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Agenda

- The Maltese Pension Plan - Is it Too Good to be True?
- Tax Planning Associated with Becoming a Bona Fide Resident of Puerto Rico
- Using High-Tax Exception and Malta to Avoid Subpart F Income
- Boot within Gain Rule and Tax-Free Distributions

Maltese Pension Plans

Maltese Pension Plans - Is the Result Too Good to be True?

- The U.S.-Malta income tax treaty, (the "Treaty") effective January 2011, provides U.S. taxpayers (citizens, residents, and green card holders) with significant tax benefits when creating a Maltese pension plan.
- Article 18 of the Treaty provides that any income earned by the Maltese pension plan cannot be taxed to a U.S. beneficiary of the plan until distributed (<u>subject to</u> Article 17).
- Article 17(b)(1) of the Treaty provides that distributions by a Maltese pension plan are exempt from U.S. federal income tax in the hands of a U.S. beneficiary (if they would have been exempt in the hands a Maltese resident beneficiary).
- Article 1(4) of the Treaty specifically provides that Articles 17 and 18 are not subject to the savings clause.

Maltese Pension Plans - Is the Result Too Good to be True?

- Requirements to qualify for Treaty benefits:
  - ✓ Beneficiary of plan must be treated as "resident" of the United States under the Treaty - includes U.S. citizens and green card holders.
    - No requirement to be a resident of Malta at any time when contributions are made to the plan.
  - ✓ Pension plan must be treated as a "resident" under the Treaty - Article 4 (2) provides that a pension plan established in either the United States or Malta qualifies as a resident.
  - ✓ Pension plan must satisfy the Treaty's LOB provision - Article 22(2)(e) provides that at least 75% of the beneficiaries of the plan must be residents of the United States or Malta.

Maltese Pension Plans - Is the Result Too Good to be True?

- Maltese pension plan treated as a foreign grantor trust for U.S. federal income tax purposes - grantor has rights to income for life
- Not subject to Section 402(b) - covers employer sponsored pension plans; statute treats these types of plans as non-grantor trusts.
- As a result, contributions to the plan are non-events for U.S. income tax purposes.
  - ✓ No tax is triggered on contribution of appreciated assets to the plan.

Maltese Pension Plans - Is the Result Too Good to be True?

- What was Treasury thinking?
- Technical explanation to the Treaty makes it clear this is correct result.
  - ✓ Compares it to Roth IRA
- Articles 1(4), 17 and 18 are based on 2006 U.S. Model Income Tax Treaty (as compared to OECD Model Treaty).

Tax Planning with Puerto Rico

PR Residency Rules

- A "bona fide resident" of Puerto Rico may exclude income from sources within Puerto Rico for the year from gross income for U.S. tax purposes
- To be such a "bona fide resident," a person must meet the following three tests: (1) the presence test; (2) the tax home test; *and* (3) the closer connection test

1. Presence Test: (i) presence of 183 days or more in Puerto Rico during the year; (ii) presence of 90 days or less in the U.S. during the year; (iii) realizing $3,000 or less of earned income from U.S. sources for the year and having presence during the year in Puerto Rico for more days than in the U.S.; or (iv) having "no significant connection" to the U.S.
   - ✓ For purposes of the 183 day test, proposed regs deem you to be resident for 30 days in Puerto Rico as long as you are not present in the United States during those 30 days. Thus, up to 30 days of travel in, e.g., Europe or Asia (or elsewhere other than the U.S.) could be counted as days of presence in Puerto Rico

