

2006 TSG Conference

Active vs. Passive --
Subpart F for U.S. Persons
Withholding Taxes for Foreign
Persons

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Subpart F – Factual Background
for Application

- U.S. person must be a “U.S. Shareholder”
- The Foreign corporation must be a controlled foreign corporation (“C.F.C.”)
- The C.F.C. must derive Subpart F Income
 - Foreign Personal Holding Company Income
 - Foreign Base Company Sales Income
 - Foreign Base Company Services Income

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U.S. Shareholder

- A U.S. person that owns directly, indirectly, or by attribution from others stock representing at least 10% of the voting power of the corporation

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C.F.C.

- A foreign corporation in which one or more U.S. Shareholders directly, indirectly, or by attribution from others own stock representing *more than 50%* of the voting power or value of corporation

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Foreign Personal Holding Company Income

- Dividends
- Interest
- Royalties
- Rents
- Gains from the sale of property that produce dividends, interest, royalties, rents, or no income
- Personal services income where shareholder is the service provider and customer can designate provider
- Other comparable income, such as Swap Income, In-Lieu of Payments, Commodity Plays, Currency Gains

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Foreign Base Company Sales Income

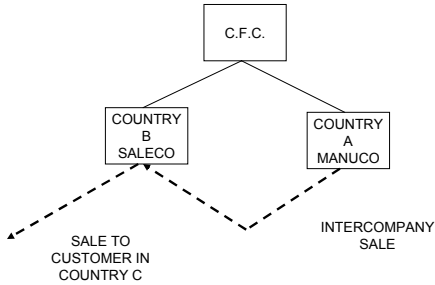
- Income in the form of gross margin in the case of a sale or fees in the case of a service
- Arises from a related party purchase or sale of personal property
- Not manufactured in the C.F.C.'s country of organization
- Not sold for disposition or use in in the C.F.C.'s country of organization

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Does Country B Saleco have FBC Sales Income?



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Foreign Base Company Services Income

- Income from services performed for or on behalf of a related person that are performed outside the C.F.C.'s country of organization
- Occurs where C.F.C. --
 - Is paid by a related person for performing services or
 - Performs services that a related person is obligated to perform or
 - Performs services relating to property sold by a related person or
 - Receives substantial assistance from a related person

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Exceptions To FPHCI for Hedging

- Hedging transaction will not produce FPHCI if it protects the C.F.C.'s
 - Ordinary inventory property,
 - Depreciable property used in a business,
 - Exposure to currency gain or loss from a transaction denominated in a non-functional currency
- The hedge must be identified on the day it is entered

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Same Country Exceptions To FPHCI for Dividends and Interest

- Dividends and interest received by a C.F.C. are not FPHCI where payer is –
 - A related person as to the C.F.C.
 - Created or organized in the C.F.C.'s country of organization
 - Uses a substantial part of its assets in a trade or business in that country

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Same Country Exceptions To FPHCI for Dividends and Interest

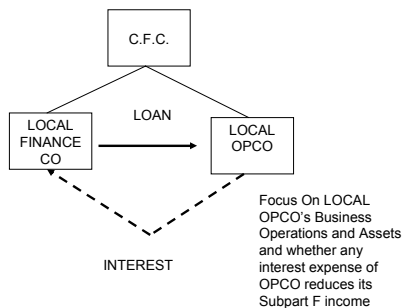
- Applicable Rules
 - Interest used by payer to reduce its Subpart F Income does not qualify
 - More than 50% of the fair market value of payer's assets must be located in the C.F.C.'s country of organization; quarterly valuations required
 - Rules are provided for determining where tangible and intangible assets are used
 - Related means under common control – ownership of more than 50% of voting power

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Is the interest received by Local Finance Co FPHCI?



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Same Country Exceptions To FPHCI for Rents and Royalties

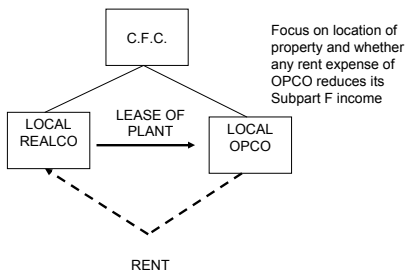
- Rents and royalties received by a C.F.C. are not FPHCI where payer is –
 - A related person as to the C.F.C.
 - Created or organized in the C.F.C.'s country of organization
 - The rents or royalties are for the use of property within the C.F.C.'s country of organization
- Rents and royalties used by payer to reduce its Subpart F Income do not qualify

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Is the Rent received by Local REALCO FPHCI?



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Active Trade or Business Rents & Royalties

- Rents and royalties received by a C.F.C. are not FPHCI where
 - They are derived in the active conduct of a trade or business conducted by the C.F.C.
 - They are received from a person that **is not** a related person

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Rents Derived in the Active Conduct of a Trade or Business

- The rents must be derived in any of the following contexts
 - The C.F.C. manufactured or added substantial value to the property
 - The leased property is real property and the C.F.C., through its own staff, regularly performs active and substantial management and operational functions while the property is leased

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Rents Derived in the Active Conduct of a Trade or Business

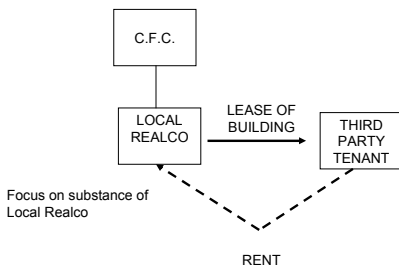
- Context (Cont.)
 - The leased property is ordinarily used by the C.F.C. in an active business, but is leased temporarily during a down period
 - The property is leased as a result of marketing functions performed by the C.F.C. through its own staff
 - The C.F.C. must maintain an organization that is regularly engaged in the business of marketing or servicing the leased property
 - The business must be substantial in relation to the rents

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Is the Rent received by Local Finance Co FPHCI?



