Swimming Upstream?
Subpart F and FTC Considerations in Upstream Oil and Gas Activities
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Agenda

• U.S. Taxation of Multinational Enterprises – The Basics
• Formation of a Non-U.S. Venture
• Operational Considerations
  — Subpart F
  — Foreign Tax Credits
U.S. Taxation of Multinational Enterprises – The Basics

• U.S. Persons — Subject to tax on all of their income regardless of where it is earned (even if taxed in the jurisdiction where earned) — worldwide system.
  — By contrast, most other OECD countries have territorial systems that tax only income that is earned within its borders.
    • Both worldwide and territorial systems employ “source of income” rules to determine where income is earned.
  — Income or loss from investments in non-U.S. partnerships or disregarded entities generally is includable currently.
• Non-U.S. persons — Not subject to U.S. tax unless the non-U.S. person is engaged in a U.S. trade or business.
  — Non-U.S. person’s participation in a U.S. partnership, joint venture or LLC taxed as a partnership can give rise to a U.S. trade or business and a permanent establishment.
Foreign Tax Credits — U.S. taxpayers are eligible for a foreign tax credit on non-U.S. income taxes paid on foreign source income.

- Section 901 credit for taxes paid directly by the U.S. taxpayer; and
- Section 902 credit for taxes paid indirectly through CFCs.
- Significant limitations on the ability to claim foreign tax credits.

Intended to minimize the incidence of double taxation under a worldwide tax regime.

- Territorial regimes typically do not provide for foreign tax credits because they do not tax foreign source income.
Subpart F Income — U.S. persons also may be subject to tax currently on the subpart F income of their foreign corporate subsidiaries that are characterized as “controlled foreign corporations,” or CFCs.

- Anti-deferral regime that is intended to prevent U.S. persons from deferring current U.S. tax on certain types of income, generally, passive income and income from certain related party transactions.
- Taxed as a deemed dividend to the “United States Shareholder,” not a tax on the foreign corporation.
- Other anti-deferral rules may apply to minority investments in foreign corporations – PFIC rules.
Formation of a Non-U.S. Venture
Formation of a Non-U.S. Venture

• Choice of Entity – Regarded or Pass-Through
  — Pass-Through Entities:
    • Except in the case of “per se” entities, U.S. shareholder may elect corporate or pass through treatment.
    • Income or loss currently includable for U.S. tax purposes, regardless of whether income is distributed.
    • Use of losses is subject to certain considerations and limitations:
      — Dual Consolidated Loss Rules;
      — Loss limitations under section 267; and
      — Potential branch loss recapture under section 367.
    • Foreign tax credit for foreign taxes paid on income taxed in non-U.S. jurisdiction, subject to application of limitation rules.
• **Choice of Entity – Regarded or Pass-Through**
  
  — Regarded Entities:
  
  • Income or loss of non-U.S. venture is not subject to current U.S. income tax (unless engaged in a U.S. trade or business).
  
  • U.S. corporate shareholder may be entitled to a foreign tax credit for taxes “deemed paid” by foreign corporation on distributed earnings.
  
  • Subpart F rules may apply to currently tax “United States Shareholders” of CFCs on certain types of income—treated as deemed dividends.
  
  — PFIC rules may apply to investments in foreign corporations that are not CFCs and that have significant passive income.
 Formation of a Non-U.S. Venture

• Choice of Entity – Regarded Entities
  — CFCs
    • More than 50% of the vote or value of a foreign corporation
      must be owned by “United States Shareholders” for a
      corporation to be treated as a foreign corporation.
    — United States Shareholders are U.S. persons that own 10% or more
      of the voting stock of a foreign corporation.
    — Constructive ownership and attribution rules apply in determining
      if CFC and United States Shareholder thresholds are met.
Formation of a Non-U.S. Venture

• Choice of Entity – Regarded Entities – CFCs

— Practice Tips:

• More than 50% of the vote or value is required—50/50 joint ventures generally are not CFCs without more.

• All facts are considered in determining the existence of control (e.g., representation on board, veto rights, supermajority requirements).

• Options to acquire shares generally are treated as being exercised for purposes of determining control.

• United States Shareholder test is based on the vote only—must own at least 10% of the vote.
Operational Considerations – Subpart F
“Subpart F Income” of a CFC is currently taxable (as a deemed dividend) to United States Shareholders.

