Individuals' Use of Offshore Holding Companies (Part I)

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 I examines the controlled foreign corporation rules as they relate to portfolio-type investments through the use of foreign holding companies.

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Moderate to high-net-worth individuals frequently solicit advice on the potential for achieving tax savings via the use of offshore holding companies, inevitably located in a low-tax jurisdiction. A person's motivations for wanting to form an offshore holding company are often as vague and unidentifiable as his or her understanding of the tax objectives intended to be achieved. Often some acquaintance (e.g., doctor, lawyer, dentist, in-law, college roommate, etc.) has mentioned that he or she has an offshore corporation that does not pay tax on its income (because it is not a U.S. taxpayer).

This two-part article will provide a guide as to why the use of a foreign corporation to shelter passive income from U.S. tax usually has negative tax consequences for the average taxpayer. There are, of course, occasions in which use of a foreign corporation to isolate earnings from U.S. tax is a fundamental element of sound Federal income tax planning (particularly when acquiring an interest in an active foreign business). Using various examples, some of the circumstances in which such an investment structure should be considered will be examined and illustrated. Part I provides an overview of the controlled foreign corporation (CFC) anti-deferral regime as it relates to "portfolio-type investments" through a foreign holding company (FHC) structure (i.e., shifting capital to an offshore corporation to facilitate conventional investments in publicly traded stocks and bonds), and the statutory deterrents to using such a structure. Part II will illustrate the tax consequences of an FHC's investments in an array of foreign business opportunities, including foreign partnerships, investment funds and closely held foreign corporations, and provide examples in which use of an FHC may be consistent with sound tax planning objectives.

Basic Anti-Deferral Regimes

For a taxpayer to benefit from deferral, the foreign entity that holds the income producing property or activity must be a foreign corporation. If a U.S. taxpayer invests through a foreign entity that is treated as a partnership, branch or disregarded entity for Federal income tax purposes, it will remain subject to tax on its allocable share of the entity's income, regardless of whether the partnership is formed under domestic or foreign law. Accordingly, the general rules applicable to the taxation of foreign corporations owned by U.S. persons must first be considered.

There are two main anti-deferral regimes under which the U.S. imposes tax on the income of a foreign corporation with U.S. shareholders. These regimes operate by applying special tax rules to shareholders of foreign entities that qualify as either CFC's or passive foreign investment companies (PFIC's). Both sets of rules are aimed predominantly at taxing a U.S. shareholder on the foreign corporation's passive and "mobile" income (i.e., income that may easily be shifted to low-tax jurisdictions). If the rules apply, the U.S. shareholder may either: (1) be taxed currently on the foreign corporation's income, despite the fact that no income was repatriated to the shareholder through a distribution; or (2) face a somewhat punitive interest charge (in addition to the shareholder's ordinary income tax liability) on an ultimate distribution to the U.S. shareholder or disposition of the entity's stock.

Rules Applicable to CFCs

Determining CFC Status

Sec. 957(a) defines a CFC as a foreign corporation with respect to which "U.S. shareholders" collectively own stock representing more than 50% of the combined voting power or value. For this purpose, only stock owned by U.S. persons that own 10% or more of the company's voting power is considered, according to Sec. 951(b).

For example, if 11 unrelated U.S. persons own the voting stock of a foreign corporation equally, the foreign corporation will not be a CFC; there are no U.S. shareholders (i.e., 10% shareholders) with respect to the foreign corporation, despite the fact that the foreign corporation is 100% owned by U.S. persons. In determining ownership, certain attribution rules apply to treat stock owned by a related party as being owned by a shareholder. For example, Sec. 958(a) provides that stock owned by a foreign corporation is treated as owned proportionately by its shareholders. In addition, certain constructive ownership rules apply, under Sec. 958(b).

