e).
- Consider making retroactive check-the-box election on CFC effective January 2 of current year (triggers deemed liquidation on January 1).
- Results in deemed liquidation of CFC but would not produce subpart F income since it would not be a CFC for 30 days or more during the calendar year.
- If CFC resident in treaty jurisdiction, Section 1248 amount is treated as qualified dividend.
- Even if CFC not resident in treaty jurisdiction, Section 1248(b) may result in long-term capital gain if CFC subject to corporate tax at least a 15 percent rate.

Bilzin Sumberg
ATTORNEYS AT LAW

Contact Information:

Jeffrey Rubinger

Jrubinger@bilzin.com

305-350-7261