U.S. Investment into Brazil: Planning to Avoid the U.S. Anti-Deferral Rules

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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.

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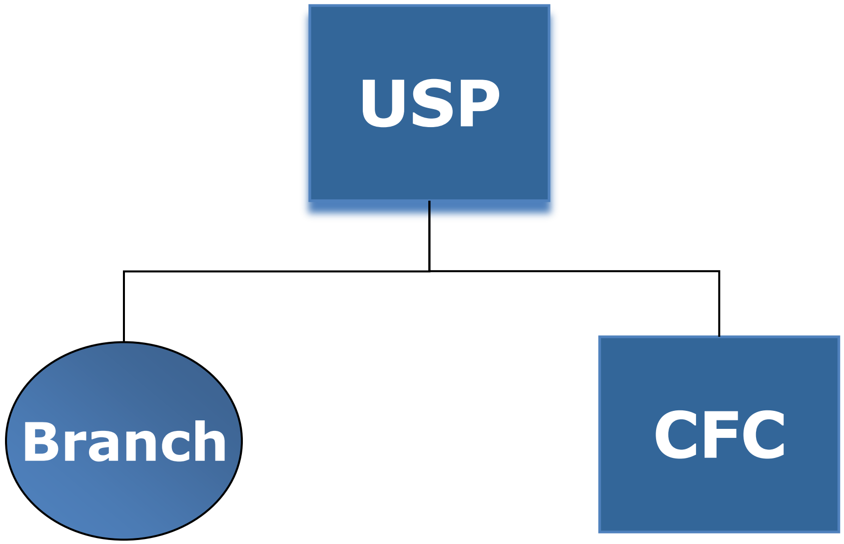
Example



Income taxed currently

Income taxed currently only if distributed or if Subpart F income

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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

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Definition of United States Shareholder

- A United States person who owns <u>10% or more of the total combined voting power</u> of all classes of stock entitled to vote of a foreign corporation. Section 951(b).
- Only direct or indirect (not constructive) U.S. shareholder includes subpart F income it its gross income.

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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:
  - ✓ subpart F income;
  - ✓ previously excluded Subpart F income withdrawn from less developed countries;
  - ✓ previously excluded Subpart F income withdrawn from shipping operations; and
  - ✓ increase in earnings invested in U.S. property.
- The subpart F inclusion "hopscotches" over intervening foreign corporations.

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High Tax Exception

- Item of income ≠ FBCI or insurance income, if effective rate of tax imposed on the income by a foreign country > 90% of the maximum rate U.S. tax (31.5%).
  - ✓ The exception is applied separately to each item of income.
  - ✓ The exception is elective.
  - ✓ Brazil corporate tax rate would cause many transactions to be exempt from subpart F rules.
  - ✓ But exception less relevant when trying to minimize taxes incurred in Brazil.

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Foreign Base Company Income ("FBCI")

- The largest and therefore the most significant category of Subpart F income:
  - ✓ Foreign Personal Holding Company Income;
  - ✓ Foreign Base Company Sales Income;
  - ✓ Foreign Base Company Services Income; and
  - ✓ Foreign Base Company Oil Related Income.

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Foreign Personal Holding Company Income ("FPHCI")

- Dividends, interest, royalties, rents and annuities. Section 954(c)(1)(A).
- Net gains from the sale of property which either:
  - ✓ generates passive types of income listed in 1 above.
  - ✓ is an interest in a trust, partnership or REMIC, or
  - ✓ generates no income. Section 954(c) (1)(B).
- Net gains from commodity transactions except
  - ✓ Bona fide hedging transactions
  - ✓ Active business gains from the sale of commodities

FPHCI Cont'd

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

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Exceptions to FPHCI

- Certain types of income that would otherwise constitute FPHCI are excluded.
- Active trade or business rents and royalties received from an unrelated person. Section 954(c)(2)(A).
- Export financing interest. Section 904(d)(2)
- Same country related person dividends and interest.
- Special rules for active banking, financing or similar business.
- Special rules for investment income of certain insurance companies.

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Look through Rule for Related CFCs

- Enacted by Tax Increase Prevention and Reconciliation Act 2005
- 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.
- Currently expired but likely will be added back to the tax Code retroactive to January 2015.