— United States Shareholder is only taxable on its pro-rata share of subpart F income.
  • Consider preferential rights to income in determining pro-rata share of subpart F income.
— Earnings and profits limitation – If no earnings and profits then no current tax (consistent with deemed dividend characterization), although recapture required in the event of future earnings.
— Income taxed to a United States Shareholder under subpart F becomes “previously taxed income,” or PTI, which can be distributed to a United States Shareholder without additional U.S. tax.
Operational Considerations – Subpart F

• **Types of Subpart F Income**
  - **Foreign Personal Holding Company Income (FPHCI)** – Passive income (e.g., dividends, interest rents, royalties, FX gain, gains from the sale of passive assets, gains from commodities transactions).
    - Look-through rule applies for purposes of determining whether dividends, interest, rents and royalties paid between CFCs are subpart F income.
    - Exception for income earned in “active conduct” of a business.
    - Business needs and/or hedging exception may be available for transactions that hedge ordinary course exposures (e.g., FX, commodity, interest rate).
    - In the case of FX, elections are available to treat gains and losses as subpart F income.
Operational Considerations – Subpart F

- Types of Subpart F Income – FPHCI – Example
  
  - F, a CFC based in Ireland receives a royalty payment from S, an unrelated corporation based in the Netherlands for use of a patented refining process. F is a corporation whose only assets are patents related to refining processes. This royalty income would be FPHCI because F is not in the active conduct of a trade or business.
  
  - If S were a related CFC, the “look through rule” may apply to treat income as subpart F and non-subpart F in the same manner as the income of S.
  
  - Note: Look-through rule does not apply to income received from related persons that are not CFCs (e.g., 10/50 companies and U.S. entities).
• Types of Subpart F Income
  — Foreign Base Company Sales Income (FBCSI) — Generally applies to:
    • Income from purchases and sales of property between related entities;
    • Where the CFC is not manufacturing;
    • And the CFC’s customers are not in the country in which it is organized.
• **Types of Subpart F Income – FBCSI**

  — *Practice Tips:*

  • *Manufacturing exception requires that the CFC engage in substantial transformation of the property.*
  
  • *Important to consider the application of the “branch rules,” which treat branches as separate CFCs for purposes of determining FBCSI in some cases.*
• Types of Subpart F Income
  — **Foreign Base Company Services Income (FBCServI)** — Related party transactions where services are not performed within the CFC’s country of organization.
    • Excludes services that are directly related to the sale of property manufactured, produced, grown or extracted by the CFC if the services are performed prior to the time of sale.
Operational Considerations – Subpart F

• Types of Subpart F Income – FBCServI
  — Practice Tips:
  • *Income from contract drilling or similar services can constitute FBCServI if performed for a related party not in the jurisdiction of incorporation—it is the CFC’s jurisdiction that matters so consider implications of disregarded entity elections.*
  • *If a related party provides substantial assistance contributing to performance of services to a CFC in its performance of services to third parties, the income of the CFC is also FBCServI.*
• **Types of Subpart F Income**
  
  — **Foreign Base Company Oil Related Income (FBCORI)** — Income derived from processing, transporting, or selling oil and gas or their primary products, and from certain related services and investment income.
    
    • Not targeted at upstream activities.
    
    • Intended to reach what Congress considered highly-profitable income from downstream activities sourced to a low-tax country as opposed to the country in which extraction or use occurred.
• **Types of Subpart F Income – FBCORI**

— Generally, FBCORI includes income derived from sources outside the United States from:

- **Processing** of minerals extracted from oil and gas wells into their primary products;
- **Transportation** of such minerals or primary products;
- **Distribution** or sale of such minerals or primary products;
- **Disposition** of assets used in the trade or business of such minerals or primary products;
- Performance of any **related services**; and
- **Dividends, interest and partnership income**.
Operational Considerations – Subpart F

• Types of Subpart F Income – FBCORI
  — Processing income includes income from:
    • Destructive distillation of crude oil into primary products;
    • Processing of natural gas into primary products;
    • Processes used to remove pollutants from crude oil or natural gas; and
    • Refining minerals extracted from oil or gas wells into their primary products.
  — CFC ownership of minerals being processed is not required.
  — No requirement that CFC perform refining services for a related person.
Operational Considerations – Subpart F