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Substance of Leasing Business

- Substantiality of leasing business determined under two tests:
 - Facts and circumstances
 - Safe harbor based on expenses
 - Active leasing expenses \geq 25% of adjusted leasing profit

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Substance of Leasing Business

- Active leasing expenses means trade or business expenses **other than**
 - Shareholder/related party compensation
 - Rental expense
 - Specifically deductible expenses under IRC
 - Expenses to agents
- Adjusted leasing profit means gross rental income reduced by
 - Rental expense
 - Depreciation
 - Expenses to Agents

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Royalties Derived in the Active Conduct of a Trade or Business

- The royalties must be derived in any of the following contexts
 - The licensed property was developed, created, produced, or had substantial value added by C.F.C., provided that C.F.C. is regularly engaged in that business at the time royalties are received

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Royalties Derived in the Active Conduct of a Trade or Business

- Context (Cont.)
 - The property is licensed as a result of marketing functions by the C.F.C., provided that
 - The marketing function is performed by the staff of the C.F.C.
 - The C.F.C. is regularly engaged in the business of marketing or servicing the licensed property
 - The C.F.C.'s organization is substantial in relation to the amount of royalties

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Substance of Licensing Business

- Substantiality of licensing business determined under two tests:
 - Facts and circumstances
 - Safe harbor based on expenses
 - Active licensing expenses \geq 25% of adjusted licensing profit

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Substance of Licensing Business

- | | |
|--|---|
| <ul style="list-style-type: none">• Active licensing expenses means trade or business expenses other than<ul style="list-style-type: none">– Shareholder/related party compensation– Royalty expense– Specifically deductible expenses under IRC– Expenses to agents | <ul style="list-style-type: none">• Adjusted licensing profit means gross rental income reduced by<ul style="list-style-type: none">– Royalty expense– Amortization– Expenses to Agents |
|--|---|

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Safe Harbor Example

- Facts
 - Royalties received \$100
 - Shareholder Comp < 25>
 - Interest < 10>
 - Amortization < 5>
 - License Commission < 5>
 - SGA Expenses < 30>
- Computation
 - Active licensing expenses (30) ÷ Adjusted licensing profit (90) = 33% which is ≥ 25%

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3-year “Canadian Rule”

- Exclusion for dividends, interest, rents, and royalties if
 - Received from a related C.F.C., and
 - To the extent attributable to income of the payer that is not subpart F income, and
 - The payment does not reduce effectively connected income of payer taxable in U.S.
- Sunsets in 2009

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Importance of Exception in Canadian Practice

- Incorporated JV that has U.S. members but is not a C.F.C.
 - Major concern is avoiding the P.F.I.C. rules
 - A P.F.I.C. is a foreign corporation if one of two tests is met
 - Passive income of foreign corporation ≥75% of its total gross income
 - Assets that produce passive income for foreign corporation comprise ≥50% of total assets
 - Passive income means FPHCI for Subpart F

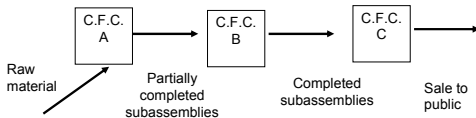
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Manufacturing Exception to FBC Sales Income

- Raw material imported by C.F.C., made into subassemblies, sold to a related party in a second country for completion, and sold for use in a third country



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What is Manufacturing?

- The personal property sold by the C.F.C. is not the property which it purchased
 - The property is substantially transformed prior to sale
 - Wood pulp converted into paper
 - Steel rods converted into screws

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What is Manufacturing?

- Property not the same (Cont.)
 - The operations of the C.F.C. are substantial in nature and are generally considered to constitute manufacturing
 - Two tests for determining substance of C.F.C.
 - Facts and circumstances
 - Direct labor and factory burden $\geq 20\%$ of total cost of goods sold
 - Packaging, repackaging, labeling, or minor assembly operations are not manufacturing

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Foreign Person Withholding Taxes in U.S.

- Three separate types of withholding tax
 - Section 1441 relating to fixed and determinable annual and periodical income from U.S. sources
 - Section 1445 relating to sales of U.S. Real Property Interests
 - Section 1446 relating to business operations carried on in the U.S. through a partnership or an L.L.C.

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FDAP

- Encompasses everything included in gross income under Section 61 except for gains derived from the sale of property and any other income excluded by the I.R.S.
 - Interest
 - Dividends
 - Royalties (including gains based on use of intangible property)
 - Fees

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Special Situations

- Income arising from a U.S. trade or business is subject to net income tax
 - Generally exempt from 30% withholding
 - Recipient must furnish W-8ECI form with taxpayer identification number on form
- Compensation exempt under treaty
 - Exemption requires providing withholding agent Form 8823 that is forwarded to the I.R.S., provided I.R.S. does not object within 10 days

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Special Situations

- If foreign person is a member of a partnership or L.L.C. that is engaged in a U.S. trade or business, the entity must pay quarterly estimated tax on behalf of foreign member
 - Payment to member is not relevant to tax
 - Limited opportunity to benefit from net operating loss carryover of prior year
 - Phantom income is a problem in real estate partnerships

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Special Situations

- Interest on portfolio debt is exempt from withholding tax
 - Creditor must not be a 10% shareholder or a 10% partner in debtor
 - Interest must be imposed at a fixed rate or floating that does
 - Interest cannot be based on profits of debtor

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Special Situations

- Portfolio exemption does not apply if the recipient is engaged in a financing business in the U.S.
 - What is a financing business?
 - How many loans can a foreign person make?
 - Importance of distinction between originating loan and purchasing an existing debt

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