Investing in Non-U.S. Companies: An Introduction to "CFC" and "PFIC" Issues

Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

December 2006

INTRODUCTION

- U.S. tax law contains a variety of “anti-deferral” rules designed to prevent the avoidance of U.S. tax liability via techniques involving non-U.S. companies
- Unfortunately, these rules may result in adverse tax consequences for U.S. persons making legitimate venture capital/private equity investments in non-U.S. companies
- With careful planning, many – and possibly all – of such adverse consequences may be avoided

THE "CFC" AND "PFIC" RULES

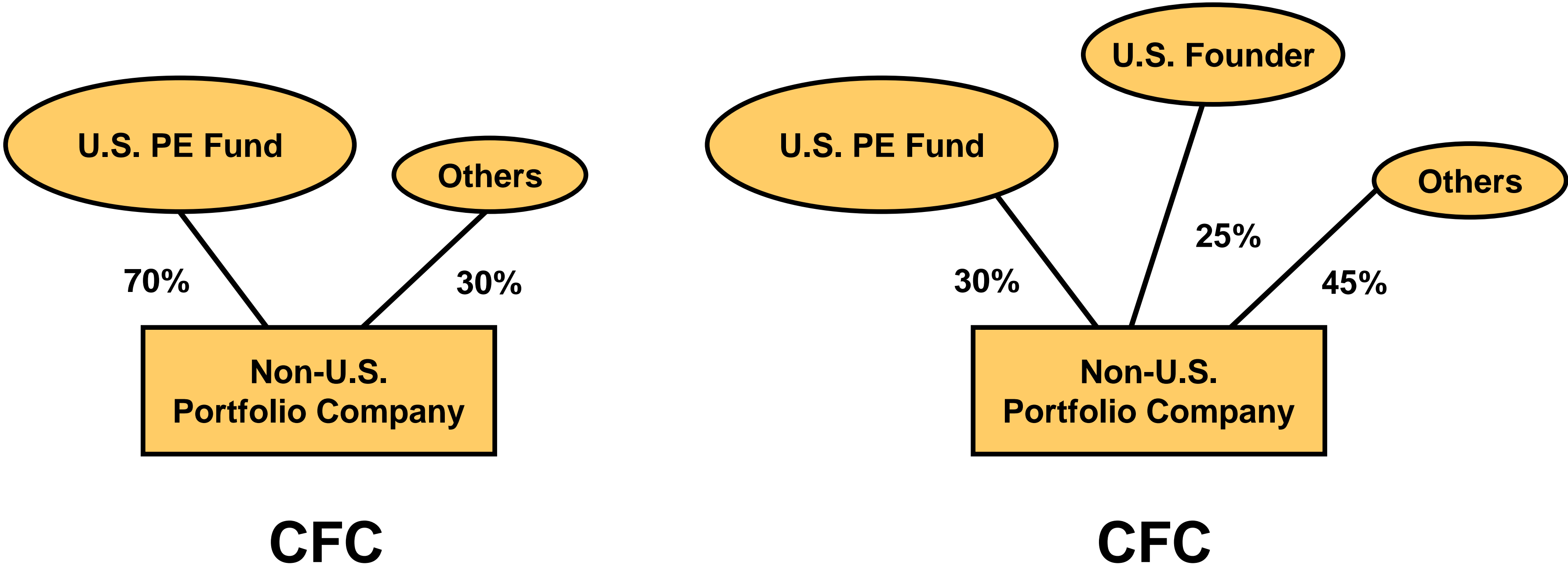
- Two key anti-deferral regimes applicable to U.S. investors holding and disposing of shares in non-U.S. portfolio companies relate to:
  - Controlled Foreign Corporations (CFCs)
  - Passive Foreign Investment Companies (PFICs)