• Types of Subpart F Income – FBCORI
  — Transportation FBCORI generally includes income derived from:
    • Transportation of minerals extracted from oil and gas wells;
    • Transportation of primary products of those minerals; and
    • Transportation can be by any means, including vessel, pipeline, automobile, rail or air.
  — Transportation FBCORI does not include:
    • Certain rental income and income from performing directly related services.
Operational Considerations – Subpart F

• **Types of Subpart F Income – FBCORI**

  — Distribution or sale means sale or exchange of minerals or primary products to:
    
    • Processors or users who purchase, store or use in bulk quantities; and
    
    • Other persons for further distribution and sales to retailers or to consumers.

  — Need not be with a related person.

  — Partial exception – If CFC extracts the oil or gas that it sells, the portion of the income attributable to extraction is not FBCORI.
Operational Considerations – Subpart F

• **Types of Subpart F Income – FBCORI**
  
  — Directly related services income is *directly related to active conduct* of a refining, transportation, distribution or sales operation, and includes income from:
    
    • The lease or license of related property, terminal services, stevedoring and cargo handling, maintenance and repairs, and training of crews.
    
    — Includes services performed for any person, without regard to whether the person is related.
    
    — **Does not include extraction income** and income from insurance, managerial or accounting services.
Operational Considerations – Subpart F

• Types of Subpart F Income – FBCORI
  – Practice Tips:
    • FBCORI always trumps:
      – Income exempt from another category of Foreign Base Company Income may still constitute FBCORI.
      – If income constitutes Foreign Base Company Income under FBCORI and another category, it is treated as FBCORI.
    • There is a “same country” exception for income from extraction and sales within a single country.
    • Allocated pro rata for refining, transportation and marketing if it includes local as well as imported.
    • Small producer exception applies if the group produces less than 1,000 barrels a day outside the United States.
Operational Considerations – Subpart F

• The Other Subpart F Income: Section 956 Investments in U.S. Property
  — Loans made by a CFC to a United States Shareholder, and certain other investments in “U.S. property,” are considered to be deemed distributions for subpart F purposes.
  — Practice Tips:
    • Pledges of assets of a CFC, or guarantees by a CFC may be considered investments in U.S. property.
    • Loans to foreign partnerships in which there are United States Shareholders may give rise to section 956 investments.
    • Does not include movable property used in exploring, developing, removing or transporting resources when used on the U.S. continental shelf.
Operational Considerations – Foreign Tax Credits
Operational Considerations – Foreign Tax Credits

• U.S. taxpayers generally are permitted a credit for foreign taxes that they pay on their foreign source income.
  — Section 901 – All U.S. persons may elect to credit foreign income taxes paid.
  — Section 902 – U.S. corporations may elect to credit taxes deemed paid with respect to dividends from corporations in which the U.S. corporation owns a 10% voting interest.
    • Generally permitted for dividends from lower tier foreign corporations (as long as the U.S. taxpayer has a 5% indirect interest and the 10% voting requirement is satisfied at each level)—Three tiers for non-CFCs and Six tiers for CFCs
• Ability to claim foreign tax credits is subject to significant limitations.
• **Foreign Tax Credit Limitations**
  
  — Section 904 – Foreign tax credit is limited to the amount of U.S. tax on foreign source income.
    
    • Taxpayer with an “overall foreign loss” or OFL cannot claim foreign tax credits.
      
      — Allocation of expenses can have significant implications for the determination of a U.S. taxpayer’s foreign source income.
    
    • Foreign source income is separated into passive and general baskets.
    
    • Specific ordering rules apply for purposes of recapturing OFL.
• **Foreign Tax Credit Limitations**
  
  — **Foreign Mineral Income** – Special rules apply to limit the amount of creditable taxes for taxes paid on “foreign mineral income” (i.e., income from extraction, processing, transporting and distributing minerals).
  
  — **Oil and Gas Taxes** – Special rules also apply to treat certain payments related to oil and gas transactions as not taxes (i.e., where the facts indicate that they are effectively an adjustment to the price of the oil and gas).
  
  — **Section 901(m)** – Limits the ability to claim excess foreign tax credits where foreign law treatment of transaction does not match U.S. treatment.
Questions?