Individuals' Use of Offshore Holding Companies (Part II)

High-net-worth clients often question their tax professionals about using offshore holding companies to avoid taxes. This two-part article discusses the tax consequences for the average taxpayer and considers when foreign corporations should (and should not) be used.
Part II explores using an offshore company to make significant investments in foreign businesses..

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Executive Summary

- **A foreign corporation will be considered a PFIC if it meets either a gross income test or an asset test.**
- **A foreign corporation may simultaneously meet the definitions of both a PFIC and a CFC with respect to a U.S. shareholder.**
- **Under U.S. tax rules, a foreign entity may be characterized as a trust, a corporation, a partnership, or an entity disregarded as separate from its owner.**

Part I of this article, in the August 2007 issue, introduced the two main anti-deferral regimes applicable to foreign corporations controlled by U.S. shareholders and explored the general federal income tax consequences related to portfolio-type investments by such corporations. As illustrated therein, there are often compelling reasons to deter a client from forming an offshore company for the purpose of holding passive investments.

Part II, below, explores the tax consequences of using an offshore company to make more significant investments in foreign businesses, including situations in which the use of an offshore holding company may be consistent with bona fide U.S. federal income tax planning objectives. As in Part I, the discussion focuses on practical tax advice that U.S. tax professionals with limited international tax exposure may provide to moderate- and high-net-worth clients seeking to defer U.S. federal income tax using offshore holding companies.

Basic Anti-Deferral Regimes

The two primary U.S. anti-deferral regimes, the controlled foreign corporation (CFC) rules and the passive foreign investment company (PFIC) rules, were introduced in Part I. This part reviews these rules and introduces some additional concepts concerning both regimes. To assist in the analysis, the U.S. entity- classification rules as they apply to foreign legal entities are reviewed.

CFC Rules

Sec. 957(a) defines a CFC as a foreign corporation with respect to which U.S. shareholders collectively own stock representing greater than 50% of the combined voting power or value. U.S. shareholders of a CFC generally are required to currently include the CFC's subpart F earnings in income, regardless of whether an actual dividend has been distributed, under Sec. 951(a)(1). A F income includes the foreign personal holding company income CFC's subpart (FPHCI) earned by a CFC, as well as special types of sales and services income.14 Generally, FPHCI includes dividends, interest, rents, and royalties earned by a CFC. Through 2008, however, those forms of income received by a CFC from a related person will not be treated as subpart F income.15 Under Regs. Sec. 1.952-1(g)(1), income received by a CFC from a lower-tier partnership is generally tested on a look-through basis. Further, under Sec. 954(c)(4), gain on the sale of a partnership interest by a CFC is characterized on a look-through basis if the CFC owns a 25%-or-greater interest in the partnership. If this ownership requirement is not met, under Sec. 954(c)(1)(B)(ii), gain on the sale of the partnership interest generally results in subpart F income.

Rules Applicable to PFICs

A foreign corporation will be considered a PFIC if it meets either a "gross income" test or an "asset" test. Under the gross-income test, a foreign corporation will be treated as a PFIC if 75% or more of its income for the year is FPHCI (within the meaning of Sec. 954(c)). Under the asset test, a foreign corporation will be considered a PFIC if greater than 50% of its assets produce, or are held for the production of, FPHCI.

Taxation of PFIC income: In contrast to CFC rules, a shareholder of a PFIC is not subject to a current income inclusion unless it elects to treat the PFIC as a qualified electing fund (QEF).16 A shareholder of a PFIC that does not make the QEF election is taxed only on receipt of a distribution from the corporation in the form of a dividend. However, under Sec. 1(h)(11)(C)(iii), the dividend distribution will not qualify for the reduced 15% rate applicable to certain qualified dividends. Further, a portion of any dividend paid by a PFIC may be subject to additional tax under the "excess distribution" rules (i.e., essentially an interest charge imposed on the deferred tax liability). The excess distribution rules serve to impose a "toll charge" that must be paid for any tax deferral on the income that supports the excess distribution.

