Trends in Structuring Cross-Border Joint Ventures

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- Phyllis Guillory represents clients including both public and private business entities, trusts, and individuals in a variety of industries. Many of Ms. Guillory's clients have energy-related businesses in the United States and in countries all over the world.
- Ms. Guillory's background includes a degree in accounting and past work history with a major international accounting firm. This experience coupled with her work with various types of businesses in many countries uniquely equips her to advise clients on tax-related issues.
- Ms. Guillory has had over 25 years of cross-border transaction experience. She has helped to launch international businesses, advises on local and overseas tax effects, personnel issues, choice of business entity and reorganization of business structure to minimize tax liability. She also assists cross-border business operations with US laws relating to foreign investments and assists non-US investors to structure operations to help minimize or eliminate liability for income and transfer tax.

- Morgan Alleyn is an associate in the Tax Controversy and International Tax Sections. She concentrates her practice on federal tax controversies involving international issues, both civil and criminal, voluntary and responsive, and international planning work.

- Ms. Alleyn's controversy work focuses primarily on guiding clients through the Streamlined Domestic and Foreign Offshore Procedures, the Delinquent Information Return and FBAR Submission Procedures, and various other methods for coming into compliance.

- In terms of international tax planning, Ms. Alleyn assists clients with a variety of international and domestic transactions, including immigration and emigration planning, cross border business transactions, and restructurings.

Options When Entering Into a Join Venture in a Foreign Country

Need for Foreign Entity

A number of factors may contribute to the decision to establish a foreign entity including whether:

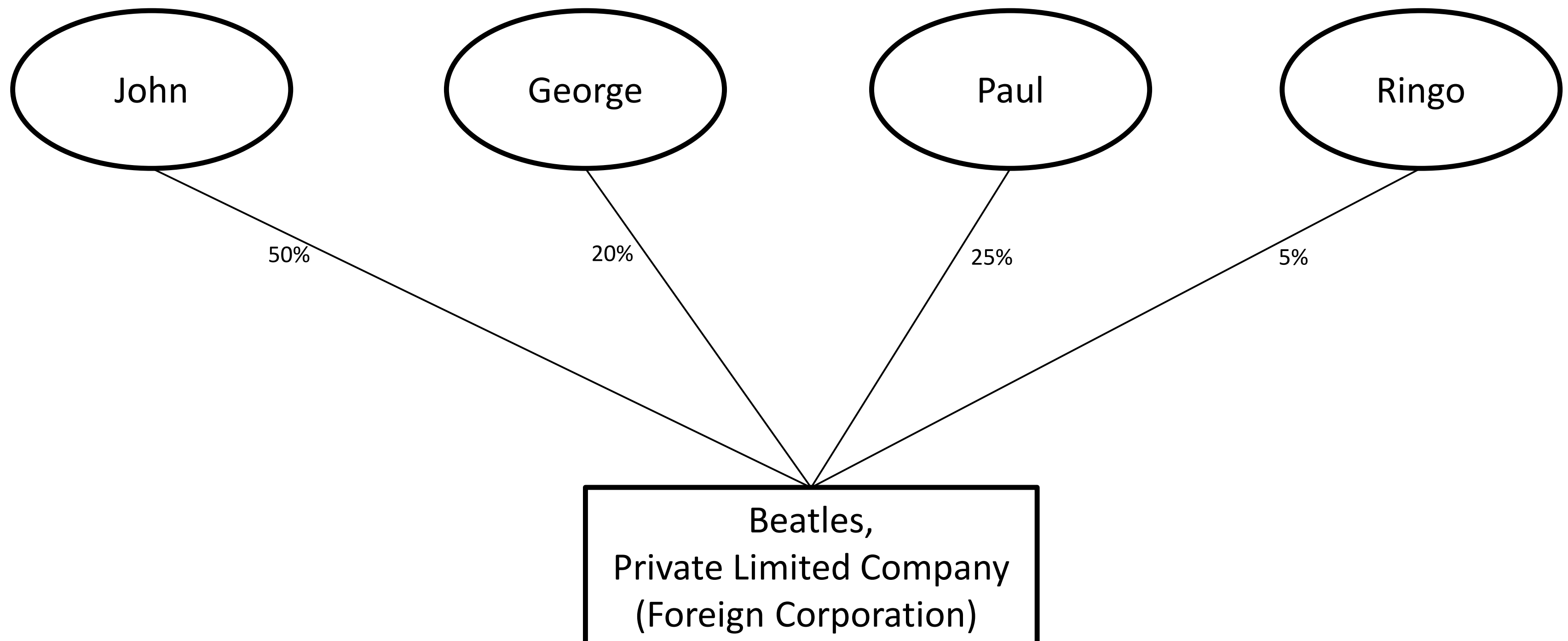
- The business will have legal and/or taxable presence in a foreign country;
- A local entity is required under local law for business; or
- There is a need for a vehicle for projects with foreign and US investors.

The question is how US investors should hold their interest in the foreign entity.

Considerations of Structure Choice

- Foreign Tax Credit
- Tax Deferral
- US Anti-Deferral Scheme
- US Reporting of Entities and Owners
- Foreign Reporting of Entities and Owners
- Limitations under Foreign Law

Option 1: Invest Directly in a Foreign Entity



Issues when Investing in Foreign Entity

- There may be a legal prohibition of US ownership directly into the foreign entity.
- Direct investors may have obligations in the foreign jurisdiction due to their investment. For example – does the foreign entity provide for limited liability to owner? Will US owners have an obligation to file tax returns and pay tax?
- How will the relationship between owners be defined? There may not be the equivalent of a US Buy-Sell agreement.
- US shareholders may be disadvantaged in a trial in a foreign court.
- How will the Foreign Entity be treated for US tax purposes?

