Repatriating Foreign-Source Income for U.S. Taxpayers: Minimizing the Tax Impact of Transferring Offshore Income and Gains

THURSDAY, NOVEMBER 3, 2016, 1:00-2:50 pm Eastern

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Repatriating Foreign-Source Income for U.S. Taxpayers

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- Albert Liguori is a Managing Director with Alvarez & Marsal Taxand, LLC in New York, with more than 20 years of international tax and accounting experience. He assists multinational organizations in assessing and improving their global tax strategies.
- Mr. Liguori leads a New York and Washington, DC based international tax and transfer pricing team that supports clients on global transactions. He oversees a practice with disciplines spanning from traditional international tax planning, cross-border inter-company arrangements, US inbound planning, mergers and acquisitions, controversy and accounting for income taxes.
- His most recent leadership experiences include: interim tax counsel for a multibillion dollar redesign of global manufacturing operations (supply chain); lead tax adviser to a $500 million publicly traded high-tech company through numerous acquisitions, legal restructurings and tax planning; lead adviser in redesigning the legal and tax structure of a multibillion dollar Tier-2 auto parts maker, improving cash flows by several hundred million dollars; and interim head of tax of a $3 billion global financial services company leading all tax aspects of a multibillion dollar IPO.
- Mr. Liguori is frequently involved in helping companies respond to tax demands from boards of directors and shareholders, as well as in fostering cross-functional communication between tax, operations, finance and treasury teams. He has worked closely with CEOs, CFOs and private equity investors.
- Before A&M, he was a core member of the global tax strategy team of Deloitte Tax, serving as lead adviser on multiple global client transactions. He began his career with Price Waterhouse in New York, where he assisted many companies with initial public offerings.
- Mr. Liguori earned a Juris Doctor from Brooklyn Law School and is a member of the New York State Bar.
- From 1999 through 2003, he served as an adjunct professor for the MS in taxation program at Fordham University. He serves as a national speaker, and has written articles and provided comments on proposed regulations and other topics related to corporate and international taxation.

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- Chip Morgan is an International Tax Partner at BDO USA, LLP in Los Angeles. Chip's career has been centered on international tax for over 30 years. He has been an ITS partner with two of the Big 4, where he advised clients across a broad range of industries, geographies and transactions. In addition, he has industry experience as VP Tax for a semiconductor manufacturer and a software company, where he had practical experience with implementing and defending international tax structures, and working to keep the tax structures aligned with the underlying business operations as they evolve over time.
- Chip has worked in New York, Brussels, San Jose and Los Angeles and has assisted companies ranging from startups to very large, mature enterprises. He has deep technical expertise, combined with practical hands on experience.
- Mr. Morgan earned a Juris Doctor from Columbia Law School and a B.S. in Accounting from the University of North Carolina. He is a member of the New York State Bar and the California and New York CPA Societies.

Agenda

1. Deferral Regime for Foreign-Source Income and Gains
2. Impact of Foreign Entity Classification on Repatriation Treatment
3. Identifying Deductions and Calculating Income on Repatriation Events
4. Strategies for Minimizing Tax Impact of Repatriating Foreign Source Income
5. Impact of Section 385 Regulations

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Subpart F, Section 956, and PFICs

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U.S. Tax System Generally

- The U.S. tax system is based on the taxation of worldwide income of U.S. persons (outbound provisions) and U.S.-source income of foreign persons (inbound provisions). Contrast: territorial system used by many countries.
- U.S. tax rules provide a foreign tax credit regime to mitigate potential double taxation across multiple jurisdictions.
- Since the U.S. taxes U.S. persons on a worldwide basis, a primary tax planning objective is to defer U.S. tax on foreign operations and minimize the incremental U.S. tax liability when foreign cash is repatriated to the U.S.
- Generally, U.S. owners of a foreign corporation are not subject to U.S. tax on the income of the foreign corporation unless and until the foreign corporation pays a dividend.
- Exception: Subpart F, Section 956, and PFICs.

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Controlled Foreign Corporation

- Under the Subpart F rules, U.S. tax be triggered currently, without regard to dividend distributions, on certain types of income of a Controlled Foreign Corporation ("CFC").
- A CFC is a foreign corporation in which U.S. Shareholders own, on any day in the foreign corporation's taxable year, more than 50% of either:
    - Total combined voting power of all classes of stock entitled to vote, or
    - Total value of the stock.
- U.S. Shareholder is a U.S. person who:
    - Owns 10% or more voting power of all classes of stock.
    - Ownership may be direct, indirect or constructive (§958(a) and (b)).
- Special circumstances:
    - Years of transition, such as acquisition or disposition.
    - Pre-CFC status years.