QUALIFYING AS A CFC

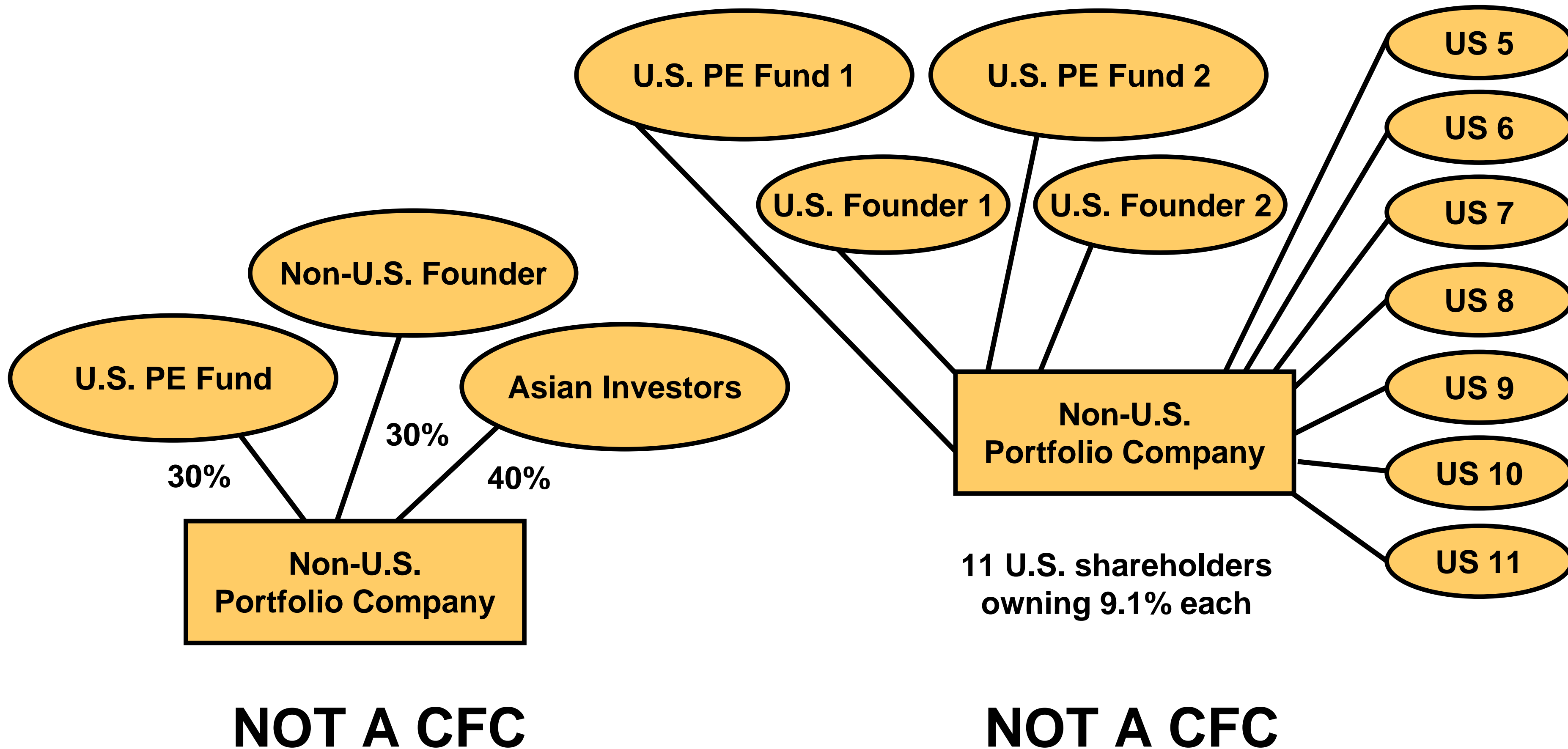
- A non-U.S. portfolio company will be a CFC if:
  - "U.S. persons" that each own 10% or more of the voting power of the company (each a "**10% U.S. Shareholder**")
  - collectively own more than 50% of the voting power or value of the company
- "U.S. person" includes:
  - A U.S. citizen or resident
  - A domestic partnership
  - A domestic corporation
  - Certain estates and trusts
- A venture capital/private equity fund ("Fund") organized under U.S. law could be a 10% U.S. Shareholder
- A Fund organized under non-U.S. law generally is treated as a "look-through" and therefore should not be a 10% U.S. Shareholder
  - However, some of its constituent partners might be 10% U.S. Shareholders based on their direct and indirect interests (as determined by attribution rules) in the portfolio company (e.g., interests held directly and/or through the Fund)