Check-the-Box Rules & Foreign Entities

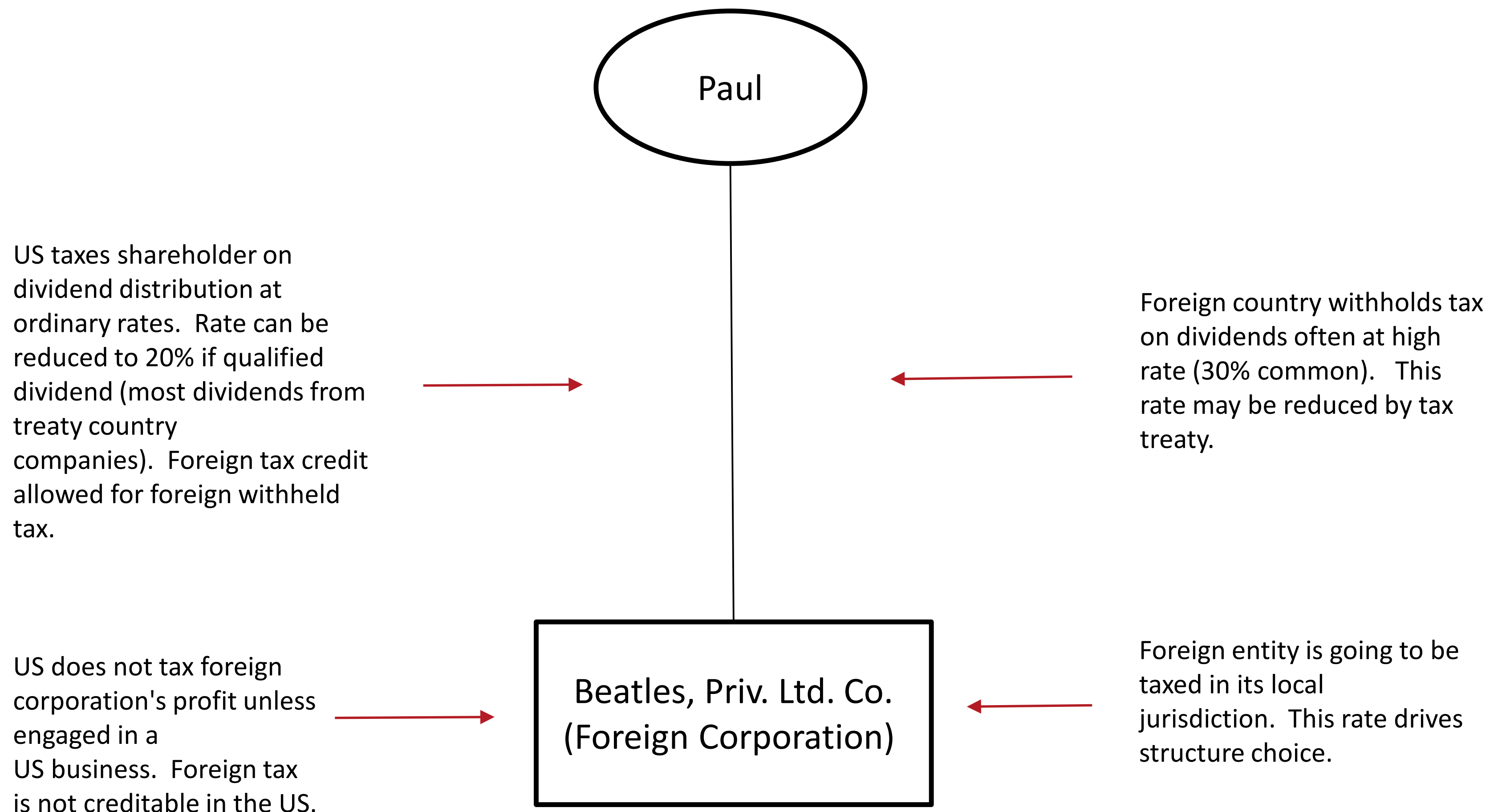
- Entities are classified under default rules or by an election made by the taxpayer.
- A foreign entity can be classified differently in the United States from its local jurisdiction.
- Check-the-box rules provide default rules for classifying entities. Different default rules apply to foreign and domestic entities.
  - The general rule is that a foreign company will default to a corporation if all owners have limited liability.
- Some entities are automatically considered corporations and no election can be made with respect to them.
  - Examples – “Corporation;” “Sociedad Anonima;” “Public Limited Company.”
  - See Treas. Reg. § 301.7701-2(b)(8)(i) for complete list of foreign entities treated as corporations.
- Election is made on Form 8832. Election generally must be made within 75 days of company formation.