Under Sec. 1291(b), an "excess distribution" is the portion of a PFIC dividend in excess of the foreign corporation's historic distribution levels (i.e., any amount in excess of 125% of the average distributions of the PFIC during the preceding three years). The excess distribution amount is then allocated over the shareholder's entire holding period for the PFIC stock on a daily basis. To the extent a portion of the excess distribution is allocated to a prior year, tax is determined on such amount by multiplying it by the highest tax rate in such year and then adding an additional interest charge representing the deferral value (Sec. 1291(c)(2)). In addition to treating dividends in excess of the historic distribution levels as excess distributions, Sec. 1291(a)(2) also treats all gain from the disposition of stock in a PFIC (including, at times, gain realized in an otherwise nonrecognition transaction) as an excess distribution. Thus, the PFIC rules may not be circumvented merely by avoiding the payment of dividends.

As indicated above, a shareholder may elect for a PFIC to be treated as a QEF by making a QEF election. Under Sec. 1293, a QEF shareholder is taxed currently on the QEF's income, regardless of distributions. The QEF election is often desirable for U.S. persons that own stock in a PFIC; it permits the pass-through of capital gains taxable at favorable rates and avoids the onerous interest charges that may apply to excess distributions from nonelecting PFICs. By making the QEF election, however, the taxpayer loses any chance to defer U.S. tax on its foreign earnings.

CFC/PFIC overlap: A foreign corporation may simultaneously meet the definitional requirements of the PFIC and CFC regimes with respect to a U.S. shareholder. Sec. 1297(e) provides that, in the event of such a CFC/PFIC overlap, only the CFC rules will apply with respect to a 10%-or-greater U.S. CFC shareholder. Accordingly, a 10%-or-greater U.S. shareholder in a foreign corporation that is both a CFC and a PFIC will be required to determine his or her U.S. federal income tax liability only under the CFC rules. By contrast, a less-than-10% shareholder in a foreign corporation that is both a CFC and a PFIC will be subject only to the PFIC rules.

Foreign Entity Classification Rules

Under U.S. tax rules, a foreign entity may be characterized as a trust, a corporation, a partnership, or an entity disregarded as separate from its owner.17 The regulations determine the proper tax classification of legal entities (the "entity classification regulations").18 Generally, a business entity organized under the laws of a foreign country must be treated as a corporation if its legal form is expressly listed in Regs. Sec. 301.7701-2(b)(8) (i.e., a "*per se* entity"). If a foreign business entity is not a *per se* entity, it is considered an “eligible entity” under Regs. Sec. 301.7701-3(a). An eligible entity is assigned a default entity classification based on both the number of its interest holders and their level of liability with respect to the entity.

Practitioners familiar with the domestic rules of the entity-classification regulations should note that the default classification rules for foreign entities differ from the rules applicable to domestic entities. Under Regs. Sec. 301.7701-3(b)(2)(i)(B), a foreign eligible entity in which no interest holder has unlimited liability will have a default classification as an association taxable as a corporation. If the foreign eligible entity has more than one interest holder and at least one such interest holder has unlimited liability, its default status will be a partnership (Regs. Sec. 301.7701-3(b)(2)(i)(A)). If the foreign eligible entity has only a single owner with unlimited liability, its default status will be as an entity disregarded as separate from its owner; see Regs. Sec. 301.7701-3(b)(2)(i)(C). A foreign eligible entity generally may elect to change its default classification by filing a Form 8832, Entity Classification Election (i.e., a check-the-box (CTB) election), within 75 days of its intended effective date.19 Once a CTB election has been filed, the entity generally may not file another election for 60 months (Regs. Sec. 301.7701-3(c)(1)(iv)). The 60-month election does not apply, however, if the previous election was effective as of the date of the entity’s legal formation.