EXAMPLES OF CFCs

***U.S. 10% Shareholders* own *more than 50%* of the voting power or value of the company**



EXAMPLES OF COMPANIES NOT CFCs



NOT A CFC

NOT A CFC

CONSEQUENCES OF CFC STATUS

- If a portfolio company is a CFC, each 10% U.S. Shareholder may be:
  - Taxed on its pro rata share of the portfolio company's "subpart F" income; and
  - Required to recharacterize a portion of its gain upon the sale of portfolio company stock as dividend income rather than capital gain
- Persons that are NOT 10% U.S. Shareholders generally are exempt from these rules, even if the portfolio company is otherwise a CFC (although the PFIC rules may apply)

SUBPART F INCOME

- Several categories of income earned by a CFC constitute subpart F income
- The most common type of subpart F income is "passive income"
  - Generally includes bank interest, capital gains, royalties from related parties, and dividends
  - A portfolio company's temporary investment of "idle funds" between financing rounds typically would generate passive income
- Most portfolio companies earn at least some amount of passive income

TAXATION OF SUBPART F INCOME

- Subpart F income generally is taxable to a 10% U.S. Shareholder at ordinary income rates
  - Even if the underlying income earned by the portfolio company consists of long-term capital gains or qualified dividends, reduced rates generally are not available to 10% U.S. Shareholders who are required to report their pro rata share of such income as subpart F income

RECHARACTERIZATION OF GAIN

- A 10% U.S. Shareholder may be required to recharacterize gain from the sale of CFC stock as dividend income rather than capital gain
  - Such dividend income may be eligible for a lower (e.g. 15%) tax rate applicable to qualified dividends
    - Dividend income from a portfolio company organized in a jurisdiction with which the U.S. has a comprehensive tax treaty (e.g., India or China) generally may be eligible
    - Dividend income from a tax-haven (e.g., Cayman Islands) portfolio company generally would not
    - In any event, the lower tax rate on qualified dividends is scheduled to expire at the end of 2010

RECHARACTERIZATION OF GAIN (cont.)

- Recharacterization generally is required only to the extent of the CFC's "earnings and profits" as calculated under U.S. tax rules
- Recharacterization may apply if, at any single time during the 5-year period ending on the date of sale, both:
  - The seller was a 10% U.S. Shareholder; and
  - The company was a CFC
- Thus, recharacterization may apply even if, at the time of sale, the seller is not a 10% U.S. Shareholder and the company is not a CFC

ALLOCATION/ATTRIBUTION ISSUES FOR PARTNERSHIPS

- U.S. Fund that is a 10% U.S. Shareholder
  - Fund treated as a U.S. Person
  - All partners (to the extent otherwise subject to U.S. tax) generally would be taxable on their allocated shares of subpart F income and subject to recharacterization of capital gains as dividends
- U.S. Fund that is NOT a 10% U.S. Shareholder
  - Fund treated as a U.S. Person
  - The Fund and its partners generally would not be subject to the CFC rules; however, the PFIC rules may apply
  - Watch out for attribution of stock ownership from partners to Fund, which may trigger unexpected 10% U.S. Shareholder status (see next slide)
- Non-U.S. Fund
  - Fund generally treated as a look-through
  - Each partner generally would be taxable on its allocated share of subpart F income, and required to recharacterize capital gains as dividends, only if it is a 10% U.S. Shareholder based on its total direct and indirect interest in the underlying portfolio company

ALLOCATION/ATTRIBUTION ISSUES (cont.)

