

FDU: U.S. International Corporate Tax

- 248 **PFIC Overview**
- Shareholders of PFICs must either
 - Include their share of PFIC earnings and capital gains in their income currently, or
 - When earnings are included (either as earnings or gain) pay interest and tax (but no penalty) as if they had been included and just omitted from return
- 249 **PFIC Defined**
- Passive Foreign Investment Company is
 - ANY foreign corporation
 - Meeting either asset or income test:
 - Over 75% of gross income is FPHCI or
 - Over 50% of assets produce FPHCI
- 250 **PFIC Look-Thru**
- Assets of 25% or more subsidiary of a foreign corporation
 - Considered proportionately owned by the foreign corporation, and
 - The shares of stock are ignored as an asset
- 251 **PFIC Startup Rule**
- Foreign corporation not considered a PFIC for its first year it has gross income if
 - No predecessor was a PFIC,
 - Shareholder satisfies the IRS that it won't be a PFIC in either of the following 2 years, and
 - It isn't a PFIC in either of the following 2 years
 - Similar rule for changing businesses
 - Trap for unwary: 1st year, not 1st 12 months
- 252 **PFIC Effects: QEF**
- Shareholder may elect to treat PFIC as a Qualified Electing Fund
 - Results in shareholder including share of ordinary earnings & capital gains currently
 - Requires disclosures, election, and promise to deliver records
- 253 **PFIC Effects: non-QEF**
- Shareholder receiving “excess distribution” must
 - Pro-rate distribution over entire period of ownership
 - Compute tax as if earnings so allocated to each post-1986 year had been distributed
 - Compute interest on such tax
 - Exclude the post-1986 portion from current taxable income
 - Include tax and interest on post-1986 as current tax
- 254 **QEF Elections**
- Pedigreed vs. non-pedigreed
 - Straight: effective from point elected
 - Deemed sale: recognize gain as if sold at FMV, pay tax (& interest)
 - CFC deemed dividend inclusion: include all post-86 E&P as if actual

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dividend

255 **PFIC Pitfalls**

- An active business can be a PFIC
- Non-pedigreed QEF can be problem for CFC

256 **Choice of Entity**

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- **Partnership:** income, deductions & credits flow through directly
- **Corporation:** no flow through except character for FTC
- **Hybrid:** entity that is treated one way in one jurisdiction and another way in another jurisdiction

258 **Check the Box**

- U.S. rules allow an entity to elect corporate or flow through treatment
 - Except entities treated, per se, as corporations, such as U.S. corporations or foreign publicly traded entities
- Election made by filing Form 8832 and “checking the box” for the desired treatment
- Election may be revoked
 - Time limits on electing & revoking

259 **What’s a Hybrid Entity**

» §7701(a)(3), Reg. §301.7701-2

- Entity treated as corporation locally and partnership or branch for US purposes (or vice versa)
- **Per se entities**
 - per IRS list
 - U.S. corporations
 - publicly traded type of entity in most countries
- **Otherwise:** choice of taxpayer

260 **Subpart F Branch Rule & Check the Box**

- Checking the box on a sales or mfg. sub causes branch treatment
- Branch rule may defeat check the box

261 **Basic Hybrid Structures**

262 **CV/BV**

263 **Double Dutch**

264 **Impact of Structures**

- Foreign tax credit
- Timing of income
- Taxability of intra-group payments
- Whether reorganizations are real for tax purposes

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265 International Corporate Transactions

266 International Corporate Transactions

- Ordinary Sub-C rules apply
 - Tax free contributions under §351
 - Tax free reorganizations under §§354-362
 - Liquidations under §§331, 332
- Section 367 may convert to recognition events
- Differing rules for outbound vs. inbound and foreign to foreign

267 The Problem of §367

- Turns corporate switch off for Subchapter C
- Tends to cause nonrecognition provisions to be inapplicable
- Does not itself do anything else
- Rules greatly simplified in 2000

268 Example 367 Problem

- USSub contributes its assets (all overseas) to FCo in a triangular D reorganization
- Without §367, this would be nontaxable
- §367 may prevent gain from escaping US tax

269 Overview of 367

- Status as corporation disregarded for purposes of recognizing gain
- Applies only to corporate nonrecognition transactions
- Exceptions allow some tax free outbound reorganizations
- Many inbound & most foreign to foreign reorgs are tax free
- 351 or 361 transfer of intangibles treated as sale for contingent price

270 Recap of Reorganizations

- A: Statutory Merger: US state law only
- B: Stock solely for voting stock
- C: Assets solely for voting stock
- D: Assets for stock with control
- E: Recapitalizations
- F: Mere change in name, form, etc.
- G: Title 11 bankruptcies: US only

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274 Transactions Subject to §367, cont.