Taxation of CFC Income under Subpart F

Generally, a CFC is respected as a separate taxable entity for Federal income tax purposes, and its U.S. shareholders are taxed on the foreign corporation's earnings only on payment of a dividend. Further, a CFC generally will not be subject to U.S. Federal income tax on its earnings unless such earnings are derived from U.S. sources. For certain classes of income, however, U.S. shareholders are required under Sec. 951(a)(1) to include currently a CFC's earnings as income, regardless of whether an actual dividend has been distributed, essentially as a deemed distribution.

The type of income required to be included currently by the U.S. shareholders as a deemed distribution is commonly referred to as subpart F income. Though essentially the economic equivalent of a dividend, subpart F inclusions do not qualify for the preferential 15% rate applicable to dividend income.

Subpart F income includes the foreign personal holding company income (FPHCI) earned by a CFC, as well as special types of sales and services income. Generally, FPHCI includes dividends, interest, rents and royalties earned by a CFC. However, certain dividends, interest, rents and royalties may be excludible from a CFC's subpart F income if received from a related person (i.e., generally a greater-than-50%-owned or commonly controlled person) for tax years beginning before 2009.

According to Sec. 954(c)(1)(B), FPHCI also includes gain from the sale of property that produces dividends, interest, rents and royalties. For example, gain from the sale of a bond is treated as a sale of property that gives rise to interest income, and thus results in FPHCI. Gain from the sale of active business assets, however, is not subpart F income. For a sale of a partnership interest, the general rule is that such a sale gives rise to FPHCI. However, if the CFC owns a 25%-or-greater interest in the partnership, it will be deemed to sell the assets of the partnership directly; thus, to the extent such assets are active business assets, the income would not be FPHCI, under a U.S. shareholder of a CFC that generates subpart F income generally will be required to include such income as gross income in the year earned, regardless of distributions. Further, such income is taxable to the U.S. shareholder as ordinary income, regardless of whether it arose from a transaction that would generate long-term capital gain if entered into directly by such shareholder.

PFIC Rules

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 passive income (within the meaning of Sec. 954(c)). Under the asset test, a foreign corporation will be deemed a PFIC if more than 50% of its assets produce, or are held for the production of, passive income. Because of the mathematical nature of the PFIC tests, the analysis of whether a foreign corporation is a PFIC as to a U.S. shareholder is a factual determination that generally requires a detailed analysis. (The PFIC rules will be explained in more detail in Part II.)

General Application to a Holding Company

Tax Consequences of an Offshore Investment Company

Assume a tax adviser's client (a U.S. individual, *T*) is seeking to achieve deferral of Federal income tax by entering into portfolio-type investments through a wholly owned foreign corporation (Holdco). Because Holdco is 100% owned by *T*, it will be a CFC. Under the subpart F rules, *T* will be required to include as income any subpart F income Holdco earns on a current basis, regardless of the payment of an actual distribution. Thus, to the extent Holdco generates passive income (or another type of subpart F income), *T* generally will have a current Federal income tax liability. The following example illustrates the potentially detrimental tax consequences that may result from Holdco's ownership of portfolio investments.

Example: Holdco is capitalized by *T* with $100,000 in a jurisdiction that does not tax Holdco on income earned from passive investments or apply a withholding tax to dividend distributions (e.g., the Cayman Islands). *T* directs Holdco to make equal portfolio investments (non-controlling) in publicly traded stocks and bonds, with the intention that any dividend income or sales gains will not be subject to tax, and thus will increase *T*'s overall return by allowing pre-tax reinvestment of the income. Holdco's investments produce the following results: (1) the stock appreciates by 10% and pays an aggregate dividend of $5,000; (2) the annual interest earned on the bonds is 7%, resulting in $3,500 of annual stated interest; and (3) Holdco sells half of the stock after it has been held for one year and one day, resulting in $2,500 gain.