Ownership of Lower-Tier Foreign Corporations

A taxpayer generally is treated as owning its proportionate share of any lower-tier foreign corporation owned through a directly held foreign corporation.20 Thus, the CFC and PFIC rules will apply to any lower-tier subsidiary of a foreign corporation with U.S. owners. For example, if a 100% directly held foreign corporation owns stock representing greater than 50% of the vote or value of a lower-tier foreign corporation, the lower-tier corporation will also be a CFC, unless a CTB election is made to treat the subsidiary as a pass-through entity. Further, if a 100% directly held foreign corporation owns 50% or less of the vote and value of a lower-tier foreign corporation, such subsidiary may be treated as a PFIC with respect to the taxpayer if the foreign corporation otherwise qualifies as a PFIC.

The tax implications resulting from a U.S. shareholder’s indirect equity investment in a foreign company will depend on whether the foreign company is treated as a corporation or a pass-through entity for U.S. federal income tax purposes. For eligible entities held by a 100%-owned foreign corporation, the U.S. shareholder may be able to elect to treat such entities as pass-through entities.21 Only entities taxable as corporations for U.S. federal income tax purposes are subject to the PFIC and CFC rules. Accordingly, by electing to treat a foreign entity owned by a foreign company as a pass-through entity (as opposed to a corporation), both sets of rules may be avoided with respect to the lower-tier entity.

Treatment of Nonportfolio Investments Through an FHC

A client often will contact a tax professional, seeking to efficiently invest in various foreign business opportunities by forming a foreign corporation to serve as an investment platform (Holdco). In Part I, the client’s objectives were limited to achieving deferral of U.S. federal income tax on investments in publicly traded stocks and bonds by investing through Holdco. This part looks at other in-vestment opportunities for Holdco, including (1) controlling interests in foreign operating companies, (2) significant noncontrolling positions in foreign operating companies, and (3) investment in lower-tier active and passive income-producing companies.

Unless otherwise indicated in a specific example below, assume (1) the client's objective is to reduce or defer his or her income tax liability to the extent legally permissible, (2) he or she owns 100% of Holdco, (3) Holdco is initially capitalized solely with cash, and (4) Holdco is incorporated under the laws of a low-tax jurisdiction.

Nonportfolio Investments Through Holdco

A foreign holding company (FHC) may provide an efficient means of redeploying foreign earnings without subjecting the earnings to U.S. tax. For example, if Holdco is formed in a low-tax jurisdiction and earns income not subject to current taxation under the CFC or PFIC rules, the pre-U.S. tax income may be reinvested offshore, thus increasing the magnitude (and earning potential) of the subsequent investment. As illustrated in Part I, taxpayers generally may not isolate passive income in an FHC with-out current U.S. tax. However, with the right structure, a taxpayer may accumulate active-business income free of U.S tax in an FHC and reinvest it on a pre-U.S. tax basis. It is this ability to redeploy foreign earnings free of U.S. tax that gives taxpayers an incentive to make foreign investments through offshore holding company structures.

Investment in a lower-tier operating CFC: If Holdco acquires a controlling interest (i.e., more than 50%) in a foreign operating company, the operating company will also be a CFC. Thus, the operating company's subpart F income, if any, will be currently includible by the U.S. shareholder. However, the active-business income of the lower-tier operating company generally will not be subpart F in-come and presently may be distributed to Holdco free of U.S. tax.

Example 1:Holdco is formed in a low-tax jurisdiction and is capitalized by U.S. individual *T*. Holdco acquires 100% of *O*, an operating company in a second foreign jurisdiction. *O* is a *per se* entity; thus, a CTB election may not be made. Accordingly, both Holdco and *O* are CFCs and neither company is a PFIC without regard to the income test or asset test (because of the Sec. 1297(e) overlap rule). *O*'s income consists of active business income generated outside the U.S. that is not subpart F income.