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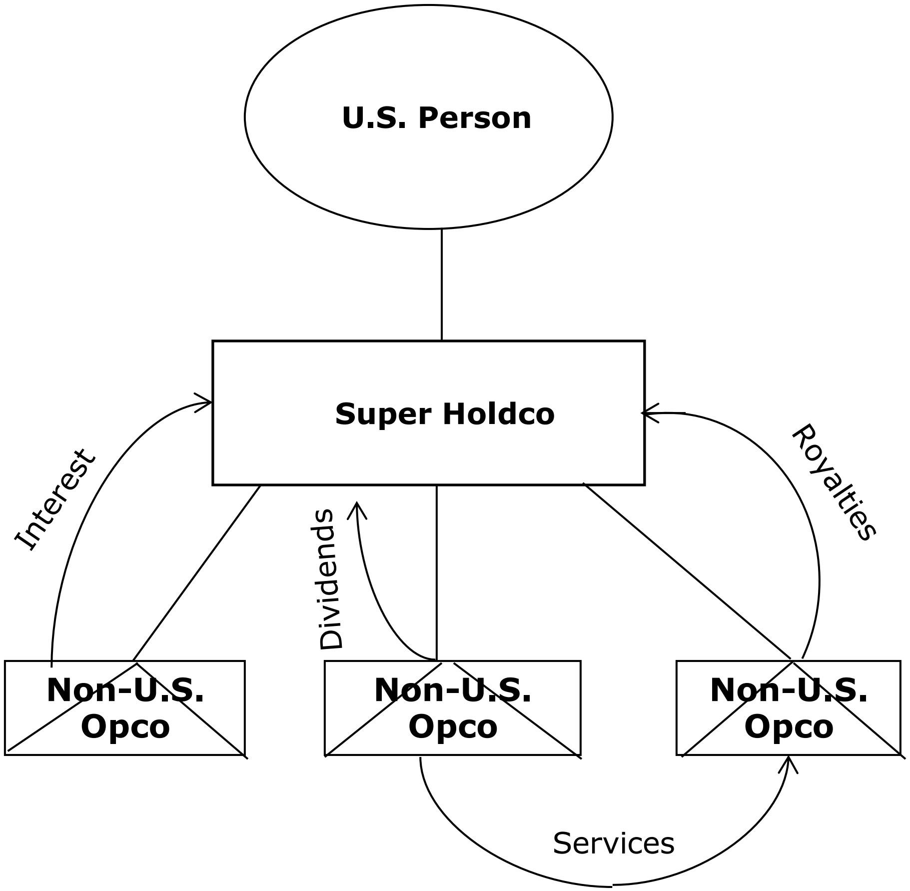
Check the Box Planning

- Minimize Subpart F income from intercompany interest, dividends, royalties, rents, and services
- Allows movement of cash between Opcos free of U.S. tax
- Facilitates sale of lower tier subsidiaries without Subpart F income



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Foreign Base Company Sales Income ("FBCSI") Section 954(d)(1)

- Income in the form of profits, commissions, fees or otherwise
- Derived by a CFC in connection with
- A purchase ***or*** 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