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Types of Subpart F Income

- Subpart F income:
  - Passive investment income.
  - Certain income from transactions with related parties.
  - Fundamental distinction: transactions within versus outside country of incorporation.
- §956 income (investments in U.S. property):
  - Certain CFC loans to U.S. shareholders.
  - CFC ownership of property in the U.S.
  - Outstanding intercompany trade payables not settled within sixty days.
  - U.S. shareholder pledge of CFC stock as collateral for a loan, or CFC guarantee of U.S. shareholder's borrowing.

Types of Subpart F Income, Cont’d

- Foreign Personal Holding Income (FPHCI) includes dividends, interest, royalties, rents, annuities, net gains from commodity transactions, net foreign currency gains, among others. Key exceptions:
  - Active business
  - Same country
  - Look-through rule
- Foreign Base Company Sales and Services Income includes sales or services income that (a) involve a related party – on either the “buy side” or “sell side” – and (b) occur outside the CFC’s country of incorporation.
- De minimis and High Tax exceptions

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FPHCI Exceptions

- Same Country Exception
  - Interest, dividends, rents, and royalties received from related corporations within the CFC's country of incorporation.
- Rents and Royalties Exception
  - Rents and royalties derived in the active trade or business and received from an unrelated person.
- Look-through Rule
  - Dividends, interest, rents and royalties received from a related CFC, to the extent attributable to non-Subpart F income of the related CFC.

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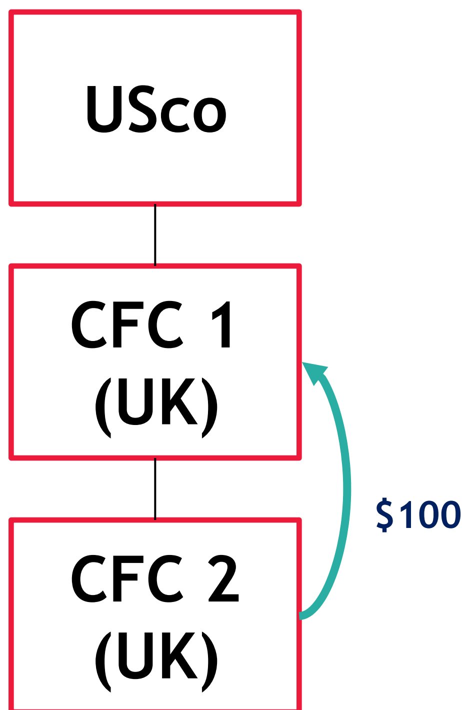
FPHCI Example

Same Country Exception

CFC 2 pays $100 of interest, dividends, rents or royalties to CFC 1.



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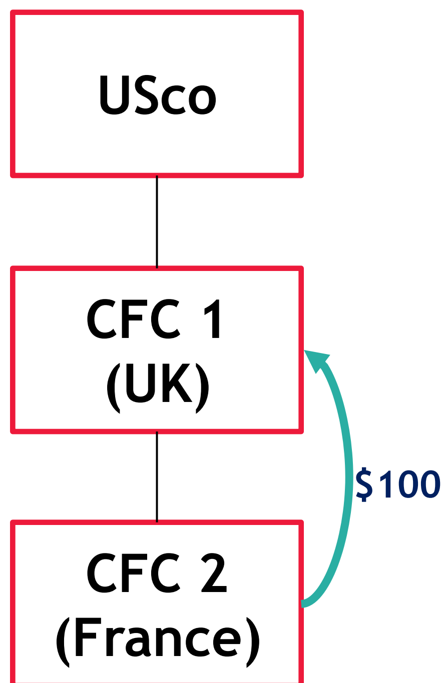
FPHCI Example

Look-through Rule

CFC 2 pays $100 of interest, dividends, rents or royalties to CFC 1.

- CFC 2 has only active trade or business income, no Subpart F income.



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FBC Sales Income

- Foreign Base Company Sales Income includes:
  - Purchase of personal property:
    - from a related person and its sale to any person;
    - from any person and its sale to a related person; or
    - from any person on behalf of a related person, where
  - The property is manufactured or sold for use/consumption outside the CFC's country of incorporation.

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FBC Sales Income – Manufacturing Exception

- Substantial Transformation
  - Substantive Test: facts and circumstances
  - Safe Harbor: CFC contributes 20% of COGS
- Substantial Contribution
  - CFC through its employees makes a substantial contribution to the final product.
  - Generally favorable branch rules.