275 Key Characteristics of Reorg

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- Nonrecognition to parties if reorg qualifies
- Parties to the reorganization
 - Corporate status important for target & acquiring
- Judicial requirements for reorganization
 - Continuity of Business Enterprise
 - Continuity of Proprietary Interest
 - Plan of Reorganization

276 Other Nonrecognition Transactions

- §351: Contribution to capital by persons in control
- §332: Liquidation of corporate subsidiary into 80% parent

277 Section 367 & Corporate Reorganizations

- Foreign Corporation not treated as a corporation for purposes of gain on non-recognition exchanges
- Statute and regulations provide exceptions and alternatives, such as Gain Recognition Agreements
- Applies only to gains (losses remain unrecognized)

278 Section 367 Corporate Reorganizations

- Section 367(a) Outbound Transfers
- Section 367(b) Inbound and Foreign to Foreign Transfers
- Section 367(c) Section 355 distributions and contributions to capital treated as exchanges
- Section 367(d) Transfers of Intangibles
- Section 367(e) Liquidations and Spin Offs

279 Formation: Outbound Transfers

- Property used in active conduct of a trade or business outside the United States can be transferred tax free, except:
 - Inventory and copyrights
 - Installment obligations and accounts receivable
 - Foreign currency and property denominated in foreign currency
 - Intangible property as defined in Section 936 (h)(3)(B)
 - Property leased to someone other than transferee

280 What is Active Trade or Business?

- Set of activities include every step in income process
 - Excludes activity giving rise to §212 deductions for individual
 - Excludes investment & casual sales
 - May include rental. See Reg. §1.954-2(d)(1)
- Officers & employees must carry out substantial managerial & operational duties
 - May contract out
 - May include officers & employees of affiliates made available

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281 Section 367(d): Intangibles

- Transfer of intangible is subject to adverse provisions of Section 367(d) so don't do it
- Transfer treated as royalty over useful life of property in amounts commensurate with income from intangible under Section 482 rules (i.e., amounts can be adjusted upward over time)

282 Section 367(d): Intangibles

- Amounts deemed received under Section 367(d) are U.S. source ordinary income
- Advisable to sell all intangibles to transferee for FMV immediately before transaction to avoid falling into Section 367(d) trap.

283 Section 367(a)(1)(C)

Branch Loss Recapture

- Foreign branch with previously deducted losses must recapture these losses when its assets are transferred to foreign corporation (even if active business assets)
- Source and character of recapture same as those of prior losses
- Loss recapture limited by expiration of losses and by gains realized in transaction

284 Outbound Transfers of Stock

- Stock or securities of Foreign Corporation
 - OK if U.S. person owns less than 5%
 - Larger shareholders must enter into 5 year Gain Recognition Agreement
- Stock or securities of U.S. Corporation
 - Must not exceed 50% ownership threshold
 - No control group after transfer
 - Gain Recognition Agreements for shareholders owning more than 5%
 - Must be active trade or business

285 Gain Recognition Agreements

- Regs. Section 1.367(a) – 8
- Agreement to realize gain if triggering event occurs
- Gain to be realized in year of initial transfer
- Payment of interest required if gain realized in year of triggering event

286 Section 367(b)

- Liquidations
- Reorganizations
- Section 1504(d) elections
- All exchanges which are not outbound transactions

287 Corporate Liquidations

- Liquidation into foreign parent is allowed as tax-free under Section 332
- Liquidation of foreign corporation into domestic parent requires transferee to include in gross income its pro rata share of all earnings and profits amount (the

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“Section 1248 amount”)