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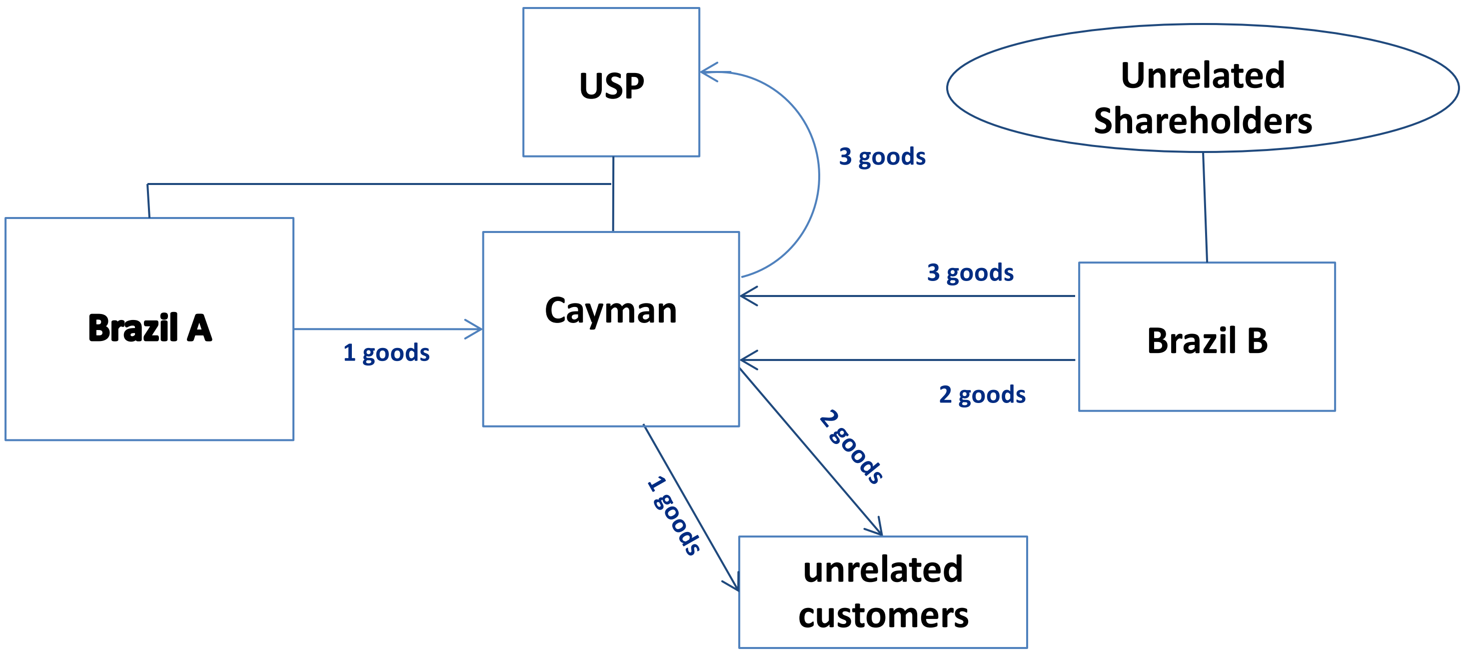
FBCSI Type Transactions

- The purchase of personal property from a related person and subsequent sale to any person;
- The purchase of personal property from any person and subsequent sale to a related person;
- The purchase of personal property from any person on behalf of a related person; or
- The sale of personal property to any person on behalf of a related person.

Outside Country of Organization

- The property is manufactured, produced, grown, or extracted outside the country of organization of the CFC.
- The property is sold for use, consumption, or disposition outside the country of organization of the CFC.

Example of FBCSI



Transaction 1: Cayman buys goods from Brazil A and sells to unrelated customers. This produces FBC Sales Income.

Transaction 2: HK buys goods from Brazil B and sells to unrelated customers. This DOES NOT produce FBC Sales Income.

Transaction 3: HK buys goods from Brazil B and sells to USP. This produces FBC Sales Income.

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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

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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

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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

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FBCSI Branch Rule

- Rule: Treats branch of CFC as separate corporation.
  - ✓ The purpose of rule is to create a related party transaction where one would not otherwise exist because transaction with branch would be disregarded for U.S. income tax purposes.
- 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.
- So cannot avoid FBCSI rules by having Brazilian CFC parent sell goods through disregarded Cayman subsidiary (disregarded by filing check the box election). The tax rate disparity test would be failed and we would be treated as having related party transaction.

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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.

- Common planning is to form a CFC in country of incorporation where services are performed but move management and control to lower-tax treaty jurisdiction that has tie breaker provision.

  ✓ For example, a company formed in Brazil but managed and controlled in Portugal (Madeira) should (theoretically) be exempt from tax in Brazil and subject to very low taxes in Portugal.

  ✓ Should also avoid U.S. CFC rules even though Brazilian domiciled company is earning income from the performance of services for related party.