Check-the-Box Rules & Foreign Entities

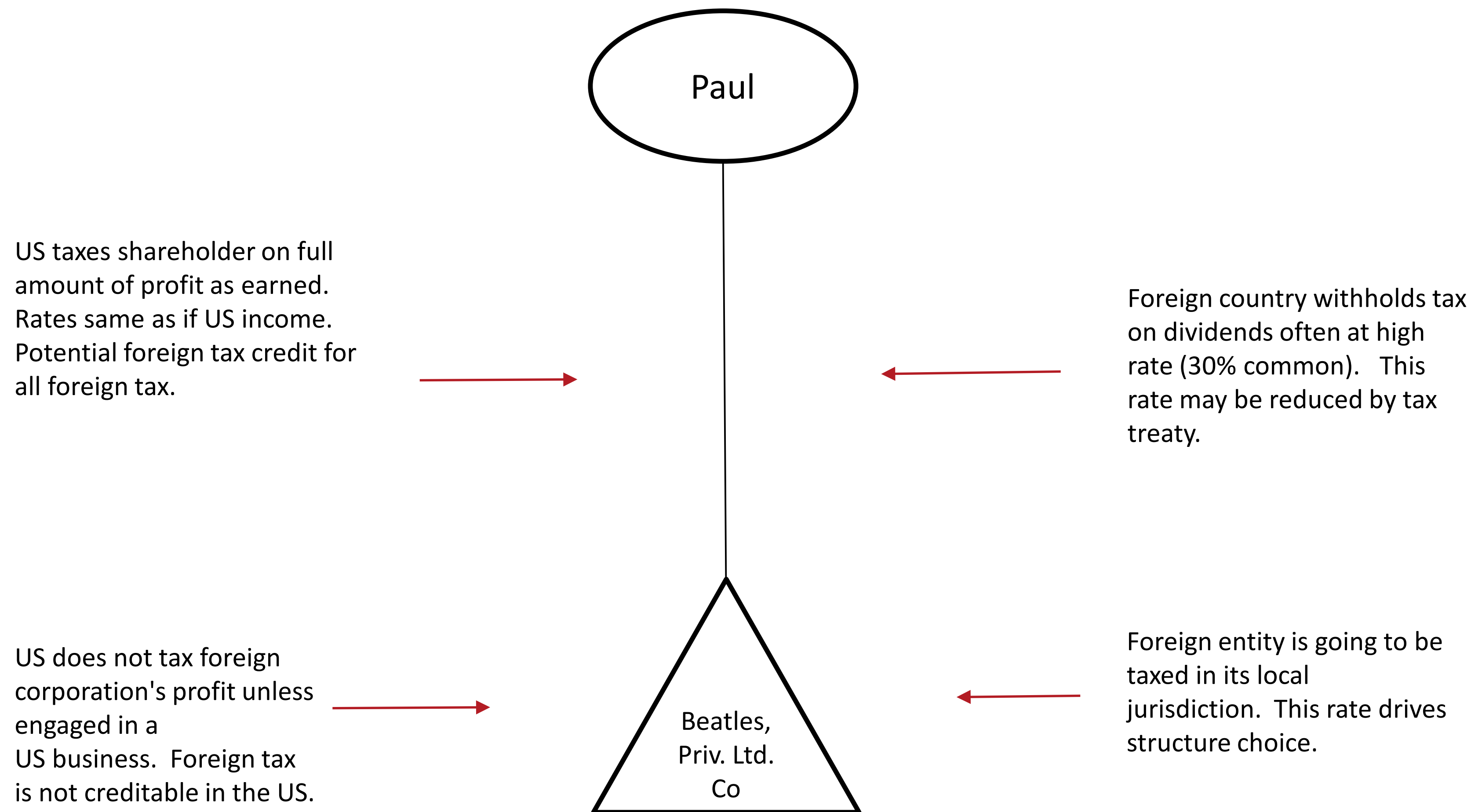
For foreign entities that have multiple US owners, the Foreign Entity will either be classified under the default rules or under an election *made by the entity*. This means that the entity will have the same US tax classification for all US owners.

- Default Rules for Foreign Entities
  - Partnership if two or more members and at least one member does not have limited liability.
  - Corporation if all members have limited liability or the entity is a per se corporation.
  - Disregarded Entity if a single owner and no limited liability.
  - Note that "limited liability" is specifically defined for these purposes as no personal liability for the debts of or claims against the entity by reason of being a member under the local laws of the country in which the Foreign Entity is organized, unless local laws also allow for an entity's governing documents to allocate such liability.
- Election
  - An election is made on Form 8832.
  - US tax classification is not required to match local tax classification.
  - Form must be signed by either each US owner, or the officer, manager, or owner who is authorized under local law or the entity's governing documents to make the election.

Direct Investment in Foreign Corporation



Direct Investment in Foreign Hybrid Entity



Why Do Investors Want Corporations?

- 2017 TCJA reduced the corporate tax rate to 21%. Thus, there is the potential for lower overall combined (corporate and shareholder) tax rate to the ultimate investor.

- Potential deferral of tax.

- But there are limitations on benefits.
  - High foreign rate.
  - Application of Anti-deferral Provisions.

Why Do Investors Want Corporations?

- Generally, a potential benefit of using corporations is deferral. To the extent that tax will be paid to the United States at the shareholder level – if you can defer the tax, the deferred tax is equivalent to a tax free loan from the I.R.S. Since the benefit of deferral is the time value of money, the longer you can defer the tax the greater the benefit.
- Individual shareholders are taxed on distributions from foreign corporations so deferral is still an issue.
  - Dividends generally taxed at ordinary rates unless qualified foreign dividends (generally dividends paid by entity in treaty jurisdiction).
  - Anti-deferral provisions apply to individuals as well as corporations.

Why Do Investors Want Corporations?

- If you can find a Goldilocks situation – an investor can have both deferral and an overall lower tax rate.
  - Requires that the Subpart F rules and PFIC rules (discussed later) are not applicable.
  - For example, an Irish trading company may be taxed at 12.5% rate in Ireland. With a qualified dividend rate, the overall tax is only 30% and you have the potential for deferral.