- In general, for purposes of determining whether a U.S. Fund is a 10% U.S. Shareholder:
  - Voting stock held directly by a partner should be attributed to (i.e., treated as if owned by) the Fund
  - With regard to voting stock held indirectly by a limited partner through another fund:
    - Typically, limited partners are not entitled to vote shares held by the other fund
    - In such a case, the better answer is that those shares should not be attributed to the Fund
    - However, the law is not entirely clear
    - Also, the other fund may have granted limited partners certain voting rights to prevent deemed ownership by its GP (see discussion below)
  - Careful analysis required for GPs
    - Attribution across Funds can result in multiple 10% U.S. Shareholders

TAX-EXEMPT AND NON-U.S. LIMITED PARTNERS

- From the perspective of a Fund's tax-exempt and non-U.S. limited partners, subpart F income and capital gains recharacterized as dividends generally should not, solely by virtue of the CFC rules, constitute:
  - Unrelated business taxable income ("UBTI")
  - Income effectively connected with the conduct of a U.S. trade or business ("ECI")

ADDITIONAL BUSINESS CONSIDERATIONS

- Beyond the U.S. tax burdens faced by its constituent partners, a Fund must consider additional business issues resulting from status of the Fund or its constituent partners as 10% U.S. Shareholders of a target portfolio company
  - If a target portfolio company would not be a CFC but for the Fund's investment, such investment may cause other 10% U.S. Shareholders to become subject to tax liability on subpart F income and recharacterization of capital gains
    - Such other shareholders may object to the Fund's investment

ADDITIONAL BUSINESS CONSIDERATIONS (cont.)

– In order for a 10% U.S. Shareholder to report its share of subpart F income, calculate “earnings and profits” for purposes of a capital gain recharacterization, and otherwise comply with reporting requirements applicable to the ownership of CFC stock, the shareholder must have access to portfolio company financial information prepared and maintained in accordance with U.S. tax principles
  - A non-U.S. company might not otherwise maintain such books and records
  - Who will perform the incremental work?
  - Who will pay the cost?
  - These issues should be addressed in stock purchase agreement

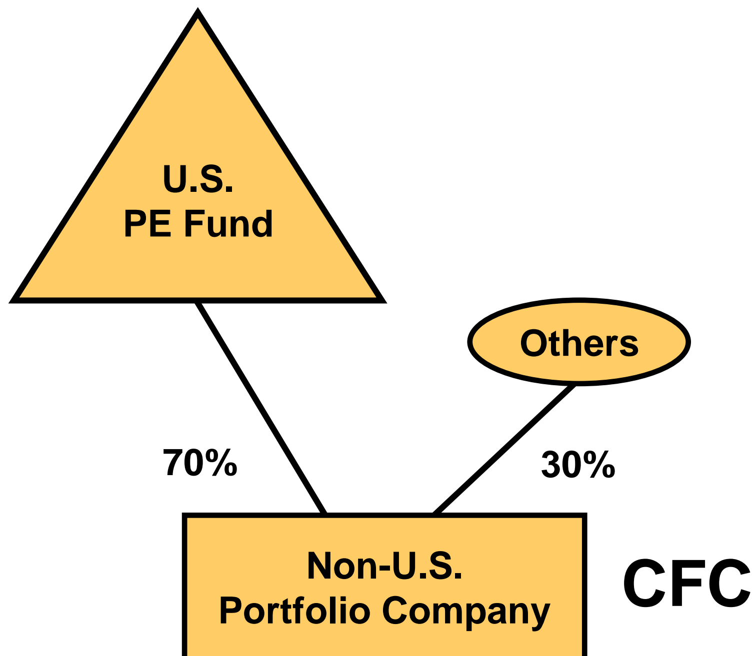
PLANNING FOR INVESTMENTS INTO CFCs

- A venture capital/private equity firm that plans to invest in non-U.S. portfolio companies should consider alternate strategies for reducing the risk that a Fund would be a 10% U.S. Shareholder. These include:
  - Strategy 1: Organize the Fund offshore
  - Strategy 2: Form an offshore "alternate investment vehicle" that operates in parallel with an affiliated U.S. Fund but only makes investments into non-U.S. portfolio companies where CFC issues could arise
  - Strategy 3: Reduce ownership of voting rights to less than 10%