Earnings: Because *O*'s income consists of active-business income, its earnings will not result in subpart F inclusions to *T*. Further, under Sec. 954(c)(6), dividends received by Holdco from *O* generally will not be subpart F income, to the extent such dividends relate to *O*'s active-business income. Thus, Holdco will be able to receive and accumulate the dividend income without current U.S. taxation. Holdco may then reinvest the income received from *O* on a pre-U.S. tax basis. Because dividends from lower-tier CFCs generally will qualify for look-through treatment only in tax years beginning on or before December 31, 2008 (absent congressional action extending Sec. 954(c)(6)), this result will no longer be available after such time. For subsequent tax years, the dividend income paid to Holdco will be treated as FPHCI and will be currently includible in income by *T* as subpart F income.

Gain on sale: Gains earned by Hold-co from the sale of *O* will be treated as a dividend to Holdco to the extent of *O*'s untaxed (i.e., non-subpart F) earnings and profits.22 Thus, such dividend income will also be excluded from subpart F income under Sec. 954(c)(6).23 Any gain in excess of the earnings and profits, however, would be subpart F income currently taxable to *T*.

If *O* were an eligible entity, the same result generally could be achieved by making a CTB election to treat *O* as a disregarded entity.24 Because Holdco would achieve pass-through treatment based on *O*'s disregarded status (as opposed to the Sec. 954(c)(6) dividend-look-through rule), the pass-through treatment would extend beyond the 2008 limitation previously described. Further, gain on *O*'s sale generally would be subpart F income only to the extent the gain is attributable to passive assets held by *O*.

If Holdco holds less than 100% but greater than 50% of the lower-tier operating company, the results will be essentially the same as in Example 1. The only difference will be that if a CTB election is made, the subpart F rules applicable to partnerships will apply (see Example 3 for an application of the subpart F partnership rules).

Noncontrolling Investment in Lower-Tier Operating Entity

If Holdco's ownership of *O* is less than 50% (taking into account direct, indirect, and constructive ownership rules), *O* will no longer qualify as a CFC. In addition, it will not be treated as a related party to Holdco for purposes of Sec. 954(c)(6). As a result, dividends from *O* to Holdco will be subpart F income currently includible by *T*. Further, *O* must be tested to determine whether it is a PFIC. If available, a CTB election may still permit *T* to achieve deferral.

Example 2: Holdco purchases 40% of *O2*, a foreign operating company that is either a *per se* entity or with respect to which the other shareholders object to a CTB election. The remaining shares of Holdco are owned by foreign persons. *O2*'s income and asset composition is such that it is not a PFIC. This determination is necessary because the Sec. 1297(e) overlap rule does not apply to prevent PFIC status.

Dividend income: Because *O2* is not a PFIC, dividends distributed to Holdco will not need to be tested as excess distributions. However, dividends received by Holdco from *O2* will be subpart F income (and consequently taxable currently to *T*) because Holdco will not own the requisite 50% of *O2* required to receive look-through treatment under Sec. 954(c)(6).

Gain on sale: Gains earned by Hold-co from the sale of the operating company will be subpart F income and will be currently taxable to *T*.

If *O2* is an eligible entity and *T* can convince the other shareholders to allow it to make a CTB election, a substantially better result may be achieved similar to the results in Example 1. The benefits of the CTB election relate primarily to the fact that the Sec. 954(c)(4) look-through treatment applies for purposes of characterizing the gain from the sale of a partnership interest, as long as Holdco owns a 25%-or-greater interest in *O2*. Example 3 illustrates this result.

Example 3: Holdco purchases a 40% interest in *O2* as in Example 2, but *O2* is an eligible entity and a CTB election is made for *O2* to be taxed as a partnership for U.S. federal income tax purposes.

Earnings: Earnings allocated to Holdco from *O2* generally will be characterized for subpart F purposes on a look-through basis. Thus, active operating income earned by *O2* generally will not be subpart F income. Actual distributions (i.e., dividends under foreign law) generally will not be subject to tax under the rules of subchapter K (of course, foreign law withholding taxes may apply and should be considered).