Complications in Check the Box Analysis

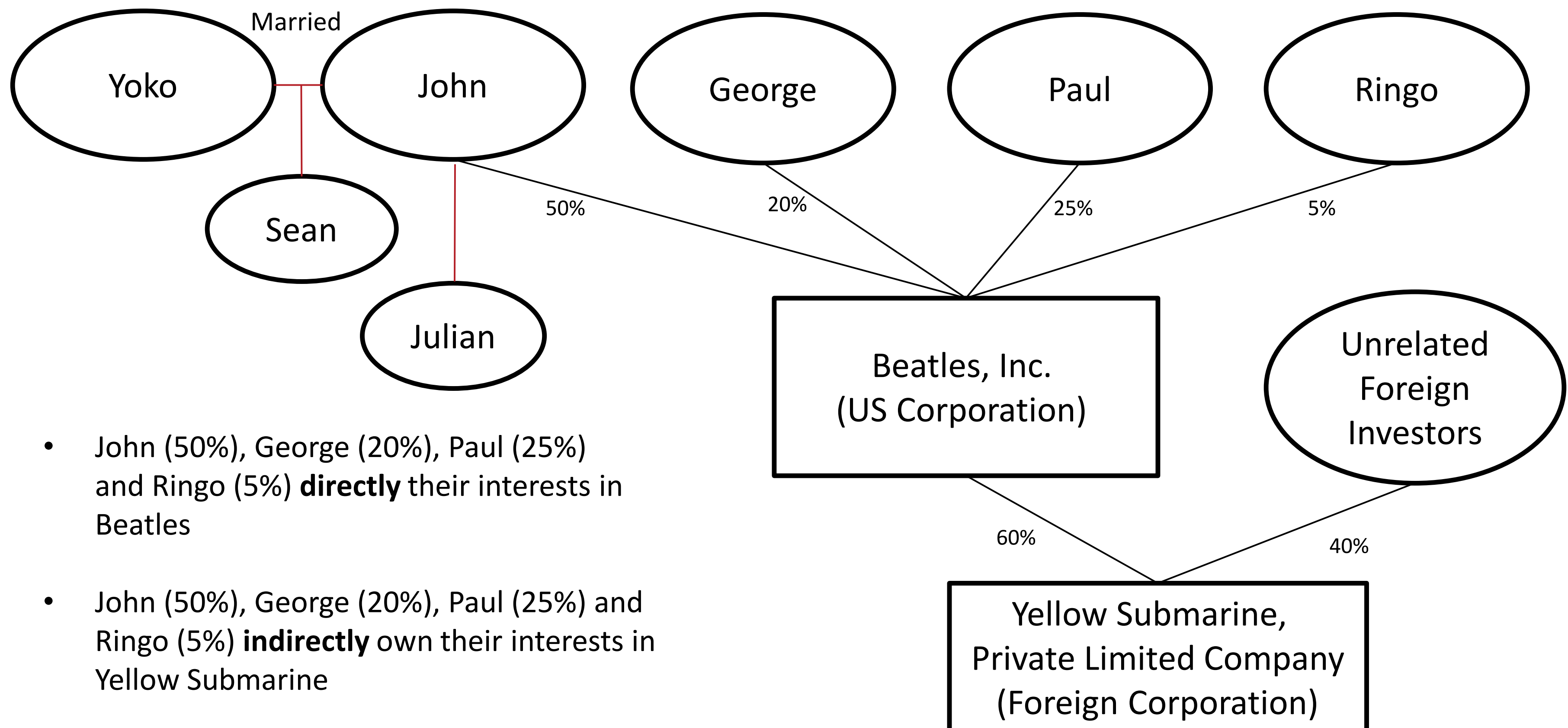
- OECD Pillar Two (also referred to as the "Global Anti-Base Erosion" or "GloBE" Rules) proposes a worldwide minimum tax and has been agreed to by more than 140 countries.
- The goal of the Pillar Two is to ensure that large multinational entities pay a minimum tax worldwide, and to limit the so-called 'race to the bottom.'
- Among other new rules, Pillar Two proposes a 'Top-Up Tax,' which will be used to fill the gap between a company's effective tax rate in the local jurisdiction and the 15% minimum rate under the GloBE rules.
- Aspects of Pillar Two will become effective for tax years as early as January 2024, and the remaining will come into effect for tax years starting January 2025. Taxpayers will need to determine whether countries they wish to do business in have implemented, or intend to implement these rules as part of determining the best structure for them.

The Anti-Avoidance Provisions

What is a CFC?

- Controlled Foreign Corporation
  - If on any day of the taxable year, a foreign corporation is owned more than 50% by US Persons by vote or value, it is a CFC.
- US Shareholder
  - A US Person who owns directly, indirectly, or constructively, 10% or more of a CFC by vote or value
- If you have a CFC
  - Subpart F and GILTI anti-deferral rules apply.
  - Section 1248 may impact the tax of your gain on stock sales.
  - Reporting obligations will greatly increase.

How Do You Get a CFC?



- John (50%), George (20%), Paul (25%) and Ringo (5%) **directly** their interests in Beatles
- John (50%), George (20%), Paul (25%) and Ringo (5%) **indirectly** own their interests in Yellow Submarine
- Yoko, Sean and Julian **constructively** own 50% in Beatles, and 50% in Yellow Submarine

How Do You Get a CFC?

- Direct & Indirect Ownership
  - Stock owned by the shareholder.
  - Stock owned by or for a foreign corporation, foreign partnership, foreign trust or foreign estate is treated as owned proportionately by its shareholders, partners, or beneficiaries.
- Constructive Ownership
  - 318 Rules, BUT
    - Stock owned by a nonresident alien individual is not treated as owned by a US Person,
    - If a partnership, estate, trust, or corporation owns more than 50% of the total voting power in a corporation, it is treated as owning *all* of the stock in that entity, and
    - IRC 318(a)(C) (attributions from corporations) applies to shareholders who own 10% or more instead of 50%.
  - The TCJA removed the restriction previously in IRC 958(b)(4) that prevented certain downward attributions from causing US Persons to be treated as if they owned stock directly owned by a Foreign Person.