STRATEGY 1 – ORGANIZE FUND OFFSHORE

- An offshore Fund (e.g., a Cayman limited partnership) generally is not a U.S. person for purposes of the CFC test
- When determining whether any shareholders of a non-U.S. portfolio company are 10% U.S. Shareholders, the law "looks through" the offshore Fund to its general and limited partners
- While a U.S. Fund is considered a U.S. person for purposes of the CFC rules, an offshore Fund allows dilution of the Fund's ownership so that the test for 10% U.S. Shareholders is done at the partner – rather than at the Fund – level
- In most cases, few – if any – partners will own a significant enough portion of the Fund to make such partners 10% U.S. Shareholders of the non-U.S. portfolio company

WHILE A U.S. FUND IS A U.S. PERSON . . .



- ***Ownership is measured at the Fund level***
- ***Non-U.S. portfolio company is a CFC***

. . . AN OFFSHORE FUND IS NOT.

4.2% 4.2% 4.2% ?% 4.9% 4.9% 4.2%

3.5% LP LP LP GP LP LP LP 3.5%

3.5% LP LP 3.5%

3.5% LP LP 3.5%

7% LP LP 3.5%

7% LP LP 3.5%

Cayman
PE Fund

Non-US Others

Look Through

(70%)

30%

Non-U.S.
Portfolio Company

NOT A CFC

- ***"Look Through" to partners***
- ***Non-U.S. portfolio company is a not a CFC***

DETERMINING GP'S OWNERSHIP

- It is unclear how the GP's carry relates to ownership of voting power or value for purposes of the CFC rules
  - For example, assume a GP with a 1% capital interest and a 20% carried interest
  - Does the GP own 1%, 20%, 20.8%, or something else?
  - Does it matter if the Fund is above, or below, water at the time of measurement?
- A conservative approach would be to run the calculation multiple ways and identify the worst-case for both GP and LPs

DETERMINING GP'S OWNERSHIP (cont.)

- If the GP has the unilateral right to vote the Fund's shares of a portfolio company, it is possible that 100% of the voting power of such shares may be attributed to the GP for purposes of the CFC rules
- To minimize this risk, with respect to voting shares of non-U.S. portfolio companies:
  - The Fund's limited partnership agreement could apportion some voting rights to limited partners
  - One or more non-U.S. members of the GP could be granted the exclusive right to vote the shares
  - Other?

