What Do You Need To Know When You’re Thinking About Investing Overseas?

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Premier Tax Services

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Overview

- A US resident or a US corporation is subject to US tax on worldwide basis
- The foreign taxes paid may be used as a credit against US tax liability subject to many limitations.
- One way to defer the income earned in foreign country is by investing through a foreign corporation.
- US Shareholder of foreign corporation generally is not subject to US taxation on earnings of foreign corporation until distributed as a dividend

Overview (continued)

- However, there are special rules that govern the taxation of foreign corporation invested by US persons
  - Controlled Foreign Corporation ("CFC")
  - Passive Foreign Investment Company ("PFIC")
  - Foreign Personal Holding Company ("FPHC") [Repealed by American Jobs Creation Act of 2004 ("AJCA 2004")]

Controlled Foreign Corporation

General Rule:

- A U.S. taxpayer must Include in gross income its pro-rata share of the CFC's Subpart F income plus certain other Items of Income, if
  - The U.S. taxpayer is a U.S. Shareholder of a Controlled Foreign Corporation ("CFC") on the last day of the CFC's tax year and the CFC was a CFC for at least 30 consecutive days during the tax year

Controlled Foreign Corporation

- A Controlled Foreign Corporation ("CFC") is a foreign corporation if more than 50% of vote **<u>or</u>** value of its stock is owned by "U.S. Shareholders", directly or indirectly, or through constructive ownership rules, on any day during tax year.

- Special rules apply for insurance companies.

U.S. Shareholder

- A U.S. shareholder is a U.S. person who owns, or is considered as owning through constructive ownership rules, 10% or more of the total combined voting power of all classes of the stock entitled to vote of such foreign corporation.

Subpart F Income

- Foreign Base Company Income (“FBCI”) (Section 954)
  - Foreign Personal Holding Company (FPHCI)
  - Foreign Base Company Sales Income (FBSI)
  - Foreign Base Company Services Income (FBSRV)
  - Foreign Base Company Shipping Income (FBSPI)
    - AJCA 2004 repeals FBSPI as Subpart F income
  - Foreign Base Company Oil Related Income

- Insurance Income (not discussed)
- Boycotts & Bribes, etc. (not discussed)

Foreign Personal Holding Company Income (FPHCI)

- Passive Items—Dividends, Rents, Interest, Royalties
- Certain Property Transactions
- Commodities Transactions (AJCA 2004 modifies certain requirements for exclusion)
- Other Items—Currency, Income from Notional Principal Contracts, Interest Equivalents
- AJCA 2004 treats the sale by a CFC of a partnership interest (at least 25%) as a sale of the proportionate assets attributable to this interest for purposes of determining FPHCI
  - A technical correction in 2005 clarifies that certain constructive owner rules apply for purposes of establishing the look-through treatment.

Exceptions to FPHCI

- From Unrelated Parties:
  - Rents and royalties derived in the “active conduct of a trade or business” and which are received from a person other than a related person.
    - AJCA 2004 amends the exception applicable to rent by providing a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce.
  - Export Financing Interest—Banks Only
- From Related Parties:
  - Dividends and interest from a related person which is a corporation created or organized in the same country as CFC and has a substantial part of its assets used in its trade or business in such same foreign country
  - Rents and royalties received from a corporation which is a related person for the use or, or the privilege of using, property within the same foreign country as CFC.

Temporary Look-Through Rule for Related CFCs

- Tax Increase Prevention and Reconciliation Act of 2005 adds a look-through rule for dividends, interest, rent, and royalties received or accrued from a CFC which is a related person. Such income will not be treated FPHCI to the extent attributable or properly allocable to income of the related person which is not subpart F income.
- Applicable to taxable year of foreign corporations beginning after Dec. 31, 2005 and before Jan. 1, 2009, and tax years of U.S. shareholders with or within which such tax years of foreign corporations end.

Foreign Base Company Sales Income (FBCSI)

- Personal property purchased from or sold to a related person outside of the country of organization of CFC; and both conditions below Apply:
  - Property purchased is manufactured, produced outside CFC country
  - sold for use, consumption, disposition outside of CFC Country
- No FBCSI if CFC manufactures
- Special rules apply if CFC's branches conduct manufacturing or sales activities

Foreign Base Company Services Income (FBSRV)

- Income from services (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with performance of technical, managerial, engineering, architectural, scientific and like services which:
  - Are performed for or on behalf of a related party or with substantial assistance provided by a related party, and
  - Are performed outside CFC country of incorporation

Special Rules Under Subpart F

- De Minimis -
  - –No subpart F inclusion if FBCI and Insurance Income is less than the lesser of $1 million or 5 Percent of CFC total gross income
- Full Inclusion -
  - –All gross income treated as subpart F inclusion if gross FBCI and gross insurance income exceeds 70% current year gross income
- High Tax Exclusion –
  - – U.S. Shareholder may <u>elect</u> to exclude items of Subpart F income that were subject to foreign taxes of at least 90% of highest U.S. corporate income tax rate.