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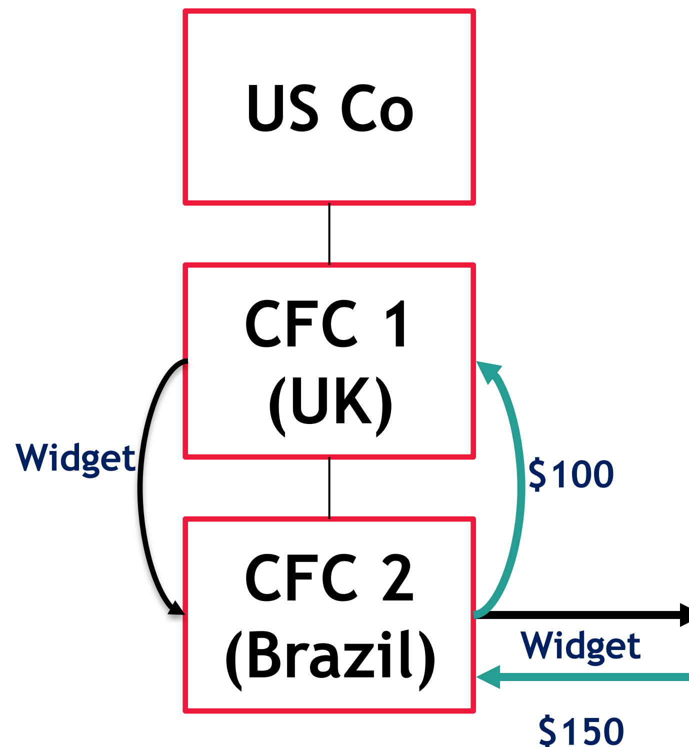
FBC Sales Income - Example

Assume the following:

- CFC 1 produces widgets, which it sells widgets CFC 2 for $100.
- CFC 2 sells these widgets to customers in Brazil and Argentina for $150.
- CFC 2 does not contribute to the manufacturing process.



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FBC Services Income

Income derived by the CFC in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services that are:

- performed for or on behalf of any related person, and are
- performed outside the CFC’s country of incorporation.

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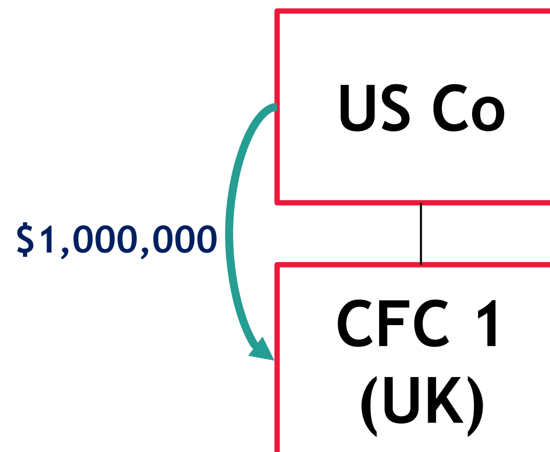
CFBC Services Income - Example

- US Co, an architectural firm, designs a skyscraper in Belgium.
- US Co hires CFC 1 to design such skyscraper on its behalf.
- US Co pays CFC 1 $1,000,000.



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Subpart F - General Exceptions

- De-minimis Rule
  - If CFC's Subpart F income is small enough, then no U.S. tax. The CFC's Subpart F income must be the lesser of:
    - $1 million, or
    - 5% of CFC's gross income.
- Full Inclusion Rule
  - If the CFC's Subpart F income is too large, then all of the CFC's income will be subject to U.S. tax if:
    - More than 70% of CFC's gross income is Subpart F Income.
- High Tax Exception
  - If the CFC's income is subject to foreign tax at a rate more than 90% of the U.S. tax rate, then none of the CFC's income will be subject to U.S. tax.

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Investments in U.S. Property

- U.S. shareholders are taxed on:
  - Certain debt of U.S. shareholder owed to CFC;
  - CFC's investments in U.S. property, including tangible property located in the U.S., U.S. stock, or U.S. rights to use of intangible property;
  - Pledges of CFC stock; and
  - Guarantees by CFCs of U.S. obligations.
- Taxable amount is limited lesser of:
  - CFC's average quarterly tax basis in U.S. property (minus amounts previously included in U.S. shareholders' taxable income), and
  - CFC's Earnings & Profits.