Potential Reporting for CFC Shareholders

- Form 8938 - Statement of Specified Foreign Financial Assets
  – Failure to file is a $10,000 penalty per year

- Form 5471 - Information Return of US Persons With Respect To Certain Foreign Corporations
  – Failure to file results in a $10,000 penalty *per form*
  – Filing categories *must* be correct
  – *All* schedules must be included based on filing categories
  – Note that some of the attribution rules for determining what category a taxpayer should file are *different* than those already discussed

- FinCEN Form 114 (FBAR) - Report of Foreign Bank and Financial Accounts
  – $10,000 penalty (adjusted for inflation) per year
  – Signature Authority or Financial Interest

Subpart F

- Applies to Controlled Foreign Corporations.
  - Taxes US Shareholders on a portion of a CFC’s income in the year earned *even if there was no distribution*.
- Generally, applies to Certain Related Party Transactions and Passive Income.
  - Under Section 956, similar rules apply to foreign corporation investments in the United States – but these have been largely mitigated for US corporate shareholders.
- Loss of Qualified Dividend Rate for individual shareholders.

Subpart F – Mitigation

- High tax exception
  - Subpart F income will not include income that was subject to an overall foreign effective tax rate that exceeds 90% of the highest US corporate tax rate.
- Foreign tax credits
  - FTCs are available to a shareholder that is a corporation for foreign taxes paid by a CFC that are allocable to Subpart F income.
- Section 962 Election
  - An election can be made under IRC 962 that allows a US individual to be treated as if they own their interest in the CFC via a domestic corporation. This allows an individual to take foreign tax credits and be in no worse position than a corporation shareholder.

GILTI

- Global Intangible Low-Taxed Income (or GILTI) under Section 951A.
  - Prevents deferral of US tax on certain items of income. Effectively acts as a minimum tax.
  - Inclusion in manner similar to Subpart F – income is taxed as it is earned rather than as distributed.
    - Corporations taxed at rate of 10.5% until 2026.
    - Individuals taxed at ordinary rates.
  - Tax is on excess of each US Shareholder's pro rata share of "net CFC tested income" over his "net deemed tangible income return" of 10% on certain assets.
    - This catches a broader swath of income than Subpart F.
    - Companies without significant tangible assets are particularly hard hit (such as service companies, companies who lease equipment, and IP companies).

GILTI

- Global Intangible Low-Taxed Income (or GILTI) under Section 951A.
  - May now elect to exclude certain income that was subject to an overall foreign effective tax rate that exceeds 90% of the top US corporate tax rate.
  - Corporations can take a foreign tax credit of 80% of the CFC's foreign tax.
    - Individuals can obtain the credit (and the lower 10.5% corporate tax rate) by making Section 962 election.

PFICs

- Passive Foreign Investment Company
  - Applies where the Subpart F and GILTI rules do not.
  - A foreign corporation is a PFIC if 75% or more of its gross income is passive income, or 50% or more of the average value of its assets (on a gross value basis) consists of assets that would produce passive income.
  - Once a company is a PFIC, it *remains a PFIC* unless certain actions are taken.

What Can Be A PFIC?

Some examples include:

- Certain foreign retirement accounts.
- Mutual funds or other corporate investment funds.
- Passive Holding Companies.
- Inadvertent PFICs:
  - SPACs
  - Capital Investment held before investment in business, producing passive income.
- Mining companies.
  - Mining income can be passive income if it generates "commodity" income rather than active income.

How Bad Are PFICs?

- "Excess Distributions"
  - Taxed at highest ordinary income tax rates.
  - Interest charge imposed over period compounded over deferral period.
- Among other things, Excess Distributions can be triggered by things such as sales of assets, reorganizations, or gifts.
- Distributions are treated as Excess Distributions generally to the extent they exceed 125% of average of the prior 3 years distributions.

How Bad Are PFICs?

- PFIC tax and interest calculation are extremely complex (and involve costly reporting).

- If a corporation is a PFIC, the statute of limitations for a shareholder’s return *does not begin* until Form 8621 filed.

PFIC – Mitigation

- PFIC treatment can be avoided by electing to report all income as earned, either under a Qualified Electing Fund ("QEF") or "mark-to-market" election.
- There is an "Overlap Rule" that prevents a PFIC that is also a CFC from triggering the PFIC rules.
  - Protection lost if the CFC status ever lapses.
  - Not available to an investor that is not a US Shareholder (10% owner).

PFIC – QEF

- QEF Election Benefits
  - Owners no longer subject to the PFIC interest charge regime.
  - Current income and gains of the company are taxed to owners (similar to a pass-through entity).
  - Gains remain capital gains. Holding period restarts with the election.

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PFIC – QEF

- QEF Election Procedure
  - Election is made by filing an election statement with the shareholder's return.
  - Election must be valid and made timely. Generally required to be filed with the return by the due date, including extensions.
  - Will require annual reporting requirements.