Gain on sale: Gains earned by Holdco from the sale of *O2* will be characterized on a look-through basis; thus, gains attributable to active assets will not be subpart F income. Any gain attributable to passive income-producing assets held by *O2*, however, will result in subpart F income currently includible by *T*.

The benefits of the Sec. 954(c)(4) partnership look-through rule are lost if Holdco's interest in the operating company drops below 25%. Income allocated to Holdco would still qualify for look-through treatment; however, gain from the sale of the operating company would be subpart F income in its entirety. Example 4 illustrates these results.

Example 4: Holdco purchases 20% of *O3*, a foreign operating company, and a CTB election is made to treat it as a partnership for U.S. federal income tax purposes. *O3*'s income and asset composition is such that it would not otherwise be a PFIC.

Earnings: Earnings allocated to Holdco from *O3* generally will be characterized on a look-through basis; thus, active operating income will not be subpart F income. Actual distributions (i.e., dividends under foreign law) generally will not be subject to tax under the rules of subchapter K (but may be subject to foreign withholding tax).

Gain on sale: Gains earned by Hold-co from the sale of *O3* will be subpart F income because Holdco owns less than 25% of *F*, a foreign company, making the Sec. 954(c)(4) look-through rule inapplicable.

Noncontrolling Investment in Lower-Tier Passive Entity

Holdco may also purchase an interest in a foreign corporation that has predominately passive income. If Holdco's interest is 50% or less, the foreign corporation will not qualify as a CFC and will likely be treated as a PFIC. As noted, ownership of a PFIC for which the shareholder does not elect QEF treatment will not result in current income inclusions. Distributions by the PFIC to Holdco, however, must be tested as excess distributions to *T*.

Example 5: Holdco purchases 40% of *F*, which is not eligible to make a CTB election. *F* has predominately passive in-come such that it is a PFIC and no QEF election is made.

Earnings: Because *F* is a PFIC that has not made a QEF election, in-come earned by *F* will not result in a current inclusion for *T*. Dividends received by Holdco from *F* will be tested to see if a portion of the dividends is taxable as an excess distribution directly to *T*. To the extent a portion is required to be treated as an excess distribution, such amount will be taxed currently to *T* as ordinary income under the excess distribution rules (potentially subject to an interest charge). To the extent dividends are received that are not part of the excess distribution, such amounts will be currently taxable to *T* as subpart F income earned by Holdco.

Gain on sale: Gains earned by Hold-co from the sale of the PFIC will be treated as an excess distribution directly to *T* in its entirety and taxed as ordinary income (potentially subject to an interest charge).

Under these facts, the benefits of a CTB election are similar to those described in Example 3. If a CTB election for *F* may be made, it will be treated as a partnership and Holdco will determine its subpart F income on a look-through basis. Accordingly, only the *F* earnings that result in subpart F income will be subject to current inclusion by *T*, and the excess distribution rules will not apply. Further, because Holdco owns a 25%-or-greater interest in *F*, gain on *F*'s disposition will qualify for look-through treatment, thus preventing any gain attributable to *F*'s active income-producing assets from being subpart F income. The benefits of the CTB election are of particular importance, because even companies with substantial active business activities may unexpectedly fail one of the PFIC tests.

Conclusion

The anti-deferral regimes impose substantial restrictions on taxpayers that seek to shelter foreign investments from U.S. tax. Nonetheless, when taxpayers have the opportunity to earn active (as opposed to passive) income from operations outside the U.S., proper use of an FHC in a tax-favorable jurisdiction may provide significant opportunities for the appropriate deferral of U.S. income tax and permit efficient redeployment of foreign earnings. Such structures should only be considered, however, after thoroughly exploring the client's tolerance for keeping earnings offshore and the after-tax value of the deferral based on the particular facts and circumstances.