Passive Foreign Investment Company ("PFIC")

- A PFIC is a foreign corporation for which:
  - 75% or more of its gross income is passive income (Income Test); or
  - at least 50% of the average value of corporation's assets are held for the production of, passive income (Asset Test).
- A U.S. shareholder of a PFIC is subject to the following tax regimes:
  - Excess Distribution regime – default regime
  - Qualified Electing Fund (QEF) regime – elective
  - Mark-to-Market Regime – elective for public PFICs
- Unlike CFC rules, there is no minimum level of U.S. ownership.
- Overlap Rule: If a CFC is also a PFIC, it is not treated as a PFIC with respect to the U.S. shareholders of the CFC.

Impact of Entity Classification on Foreign Entity Repatriation

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Check-the-box Election

- Check-the-box regulations permit certain entities to elect their U.S. tax classification as either a corporation or flow-through entity
  - Applies for U.S. tax purposes only
  - Generally no effect under foreign tax law, although "anti-hybrid" rules are evolving in various countries.
- Certain foreign entities generally default to one of the three following categories:
  - a corporation if all of its owners have limited liability,
  - a partnership if it has two or more owners and at least one owner does not have limited liability, or
  - a disregarded entity if it has a single owner that does not have limited liability.

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Check-the-box Election, Cont'd

- Change in Classification:
  - Only certain entities can change their tax classification.
    - Certain foreign corporations can change their classification to either a partnership or a disregarded entity.
    - Certain partnerships can change their classification to be treated as a corporation.
    - Certain disregarded entities can change their classification to be treated as a corporation.
- In general, a check-the-box election is binding for 60 months, unless the foreign entity made an initial election upon formation.

Check-the-box Election, Cont'd

- Benefits:
  - A CTB election can convert intercompany transactions to intracompany transactions, thereby eliminating transactions for U.S. tax purposes.
  - Useful planning tool for purposes such as Subpart F, PFIC, among others.
- Considerations:
  - A change in entity classification can have significant U.S. tax consequences, which may be taxable.
  - Certain disregarded entities that operate as a manufacturing branch or a sales branch may be treated as a separate CFC for purposes of Subpart F rules, thus, possibly creating Subpart F income if certain conditions are met.

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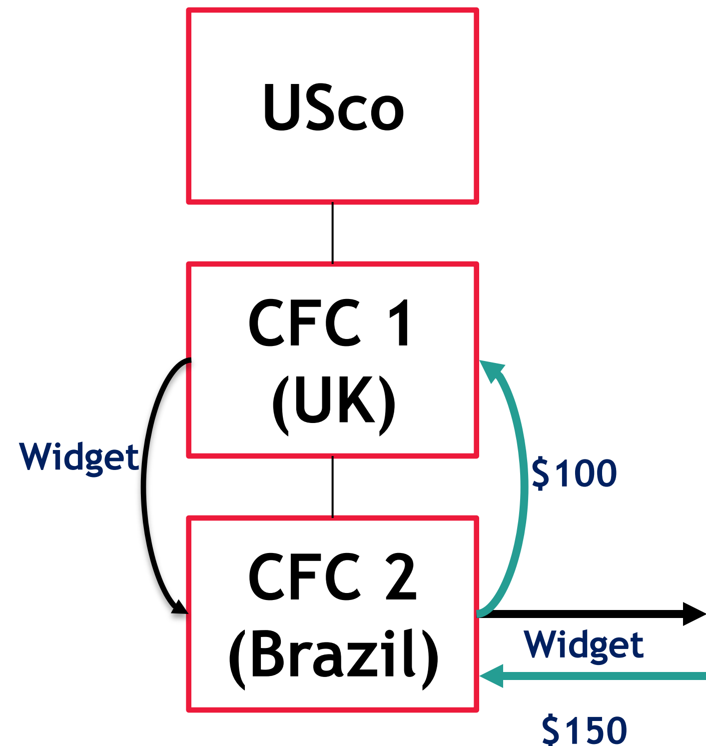
Controlled Foreign Corporation
Entity Classification Example

Assume the following:.

- CFC 1 manufactures widgets, which it sells widgets CFC 2 for $100.
- CFC 2 sells these widgets to customers in Argentina for $150.
- CFC 2 does not contribute to the manufacturing process.
- CFC 2 does not have any other income.
- No tax treaty applies.
- Possible solution?