Investment in U.S. Property

- If a foreign corporation is a CFC for 30 days or more, a U.S. shareholder of such CFC who held stock on the last day of the year must include in his gross income his share of earnings invested in U.S. property.
- It only applies to earnings not already included under Subpart F

U.S. Property

- Tangible property in the United States
- Related domestic corporation stock
- U.S. debt obligations
- Exceptions for Stock or Debt:
  - Unrelated Parties
  - Regular Business Transactions
  - Bank Deposits/U.S. Treasury Debt (JACA 2004 limits the applicability of exception to bank deposits)
- Right to use intangibles in the United States
- **Beware** of CFC guarantees or pledge of CFC stock in respect of U.S. shareholder obligations
- AJCA 2004 adds two exceptions to the definition of US property for active dealers and non-corporate US debt.

CFC Tax Reporting

- Form 5471
- Separate Form 5471 for Each CFC
- Filed With U.S. shareholder’s annual tax return and separately with IRS
- Record keeping requirements
- There are exceptions for dormant CFC
- **Many penalties apply for not complying with the rules**

Passive Foreign Investment Company ("PFIC") – Overview

- Congress adopted the PFIC rules in 1986 to limit the ability of US persons to avoid current taxation on passive investment income or convert ordinary income into capital gains.
- If a foreign corporation meets the PFIC definition, a US shareholder (no matter what % he owns) must either pay a deferred tax charge on dividends received or elect to be subject to US tax on PFIC's earnings currently.

Passive Foreign Investment Company ("PFIC")

- A PFIC is a foreign corporation that meets either of the two tests:
  - At least 75 percent of the corporation's gross income for the tax year is passive income; or
  - At least 50 percent of the average fair market value of the corporation's assets consists of assets that either produce or are held for the production of passive income
- Passive income includes dividends, interest, royalties, rents, net gain from sale of passive assets, etc.
- There are special look-through rules in case of 25% owned corporations.
- There are exceptions for start-up companies.

PFIC – Deferred Tax Charge

- If a U.S. taxpayer receives a dividend distribution in a tax year that exceed 125% of the average distributions for the last three years (i.e., excess distribution) and recognizes gain from stock disposition with respect to stock in a PFIC, then the amount of excess distribution and the gain recognized is considered to be earned ratably over the shareholder's holding period for the stock .
- Amounts allocated to prior PFIC years are taxed at the top marginal tax rates applicable to those years plus interest on the tax – deferred tax charge.
- Amounts allocated to the current tax year and to years before the foreign corporation became a PFIC are taxed as current year's ordinary income.

PFIC – Qualified Electing Fund

- When a PFIC is a qualified electing fund (QEF), a U.S. shareholder currently includes in income his share of the PFIC's earnings and profits, with appropriate basis adjustments for amounts not distributed and for distributions previously included in income.
- A PFIC is treated as a QEF if an election is made by a shareholder in the company for the tax year. The election only applies to the electing shareholder. In addition, the election is effective only if the company complies with the information requirements that the IRS may prescribe for purposes of:
  - determining the ordinary earnings and net capital gain of the company; and
  - otherwise carrying out the QEF provisions
- Any inclusion by a shareholder requires current payment of tax, unless the shareholder elects deferral.

PFIC Taint

- If the QEF election was not made in the first year the corporation was a PFIC, the shareholder must report the PFIC's earnings every year because of the PFIC taint.
- A shareholder can purge the PFIC taint by making a deemed sale election or deemed dividend election (for a corporation that is a CFC) at the time making the QEF election
  - The gain recognized on the deemed sale and the deemed dividend are subject to the deferred tax charge.
- If the foreign corporation is no longer a PFIC, a US taxpayer that is subject to the PFIC taint can purge the taint by making either a deemed sale election or a deemed dividend election (only for a foreign corporation that was a CFC) in the last tax year in which the foreign corporation was a PFIC.
  - The gain recognized on the deemed sale and the deemed dividend are subject to the deferred tax charge.

CFC and PFIC Overlap

- Effective January 1, 1998, if the PFIC is also a CFC, the corporation is not a PFIC with respect to 10-percent U.S. shareholders.

Where Do We Go From Here?

- The rules are complex.
- To minimize US tax impact and avoid penalties, proper planning is a "must".
- If you want to know more about it, please call us at (562) 463-3818, or send us an e-mail at: info@chiu-wang.com.

Final Words

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