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Performance of Services For or on Behalf of a Related Person

- The CFC is paid by, released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing the services.
- The services are services which a related person is or was obligated to perform.
- The performance of the services are a condition or material term of a sale of property by a related person.
- Substantial assistance in the performance of the services by the CFC has been furnished by related person.
  - ✓ Therefore this rule applies even if services are performed for an <u>unrelated party</u>, if a related party provides substantial assistance in rendering the services.

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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

  - ✓ Notice 2007-13-only assistance from U.S. related person counts and it is substantial if the cost to the CFC equals 80% (so CFC only needs to incur 20% of the costs incurred to furnish services and will avoid this provision)

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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."
  - ✓ High-tax exception does not apply to this rule.
    - Thus Brazil's high tax rate has no impact on this provision

Section 956 Inclusion

- The lesser of
  - ✓ U.S. shareholder's pro rata share of CFC's U.S. property; or
  - ✓ 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.

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Items Excluded from United States Property

- Obligations of the United States and money and bank deposits.
  - ✓ See, The Limited 286 F.3d 324 (6th Cir. 2002), and Section 956(c)(2)(A) as amended by the JOBS ACT.
- 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.

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Distributions of Previously Taxed Income

- Previously taxed income (PTI) not:
  - ✓ Dividend when distributed
  - ✓ Subpart F income when distributed
  - ✓ Section 956 inclusion when earnings invested in U.S. property

Foreign Tax Credits With Respect to Amounts Included Under Supbart F

- Deemed paid credit available under Section 960(a) to U.S. corporate shareholders
  - ✓ Similar to Section 902 credit
- Adjustments under Section 960(b) to Section 904 limitation in years when PTI actually distributed
- Section 960(c) added by P.L. 111-226 and effective for acquisitions of U.S. property after December 31, 2010 overrides the hopscotch rule for purposes of calculating the deemed paid tax amount with respect to Section 956 inclusions

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Example

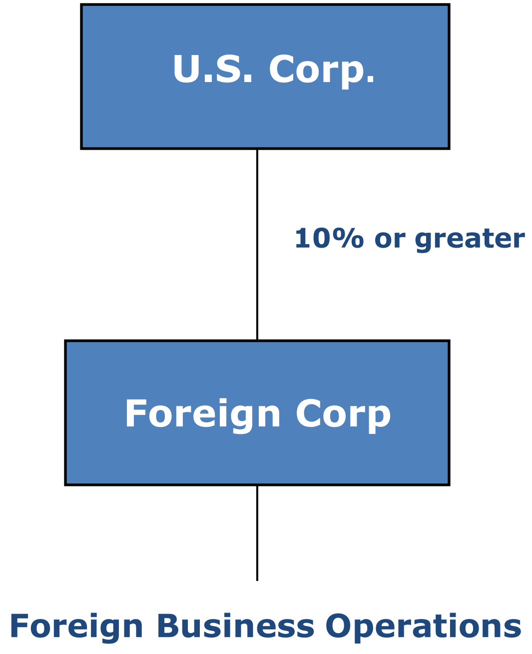
FC's Subpart F income treated similar to dividend for FTC purposes- Sec. 960

Thus, Section 960 deemed paid foreign taxes available to US Corp.

Prorate foreign taxes based on E&P

Also indirect FTC for gains on sale of FC

Ability to "time" repatriations for when U.S. Corp. can use FTC



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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 - gain on sale of shares of Brazilian CFC would be recharacterized into a non-qualified dividend, taxable at ordinary income rates.

    - Many times holding companies (e.g., Spain, Netherlands, etc.) are used to own shares in Brazilian companies to help with repatriation of profits and avoid section 1248 treatment.

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Example

USP

CFC

$60 subpart F income (passive income)
$40 nonsubpart F income
$100 total E&P

- Generally, gain from the sale of shares is taxed at capital gain rates.
- Subpart F rules make $60 subpart F income currently taxable to USP.
- If USP sells stock of CFC for $100 gain, $40 of nonpreviously taxed E&P treated as capital gain.
- Section 1248 prevents this conversion, treats $40 as dividend (ordinary) income, subject to gain limitation (assuming non-treaty jurisdiction like Brazil). If Brazil owned by Spanish holding company and Brazil treated as branch of Spain, Section 1248 would treat income as qualified dividend income taxed at 20 percent (assuming U.S. individual shareholders).

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