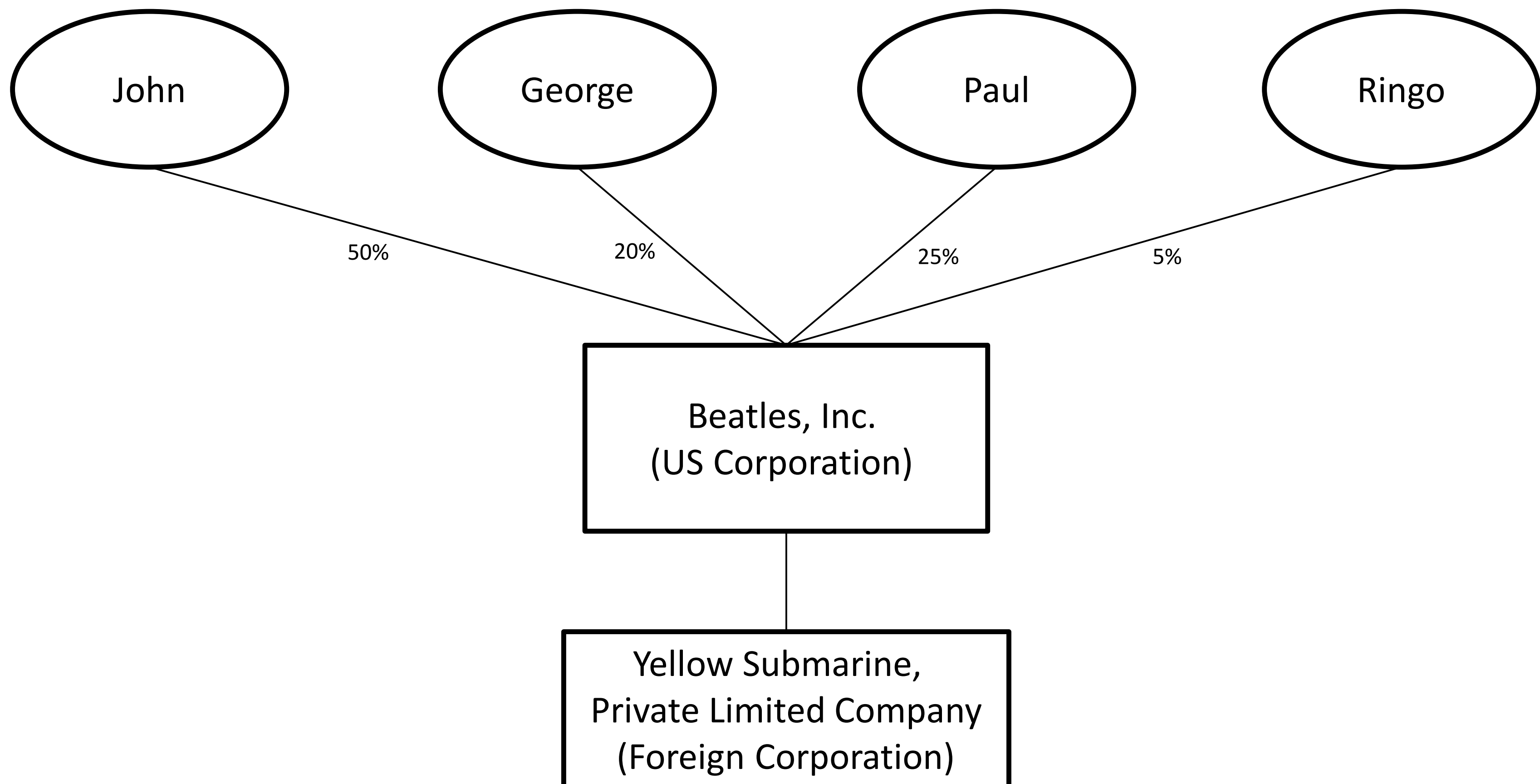
PFIC – QEF & Purge

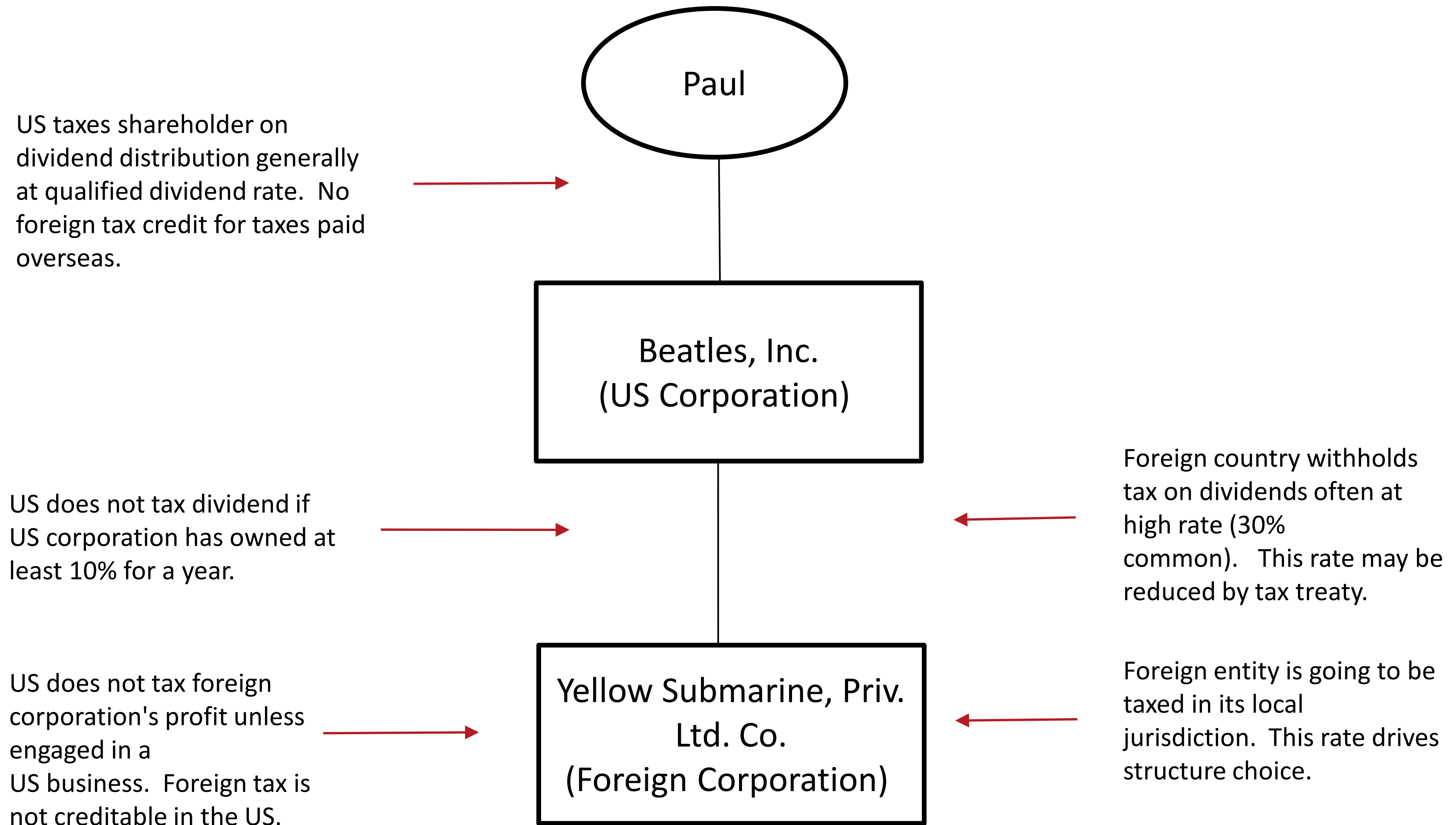
- Generally, if a QEF election is not made at the first date the company became a PFIC, a purge election will also be needed. The purge election:
  - Removes the taint of "once a PFIC always a PFIC" rule.
  - Excess Distribution regime no longer applicable.
  - Allows a Shareholder to have capital gain on sales.