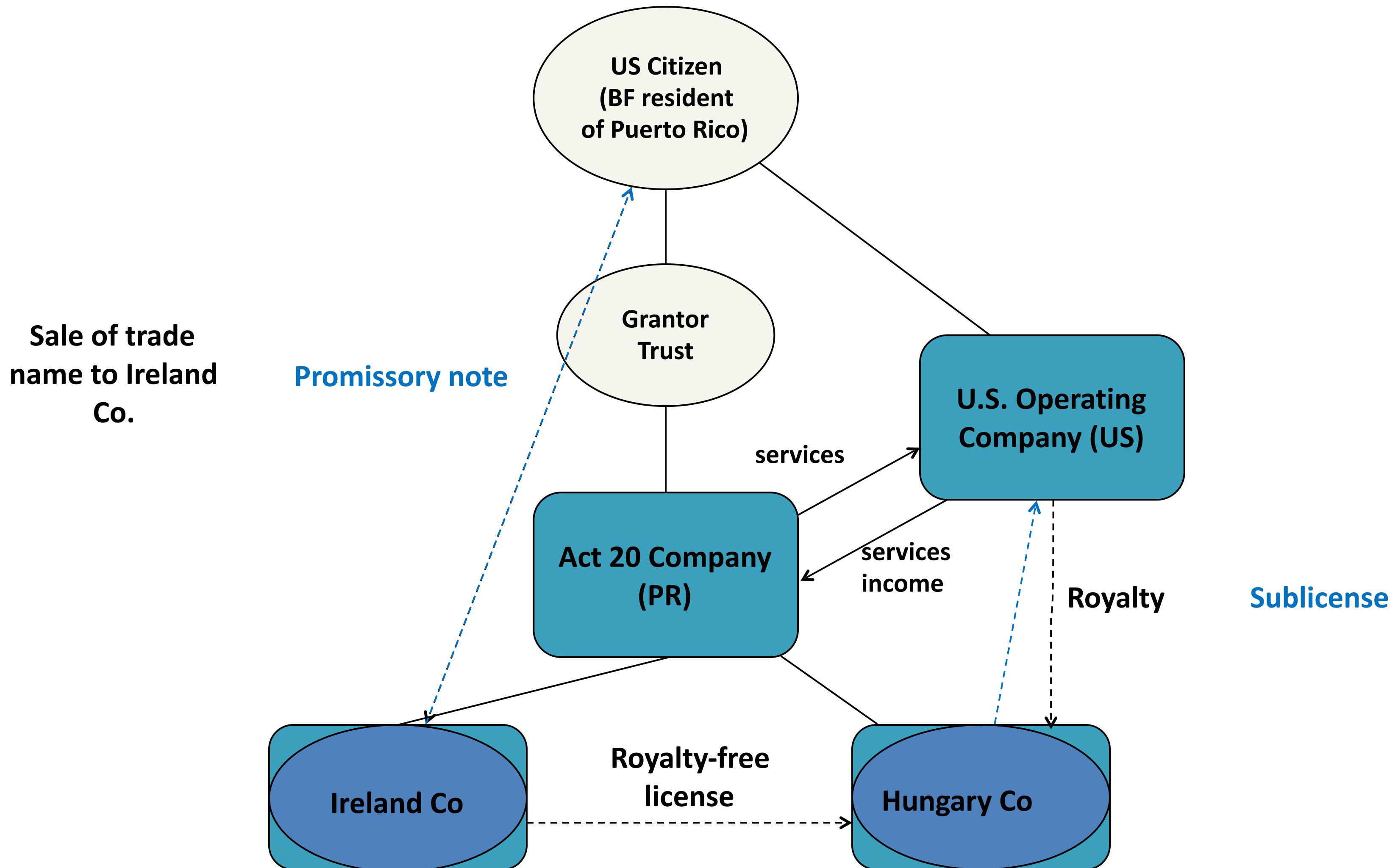
PR Residency, Cont'd

2. Tax Home Test: a person has a “tax home” at a particular place if he or she would be allowed a deduction under Section 162(a)(2) for expenses incurred in traveling away from that place on business
3. Closer Connection Test: a person has the closest connection with the place with which he or she "has maintained more significant contacts," including the location of his or her permanent home, family, personal belongings, and personal bank accounts, the location of the social, political, cultural, and religious organizations "with which the individual has a current relationship," where he or she obtained his or her driver's license, where he or she votes, and the country of residence designated on documents filed by the individual

Benefits of Being Bona Fide Resident of Puerto Rico

- U.S. citizen is able to exclude from U.S. federal income tax (and PR tax) Puerto Rican source income, including dividends, interest, and capital gains from all sources under Section 933.
- BF residents are exempt from CFC and PFIC rules with respect to PR companies under Section 937.
- PR companies subject to 4 percent corporate income tax on export services income, royalties, interest, and many other types of income.
- Only statutory regime available that allows U.S. citizens to exempt many types of income without expatriating.