Dividend and interest income: The $5,000 dividend income on the stock and the $3,500 interest income on the bonds generally will be FPHCI. Thus, both will be currently includible by *T* as subpart F income. Subpart F income does not qualify for the preferential 15% rate applicable to qualifying dividends from U.S. companies and certain qualified foreign corporations. Accordingly, as to the dividend income, in addition to failing to achieve deferral, *T* has converted income potentially taxed currently at 15% into currently taxable ordinary income subject to *T*'s ordinary income rate. If *T* is taxed at the maximum rate applicable to individuals (35%), *T*'s Federal income tax liability with respect to the income would be $2,975. Had *T* made the investments directly, he would have incurred a Federal income tax liability of $1,975 ($5,000 dividend income at 15% + $3,500 interest income at 35%). Thus, not even considering the cost of compliance, the investment strategy cost *T* $1,000 in additional Federal income tax as to the income generated on the investments.

Gain on sale: The $2,500 gain from the sale of the stock (as well as any bonds sold) similarly will be FPHCI. Thus, gain from the sale of stock will be currently includible by *T* as subpart F income. In general, a U.S. person's capital gains on sales of most stocks and bonds held for more than one year qualify for a 15% rate. Accordingly (as with the dividend income), *T* has potentially converted income taxable at 15% into income subject to his ordinary income rate. Assuming a maximum individual rate of 35%, the investment structure will result in $500 additional tax.

Because the subpart F rules generally require the current taxation of most forms of passive income, the example is a good illustration that the Federal income tax rules do not result in a tax benefit in connection with the isolation of passive investments in a foreign low-tax jurisdiction. On the contrary, such a structure may be detrimental, because the taxpayer may not benefit from preferential dividend and capital gain rates.

Reporting Concerns

An analysis of implementing an FHC structure also must address the practical realities of the fairly complex reporting obligations involved. Every tax adviser is charged by his or her applicable ethical standards to provide clients with advice on the illegality of failing to report income and the potential financial and criminal ramifications of such actions. Providing a client with a clear understanding of the likely penalties for failing to report income or meet tax reporting obligations typically will serve as a sufficient deterrent to generally honest taxpayers. U.S. taxpayers are required to satisfy various information reporting requirements when funding and maintaining offshore investments. If a taxpayer transfers capital (including cash) to a foreign corporation, he or she generally will be required to complete Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. Form 926 requires certain information as to the

amount of the property transferred and the identity of both the transferor and the transferee. Failure to file this form may result in a penalty of 10% of the amount transferred, up to $100,000. The $100,000 limit does not apply, however, if the failure to file was due to the taxpayer's intentional disregard of the rule. Further, a U.S. person that owns greater than 50% of a foreign corporation with a foreign bank account and that has on deposit in foreign bank accounts amounts exceeding $10,000 during the year must file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, for each year in which the threshold is met. A non-willful failure to file Form TD F 90-22.1 could result in penalties up to $10,000 per occurrence.
U.S. taxpayers also have certain annual information reporting requirements as to foreign corporations. Generally, taxpayers that own material interests in foreign corporations are required annually to file Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, with their Federal income tax returns. Form 5471 is an informational return that reports the activities of the foreign corporation. Failure to file it may result in a $10,000 penalty per occurrence (i.e., with respect to each year in which a required form is not filed). If a taxpayer receives notice of a failure to file a Form 5471 from the IRS and does not provide the required information within 90 days, the penalty may be increased by $10,000 for each 30-day period such failure continues (after the original 90-day period), up to a maximum additional penalty of $50,000. In addition, the statute of limitations on assessment on items that should have been reported on Form 5471 generally will not start to run until the form is filed.

Conclusion

The IRS takes attempts by U.S. persons to erode the U.S. tax base through the use of offshore investment vehicles seriously, and U.S. tax law looks to deter such investment strategies. Nevertheless, clients unfamiliar with the complicated labyrinth of potentially applicable tax laws may seek to achieve deferral of U.S. tax on investment income through the use of controlled offshore investment vehicles. By being aware of the basic taxation of such structures and the associated compliance and reporting burdens, tax advisers generally should be able to assist clients in understanding that such investment strategies are often not likely to achieve the intended result (and could, in fact, have many unfavorable consequences).

Part II of this article will discuss the PFIC rules and explore the tax consequences of investments by an FHC in non-portfolio type opportunities, including investment strategies that may warrant the use of an FHC as part of sound Federal income tax planning.