PFIC – QEF & Purge

- A purge election is made on Form 8621.
- Purging can be costly because it recognizes as gain the difference between FMV and basis.
- With a CFC, there is a special purge election to limit the income on the purge to the accumulated earnings and profit of the foreign corporation.

Option 2: US Corporation Invests in Foreign Entity




Paul
Beatles, Inc.
(US Corporation)
Yellow Submarine, Priv. Ltd. Co.
(Foreign Corporation)
US taxes shareholder on dividend distribution generally at qualified dividend rate. No foreign tax credit for taxes paid overseas.
US does not tax dividend if US corporation has owned at least 10% for a year.
US does not tax foreign corporation's profit unless engaged in a US business. Foreign tax is not creditable in the US.
Foreign country withholds tax on dividends often at high rate (30% common). This rate may be reduced by tax treaty.
Foreign entity is going to be taxed in its local jurisdiction. This rate drives structure choice.

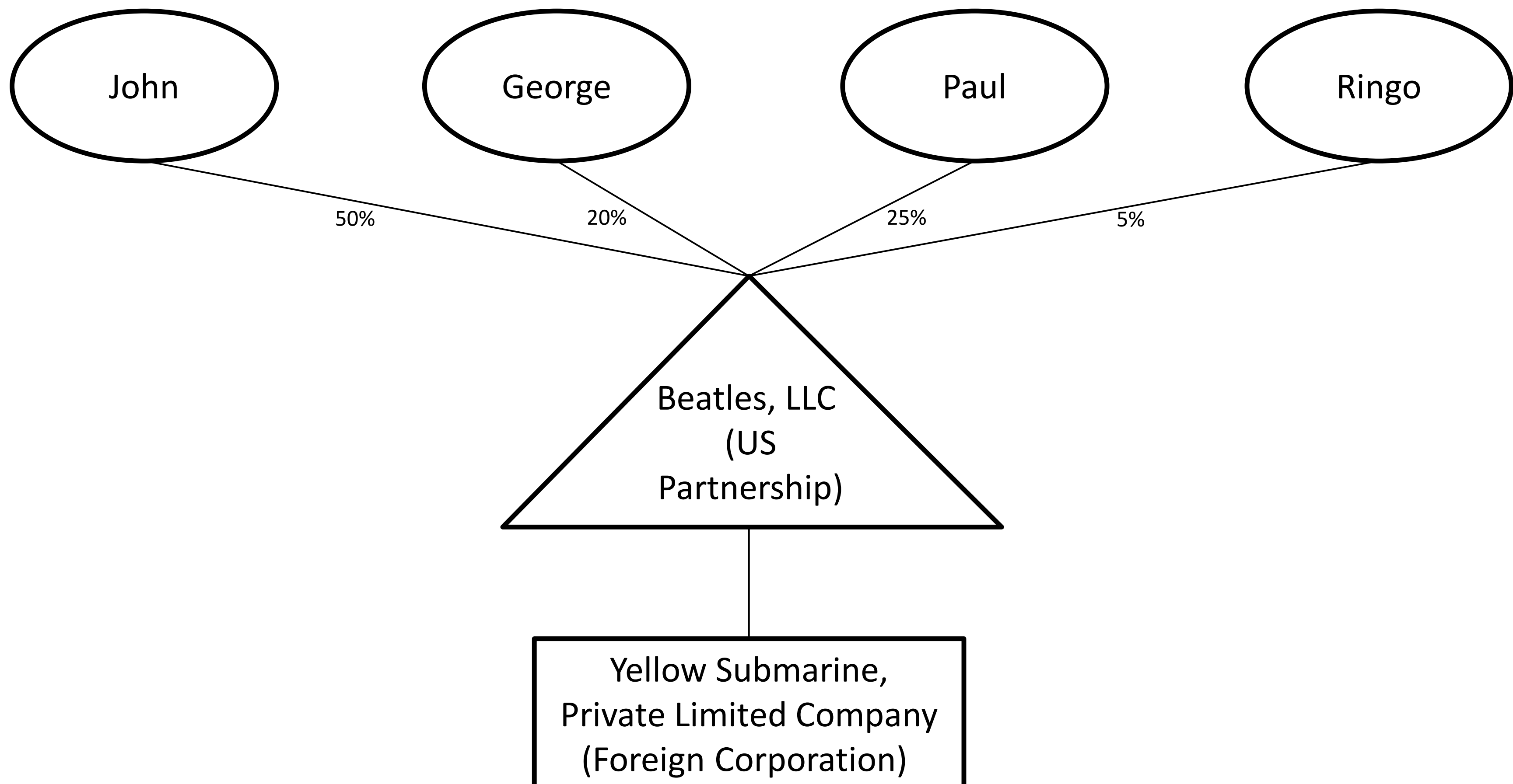
Why Do Investors Want a US Corporation to Hold Foreign Investment?