- 288 **Non-Outbound Reorganizations**
- Section 367(b) applies if Section 354 or 356 exchange coupled with B,C,D, or E reorganization
 - General rule for exchanging shareholder is to include Section 1248 amount in gross income
 - Special limited rules for F reorganizations
- 289 **Reorganizations**
- If stock received is a CFC at all times as to exchanging shareholder, then the earnings and profits of CFC may be adjusted instead of immediate inclusion in gross income
 - Section 367(b) also applies to Section 351 transfers made by a foreign corporation to a new foreign corporation
- 290 **§332 Liquidation**
– Reg. §1.367(b)-3
- If a foreign subsidiary is liquidated into a U.S. corporation which is a U.S. shareholder (§951) under §332, the U.S. corporation must include the all E&P amount in its income
 - If a foreign corporation is liquidated into a non-U.S. shareholder under §332, the shareholder may either
 - Treat the liquidation as not qualifying under §332 (i.e., treat as taxable exchange) for recognizing gain only, or
 - Include the all E&P amount in income
- 291 **§304**
- “Redemption through use of a related corporation”
 - Designed to prevent bailing out earnings without paying tax
 - Applies to sale of subsidiary to affiliate or to a subsidiary
- 292 **§304: Cross Chain Sales**
- §304 treats cross chain sale as redemption & capital contribution
 - Can be used to trigger deemed dividend of E&P of **both** target and buyer
 - Can cause unexpected consequences in international context
- 293 **§304(a)(1) Brother/Sister Sale**
- If 2 corporations are commonly controlled and
 - One acquires the other for property
 - Then property is redemption of acquiring’s stock
- 294 **§304(a)(2) Acquisition by Sub**
- If corporation acquires shares of a corporation (parent) which controls it
 - In exchange for property
 - Then property treated as distribution in redemption of parent shares
- 295 **Deemed Dividend**
- Property is treated as distributed in redemption under §302
 - If §304 applies, none of exceptions under §302 to dividend treatment apply

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- Thus property or money received is treated as dividend
- If from foreign corporation, then §902 may apply to grant FTCs (but see below)
- §351 does not apply to property received

296 §304: Cross Chain Sales

- Importance of Section 304 as a planning technique in the foreign area
- Cross chain sales can generate additional foreign tax credits without foreign withholding taxes
- Section 304(b)(5) applies to foreign corporations involved in Section 304 transactions

297 Cross Chain Sales

- IRS has been attempting to curb perceived abuses in this area
- Watch out for the application of 30% withholding tax under Section 1441 to deemed dividends under Section 304

298 Intercompany Pricing: Overview

- **IRS has authority to adjust intercompany charges**
- **Taxpayer has burden of proof to show:**
 - IRS arbitrary & capricious
 - Taxpayer pricing was right
- **Complex regs & significant litigation**

299 Intercompany Transfer Pricing

300 §482: Goods

- **Taxpayers must have pricing policies in advance of filing returns**
 - Must be analysis under 482 rules
 - Must determine that prices charged are more likely than not correct
- **Penalties up to 40% of tax adjustment for failing to document or documenting wrong**

301 §482: Goods, cont.

- **Best Method Rule: select**
 - Comparable Uncontrolled Prices (CUP)
 - Resale Price method
 - Cost Plus method
 - Comparable Profits Method
 - Profit Split
 - Other method
- **Specific rules for each of above**

302 §482: Best Method Rule

303 §482: Services

- **Generally cost plus zero unless services are “integral part” (25% test) of T or B of provider or recipient**

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– Includes deductions allocated or apportioned under reasonable & consistent method

- 304 **§482: Services**
- No deduction where recipient of services does not meet “benefit test”
 - PLR 8806002
- 305 **§482: Interest**
- Safe haven rate for \$ denominated: 100% to 130% AFR
 - No safe harbor for non-\$
 - Good source of comparables: Bank quote
 - No interest required for payables for purchase of goods during average collection period + 10 days
- 306 **§482: Rents**
- Generally must be CUP
 - No safe haven for leases after 1986
 - Subleases: arm’s length is exact pass-through of costs only
- 307 **§482: Royalties**
- Comparable uncontrolled transaction method
 - CPM
 - Profit split
 - Special rules on transfer of ownership
- 308 **Intercompany Pricing Penalties**
- 20% Penalty if
 - Outside range of 50% to 200% of ultimately determined price or
 - 482 adjustment exceeds \$5 million or 10% of taxpayer’s gross receipts
 - 40% Penalty if
 - Outside range of 25% to 400% or
 - 482 adjustment exceeds \$20 million or 20% of gross receipts
- 309 **Avoiding Penalty**
- Either be right or
 - Have a transfer pricing study in place that meets the documentation requirements
- 310 **Advance Pricing Agreements**
- Taxpayers & governments may agree in advance on how prices should be determined
 - Agreements can be with one government or involve more than one (multilateral)
 - Agreements usually specify HOW prices are determined, not the price
 - IRS audits then limited to checking that APA was followed