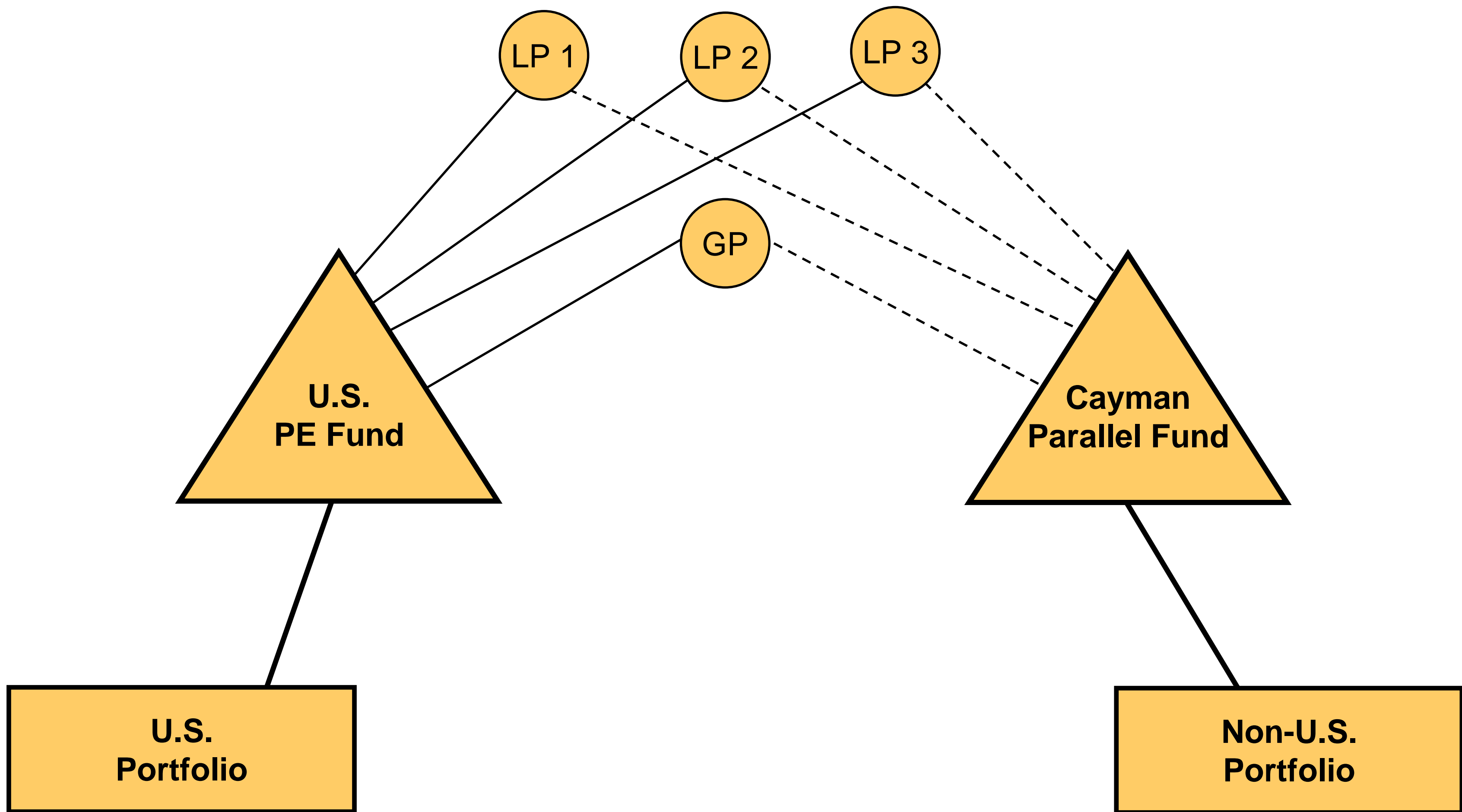
DETERMINING GP'S OWNERSHIP (cont.)

- Once you've determined the GP's ownership interest, consider whether the GP is:
  - A U.S. entity (and, therefore, a U.S. person)
  - A non-U.S. entity (and, therefore, a look-through)
- Example: Assume that non-U.S. Fund owns 80% of non-U.S. portfolio company, that the GP is deemed to own 20.8% of the Fund, and that the GP has 5 equal U.S. members
  - If the GP is a U.S. entity, it will be a 10% U.S. Shareholder (with a 16.6% interest in the portfolio company)
  - If the GP is a non-U.S. entity, each member will be deemed to hold a 3.3% interest in the portfolio company, and neither the GP nor any of its members will be a 10% U.S. Shareholder

STRATEGY 2 – ALTERNATE INVESTMENT VEHICLE

- An alternate investment vehicle operates in parallel with a U.S. Fund, for the purpose of making investments in non-U.S. portfolio companies where CFC status is possible
- Use of an alternate investment vehicle must be authorized in the main Fund's limited partnership agreement/subscription agreement
- Alternate investment vehicle provisions in the main Fund's documents can be a useful "safety net" for a U.S. Fund that doesn't expect to have CFC issues at the time of formation, but wants to retain flexibility
- The "look through" rules applicable to non-U.S. partnerships generally should apply with respect to an alternate investment vehicle

ALTERNATE INVESTMENT VEHICLE



STRATEGY 3 – REDUCE OWNERSHIP OF VOTING RIGHTS

- 10% U.S. Shareholder status is based on voting rights
- Depending on facts, holding a portion of the Fund's investment through non-voting stock or, possibly, arranging for a third party to hold some/all voting rights may eliminate 10% U.S. Shareholder status
  - Watch out for attribution rules and concerns about "sham" transfer of voting rights or implicit "nominee" arrangements
- Example:
  - Fund holds 12% of portfolio company stock, which ordinarily would entitle it to 12% of voting rights
  - One quarter of Fund's stock (i.e., 3% of total company stock) is changed to non-voting stock, which essentially shifts voting power to other, unrelated shareholders
  - Absent attribution, sham, nominee, etc., Fund may thereafter not be deemed a 10% U.S. Shareholder