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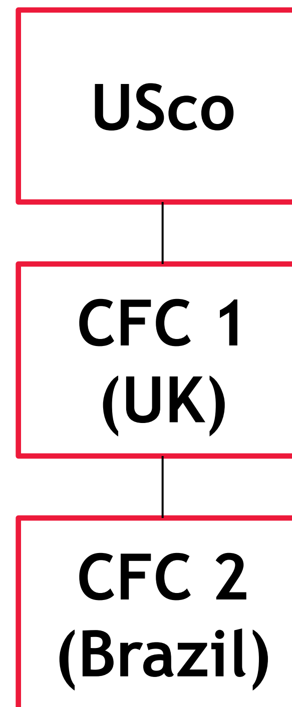
Passive Foreign Investment Company

Entity Classification Example

Assume the following:

- CFC 1 has substantial manufacturing income and activities.
- CFC 2's income is all from interest, and CFC 2 would be classified as a PFIC in the current year.
- CFC 2 has never been a PFIC.
- Possible solution?



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Calculating U.S. Tax on Repatriated Earnings

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Foreign Tax Credit (“FTC”)

- Foreign Tax Credit (“FTC”) regime is intended to mitigate double taxation.
- U.S. citizens and domestic corporations are allowed to claim a FTC, a dollar for dollar offset against U.S. tax liability.
- FTCs are elective; the alternative is a deduction of the foreign taxes paid.
- For any given year, U.S. taxpayer must elect either credit or deduct all foreign taxes.
- Excess foreign tax credits can be carried back and forward
    - 1 year carryback
    - 10 year carryforward

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Creditable Foreign Taxes

- Only income or excess profits taxes are creditable.
- Tax must resemble U.S. income tax.
- Penalties, fines, interest, custom duties, VAT, capital and asset taxes do not qualify for the credit.
- Foreign tax payment must be compulsory.
- Competent Authority relief may be available in tax treaty scenarios.

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Direct and Indirect FTC

- Direct Foreign Tax Credits (Sec. 901)
  - Withholding tax imposed on U.S. tax payor even though foreign payor remits.
  - Income tax profits of flow-through entity (branch or partnership) paid on business income.
- Indirect Foreign Tax Credits (Sec. 902)
  - Income taxes paid by foreign corporations.
  - Who is eligible to take the credit on their U.S. tax return?
    - Certain domestic corporations (generally 10% or more owners)
    - Not allowed for individuals or S corporations

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FTC Limitation

- Foreign tax credit is equal to the lesser of foreign taxes paid or:

$$\frac{Net\ Foreign\ Source\ Taxable\ Income}{Total\ Taxable\ Income}\ X\ U.S.Tax\ on\ Total\ Taxable\ Income$$

- Maximizing FTC utilization includes minimization of U.S. expenses allocable to foreign source income:
  - Facts and circumstances
  - Interest expense
  - R&D expense
  - Governance expense

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Ways to Repatriate in Lieu of Dividends

- Transfer Pricing
- Service fees
- Royalties (consider foreign withholding tax)
- Interest and/or principal repayment (consider foreign withholding tax and foreign thin capitalization rules)
- Basis Repatriation if there are no Earnings & Profits
- Distributions of Previously Taxed Income
- Stock-based Compensation of Foreign Employees

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Debt vs Equity: New Section 385 Regulations

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In General

- Sec. 385 was enacted to determine whether an interest in a corporation should be treated as equity or debt, with key tax differences being that:
  - Interest is deductible, but dividends are not; and
  - Debt principal can be repaid in the absence of positive Earnings & Profits.
- In addition to debt versus equity rules, the use of debt not recharacterized as equity can be limited by thin capitalization rules.
  - May look to debt-equity ratios or a comparison of interest expense versus the amount of taxable income before interest expense (in the U.S., see Sec. 163(j); other countries have their own variations).
  - Also consider limitations related to cash versus accrual accounting (such as Sec. 267 in the U.S.).

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New Sec. 385 Regulations

- Issued October 21, 2016, the new Sec. 385 regulations:
  - Create extensive documentation requirements necessary for related party instruments to be respected as debt; and
  - Recast debt as equity if issued as part of a perceived base erosion transaction.

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Documentation Requirements

- Debt issued by a U.S. corporation to a related party outside the U.S. consolidated group are subject to the following substantive documentation requirements disclosing:
  - Outstanding debt;
  - Creditor's rights;
  - The borrower's ability to repay; and
  - Go-forward compliance with terms of debt instrument, such as evidence of timely payment and enforcement actions in the event of a default.
- Key exceptions in final regulations:
  - Foreign issuers, and
  - S Corp issuers.

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Effective Dates

- Final Documentation rules:
  - Apply to debt issued on or after January 1, 2018; and
  - Required to be completed as of the filing of the tax return (including extensions) for the taxable year in which the debt was issued.
- Recast Rules:
  - Apply to transactions occurring and debt issued on or after April 4, 2016.

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