Proposed Structure for Royalties and Services



Royalties- Tax Implications

- Sale should be eligible for long-term capital gain and installment sale treatment in US
  - Section 1249 does not apply to recharacterize income as ordinary because trade names are specifically excluded
- Royalties paid from US to Hungary eligible for 0% withholding tax per US-Hungary treaty
- US citizens qualify under both old and new Hungary treaty for purposes of derivative benefits provision
- 894(c) does not apply because income derived in Hungary

Tax Implications, Cont'd

- Hungary Co entitled to deemed deduction for Hungary purposes, pursuant to royalty-free license arrangement
- However, Ireland does not require income inclusion under its transfer pricing principles because the income is passive
- Conduit financing regulations in US should not apply to reduce benefits because if royalties paid directly to Ireland, 0% withholding available per US-Ireland treaty

Subpart F and PFIC issues

- Both Ireland Co and Hungary Co treated as branches of Puerto Rican corp
- PR corp (including the disregarded branches) not treated as CFC pursuant to Section 957(c)(1)
  - Because dividend from PR corp will be treated as PR source income, which is excludible under Section 933(1)
- Section 861(a)(2)(B) will not treat dividend from PR corp as US source because PR corp will not have any ECI for US purposes
- US PFIC rules should not apply, as result of Proposed Regulation Section 1.1291-1(f)

Services- Tax Implications

- Services income paid to PR corp will be subject to 4% corporate tax rate in PR under Act 20

High Tax Exception and Subpart F Income

Subpart F - Basic Mechanics

- Subpart F inclusion applies to U.S. shareholder holding stock on last day in taxable year on which FC is a CFC.
- CFC defined as foreign corporation that is more than 50 percent owned (directly, indirectly, or constructively) by "U.S. shareholders."
- “U.S. shareholder” – U.S. person that owns (directly, indirectly, or constructively) 10 percent or more of voting power of CFC.
- Pro rata share of subpart F income – based on direct and indirect ownership. Not constructive ownership.
- FC must have CFC status for 30 days or more during the taxable year.

Using Malta to Avoid Subpart F Income Under High Tax Exception

- Under Section 954(b)(4), a U.S. shareholder of a CFC is able to exclude from foreign base company income an item of income earned by a CFC if the taxpayer can show that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum federal income tax rate specified in Section 11.
- The maximum rate of tax specified in Section 11 is currently 35 percent.
- Therefore, the high-tax exception will apply to income earned by a CFC that is subject to an effective foreign tax rate of at least 31.5 percent.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

- For purposes of this provision, the effective tax rate equals (1) the foreign income taxes paid, accrued, or deemed accrued with respect to the net item of income, divided by (2) the net item of FBC income (increased by the income taxes on the item).
- The amount of foreign income taxes paid, accrued, or deemed accrued with respect to an item of income is generally the amount a taxpayer would be deemed to have paid under Section 960 if the item of income were included in gross income under Subpart F.
- In the case of an individual, this amount is determined as if an election under Section 962 has been made to treat the individual as a corporation for the purposes of Section 960.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

- Regulation Section 1.954-1(d)(3)(i) specifically provides that the amount of foreign income taxes paid, accrued, or deemed accrued with respect to an item of income will <u>not</u> be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholder of all or part of such income.
- Further, Regulation Section 1.904-4(c)(7)(iii) (dealing with the "high-tax kick out" exception under the foreign tax credit rules) specifies that if the effective foreign tax rate imposed on a foreign corporation is reduced under foreign law upon the distribution of that income, the rules of Section 954(b)(4) are applied <u>without regard to the possibility of a subsequent foreign tax reduction</u>.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

- An example in the Section 904(d) regulations (1.904-4(c)(8), Ex. 7) illustrates this concept:
  - ✓ S, a CFC, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of $200 of passive income that is FPCHI that is earned in foreign country X.
  - ✓ Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed.
  - ✓ In 1987, S pays $100 of foreign tax. P elects to apply the Section 954(b)(4) high-tax exception to S's passive income that is subpart F income.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

- ✓ In 1988, S distributes $150 to P. The distribution is a dividend to P because S has $150 of accumulated earnings and profits (the $100 of earnings in 1987 and the $50 refund in 1988).
- ✓ The example concludes that the $200 of FPHCI will be eligible for the Section 954(b)(4) high-tax exception to subpart F income, even though the effective foreign tax rate is reduced from 50 percent to 25 percent (which is less than the 31.5 percent generally needed to qualify) as a result of the $50 tax refund received in 1988.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