- Relationship between US investors can be governed by US law.
- Corporation rather than individual owners potentially bears reporting obligations.
- Provides additional layer of liability protection.

Why Do Investors Want a US Corporation to Hold Foreign Investment?

- The US corporation is the "US shareholder" and will be used in determining CFC status and whether there is Subpart F income.
- Since 2018, advantages of this structure include -
  - Lower corporate tax rate (21%),
  - Section 245A exempts dividends from 10% owned, foreign corporation that meet 365 day holding period requirement, and
  - Beneficial GILTI rate and foreign tax credit provisions.

Option 3: US Partnership Invests in Foreign Entity



Why Do Investors Want a US LLC to Hold Foreign Investment?

- LLCs are commonly used for joint ventures in the United States. Relationships between US investors can be governed by US law.
- LLCs allow flexibility in determining entity status if there are multiple foreign entities.
- Provides additional layer of liability protection.

Common Issues with LLC Ownership

- Potential issues in qualifying for treaty benefits.
- New overlap provisions make application of anti-deferral provisions more complex.

The Evolving CFC Overlap Rule

- Subpart F Overlap Rule provides that if income of a foreign corporation is subject to Subpart F income inclusions, the PFIC rules do not apply.

- The application of the Subpart F rules where the US owner is a US domestic partnership has changed.

A Snag in the CFC Overlap Rule

- A US partnership is a US person and was considered, until recently, the US Shareholder for purposes of Subpart F recognition.
- Under the old rules, if there was Subpart F income in the foreign corporation:
  - The US Partnership would have Subpart F income to the extent that it owned the CFC.
  - The US Partnership's Subpart F income would be allocated among ALL of its partners and they would all report Subpart F income on their returns (regardless of their percentage ownership).

A Snag in the CFC Overlap Rule

- Under new rules, the partnership is not considered, and the US Shareholder determination is made with respect to each partner.
- If a partner does not directly or indirectly own 10% of the CFC, it does not recognize any portion of the CFC's Subpart F income.

A Snag in the CFC Overlap Rule

- Before the change in rules, a less-than-10% shareholder was protected by the Overlap Rule if the Partnership itself owned at least 10%.
- Now, a partner that is a less-than-10% shareholder of a CFC is no longer protected by the Overlap Rule. The partner must consider whether the company is a PFIC. The partner can have PFIC income and the shares be subject to the PFIC taint.

Protective Elections

- While the proposed PFIC regulations are not effective yet, this change in the overlap rule is based on Subpart F and GILTI regulations that are now finalized.

- Partnerships or S Corporations that own interests in PFICs may consider alerting less than 10% shareholders to this issue.

Protective Elections

- A minority shareholder of a PFIC should consider a QEF election.
  - The transition rules provide that QEF elections that were made by a domestic partnership or S Corporation before the effective date of the regulations will be respected.

Protective Elections

- Less than 10% shareholders may determine that they held shares in a PFIC for a period prior to the initial QEF election. These shareholders may consider making a purge election to avoid PFIC complications.
  - It is not clear if this election can be made by the partnership or S Corporation or it should be made by the ultimate shareholder. When finalized, the proposed regulations will prevent the election at the entity level.

Wait, There's Moore?

- Moore v. United States is a tax case pending in the Supreme Court.
- The central issue is whether the 16th Amendment authorizes Congress to tax unrealized sums without apportioning such tax among the states. In other words, the Moores are challenging the Constitutionality of whether Congress can levy a tax on income that has not been realized.
  - Specifically, the case challenges IRC 965, a one-time mandatory repatriation tax imposed on shareholders of specified foreign corporations on their pro rata share of previously untaxed earnings. The tax was payable in installments over 8 years.
  - In general, IRC 965 resulted in a roughly 15% tax on CFC income earned between 1986 and 2017 for US Shareholders of foreign corporations.
  - The Moores owed $14,729.
    - Apple owed $38 Billion
    - Google $10 Billion
    - Microsoft $18 Billion
- Moore was decided in favor of the Government in both the Western District of Washington and the Ninth Circuit.

Wait, There's Moore?

- IRC 965 is a one-time repatriation tax, the case was decided for the government at both the District and Circuit levels with no disagreement between the Circuit Courts, and, historically speaking, SCOTUS dislikes tax cases. So why would SCOTUS grant Cert?
  - One theory is that the Court wants to set a line in anticipation of wealth taxes.
- Regardless of the motivations for accepting this case, the discussion central to Moore will focus on the Constitutionality of IRC 965 under the 16th Amendment, and the decision could impact Subpart F and GILTI.
  - Worst case scenario could lead to the implosion of long-standing tax regimes such as Subchapter K.
  - Best case scenario may be an extremely narrow decision that leaves broader tax concepts intact, but could still impact various financial products statutes.
- For now, everything is theory and conjecture. Arguments were held on December 5, 2023, and a ruling is expected in Spring, 2024.
- Tax professionals are watching this decision closely. This decision is going to cause a wave, the question now is just are we looking at the start of a tsunami?