QUALIFYING AS A PFIC

- The PFIC rules are entirely separate from the CFC rules
- A non-U.S. portfolio company will be a PFIC if:
  - At least 75% of the company's income consists of passive income; or
  - At least 50% of the company's assets are held for the production of passive income
- For this purpose, cash is considered to be an asset held for the production of passive income
- Many early stage, non-U.S. portfolio companies qualify as PFICs
- For intermediate and late-stage companies, investing capital in multiple increments may avoid PFIC status

QUALIFYING AS A PFIC (cont.)

- Test for PFIC status, as to a Fund investor, is made as of time of investment
  - In general, shares of a PFIC do not lose their PFIC status over time, even if the portfolio company otherwise ceases to qualify
  - A company generally will not be deemed a PFIC in respect of a "start-up year" (i.e., the first year in which it has gross income) if it does not qualify as a PFIC in each of the next two years
  - A new investment in a company that formerly qualified as a PFIC will not yield PFIC shares if the company never qualifies as a PFIC while the shares are held by the investor

CONSEQUENCES OF PFIC STATUS

- A U.S. investor that owns stock of a PFIC:
  - Generally will be taxed at ordinary income rates on “excess distributions” received from the PFIC
    - Not eligible for lower dividend rates, even if regular dividends paid by the company would qualify
- An actual distribution will be treated as an “excess distribution” only to the extent the total of actual distributions during a taxable year received by the investor exceeds 125% of the average of actual distributions received in the three preceding taxable years
- Gain recognized upon the sale of PFIC stock generally is treated as an “excess distribution”
- Interest charge is imposed on any excess distribution (including gain on sale of PFIC stock) as if the excess distribution had been taxable on a ratable basis over the entire holding period of the PFIC stock

CONSEQUENCES OF PFIC STATUS (cont.)

- The PFIC rules:
  - Apply without regard to a U.S. investor's percentage ownership in the PFIC (i.e., no 10% U.S. Shareholder requirement)
  - Do not apply to a U.S. investor that is actually a 10% U.S. Shareholder of a CFC
  - Generally should not result in UBTI or ECI

PLANNING FOR INVESTMENTS INTO PFICs

- A U.S. investor generally may reduce the adverse tax consequences of investing in a PFIC by making a timely "qualified electing fund" (QEF) election
  - Investor must include in income its share of the PFIC's "net" ordinary earnings and net capital gains on an annual basis
  - Income included by the investor retains its original character (e.g., capital gain or ordinary income)
  - No recharacterization of gain on sale of PFIC stock
  - No interest charge
- Election generally must be made in the year of the original investment
  - In general, a U.S. Fund can make a QEF election, which will be effective for all of its constituent partners. A Non-U.S. Fund generally cannot make a QEF election, but each constituent partner can make its own individual election.
- QEF election should not give rise to UBTI or ECI

BURDENS ON A PORTFOLIO COMPANY PFIC

- In order for a QEF election to be effective, the PFIC must:
  - Provide the U.S. investor with a PFIC annual information statement containing information prepared in accordance with U.S. tax principles
    - A non-U.S. company might not otherwise maintain the necessary books and records
    - Who will perform the incremental work?
    - Who will pay the cost?
  - Allow the non-U.S. investor to inspect and copy its books and records
    - This may give rise to confidentiality concerns
- These issues should be addressed in stock purchase agreement

CONCLUSIONS

- Without proper planning, CFC and PFIC issues can be costly and disruptive
- Proper planning can mitigate, or even eliminate, most issues
- Even in the best-planned structure, incremental costs may result from the need for:
  - Customized or offshore entities
  - Specialized books, records and reports
  - Education of other investors and non-U.S. company managers

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

Wilson Sonsini Goodrich & Rosati
Fund Services Group
650 Page Mill Road
Palo Alto, California 94304
Tel: 650-493-9300
www.wsgr.com