- A similar result may be accomplished by forming a CFC that is tax resident in Malta.
- In general, Malta has a corporate income tax rate of 35 percent. Malta, however, applies an "imputation system" whereby the corporate income tax paid by the company is refunded to the shareholders when distributions are made to them. The amount of the refund depends on the type of income earned by the company.
- When dividends are paid by a Maltese company earning active income, the shareholders become entitled to claim refunds of 6/7 of the Maltese corporate income tax paid. This results in an effective corporate income tax rate of 5 percent.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

- If, on the other hand, dividends are paid by Maltese companies out of profits earned from passive interest and royalties, the shareholders are entitled to claim a refund of 5/7 of the Maltese corporate income tax paid. This results in an effective corporate income tax of 10 percent on these types of passive income.
- The refunds are payable within 14 days from the last day of the month in which the request is made to the Maltese tax authorities.

Using Malta to Avoid Subpart F Income Under High Tax Exception (Continued)

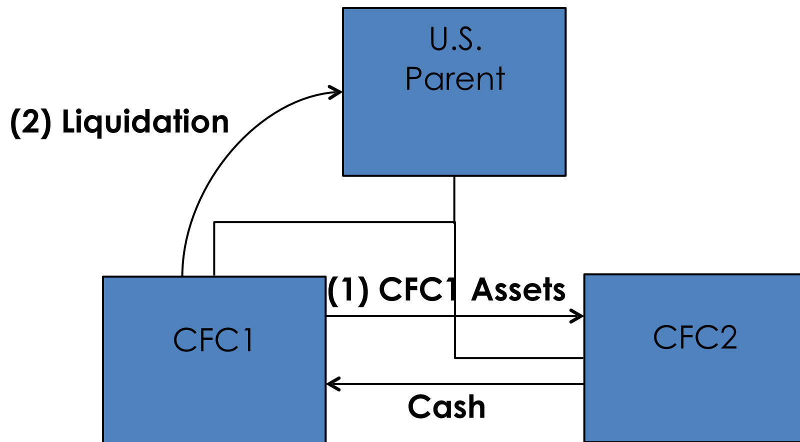
- Therefore, if a Maltese CFC earns, for example, passive income that would otherwise be characterized as foreign personal holding company income, that income should not be treated as subpart F income since the income initially will be subject to corporate income tax in Malta at a 35 percent rate.
- Based on the regulations previously discussed, this result should not be affected by a subsequent distribution of the earnings of the Maltese company that causes a reduction in the effective corporate income tax paid in Malta to a rate as low as 5 percent.
- Accordingly, if successful, this structure would allow a U.S. taxpayer to earn passive income or other types of potential subpart F income (foreign base company sales or services income) and have that income be deferred from U.S. federal income tax without incurring much in the way of foreign income taxes.

Boot Within Gain Rule and Repatriate of Profits

Boot-Within-Gain Limitation

- Under current law, gain or loss is not generally recognized with respect to exchanges of stock and securities in corporate reorganizations.
- Under Section 356, a recipient of money or other property ("boot") in a tax-free reorganization recognizes gain on the transaction, if any, in an amount not to exceed the sum of such money and the fair market value of such other property.
- Under Section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's undistributed E&P.
- The remainder of the gain, if any, is treated as gain from the exchange of property.
- Accordingly, if a shareholder receives boot in connection with a corporate reorganization, the amount that the shareholder is required to recognize as income is limited to the amount of gain realized in the exchange (i.e., the boot-within-gain limitation).
- This rule applies regardless of whether the property received would otherwise be considered a dividend for tax purposes.

Boot-Within-Gain Limitation



- In cross-border transactions, U.S. shareholders can utilize the boot-within-gain limitation to repatriate previously untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences.
- The transaction shown should be treated as a valid D reorganization under Treas. Reg. §1.368-2(l).
- Under the boot-within-gain limitation, the U.S. Parent will recognize gain under Section 356 on the lesser of (i) the cash it receives from the liquidation of CFC1, or (ii) its gain on its CFC1 stock.
- The result is the same regardless of whether the boot is potentially taxable as a dividend or as capital gain under section 356.
- This is the result even if CFC2 has previously untaxed earnings and profits equal to or greater than the boot.

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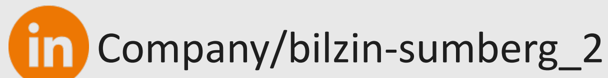

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Thank you

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