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U.S. Tax Consequences of Permitted Activities in Cuba

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US Regulatory Overview

Basic Principles

- Two regulatory regimes to consider:
  - "Who" is involved:
    - *Cuban Assets Control Regulations*, 31 CFR Part 515 ("**CACR**"), administered by US Treasury Department's Office of Foreign Assets Control ("**OFAC**")
  - "What" is involved*:*
    - *Export Administration Regulations*, 15 CFR Part 730 *et seq.* ("**EAR**"), administered by US Commerce Department's Bureau of Industry and Security ("**BIS**")
- U.S.-based multinationals need to consider both regulations
- Non-U.S. based companies primarily need to consider the EAR
- Parties engaging in activities or transactions under CACR and/or EAR have five (5)-year record-keeping requirement

Jurisdiction

- CACR apply to "CACR Parties:"
  - Entities organized under U.S. laws, including their non-U.S. branches
  - Parties physically located in the United States
  - U.S. citizens and "Green Card" holders wherever located
  - *Non-US entities owned or controlled by above parties*
- EAR apply to the following types of "items" (goods, software, technology):
  - U.S.-origin items
  - Items exported from the United States
  - Non-U.S. items with more than 25% U.S. content by value (*previously 10% threshold*)
  - Certain foreign direct product of U.S. technology controlled for national security reasons

General CACR and EAR Prohibitions

- CACR
  - Prohibition on engaging in virtually any dealing with Cuba, Government of Cuba, Cuban entities, Cuban individuals, Cuban SDNs, or goods/services of Cuban origin or with Cuban content
  - "Blocking"/freezing of assets required for the above – any "property" in which Cuba has an interest
  - Prohibition on CACR Parties "facilitating" Cuba-related transactions by non-US parties that are prohibited as to CACR Parties
  - **Terminology:** specific license v. general license
- EAR
  - Comprehensive export/reexport ban for all items subject to the EAR
  - Applies to non-controlled items subject to the EAR
  - **Terminology:** specific license v. license exception
- Also a U.S. arms embargo under International Traffic in Arms Regulations, 22 CFR Part 120 *et seq.* (aka "**ITAR**")

What Has Changed?

- Non-tourist travel (12 categories) for authorised U.S. travellers, including conferences/professional research/professional meetings and authorizations for normal flights and ferry services
- EAR License Exception Support for Cuban People
  - Exports/re-exports to Cuban private sector/telecommunications sector
  - Tools of trade for repairs / kits of replacement parts / exhibitions/demonstrations in Cuba
- Imports of Cuban private entrepreneur goods/services into United States
- Exports/reexports to Cuba of consumer communications services/items
- Telecommunications, Internet-based services, software development
- Establishment of business or physical presence in Cuba *for some sectors*
- Banking sector – new authorizations for U.S. banks:
  - Establish correspondent accounts at Cuban banks (but not vice versa)
  - Finance most authorized exports/reexports to Cuba (not for agricultural commodities)
  - Maintain accounts for individuals in Cuba in connection with authorized or exempt transactions under U.S. embargo
  - U-turn transactions in U.S. dollars permitted for non-U.S. parties
- Dealings with Cuban individuals in third countries generally permitted
- U.S. Government open to “creative” specific licensing proposals for Cuba

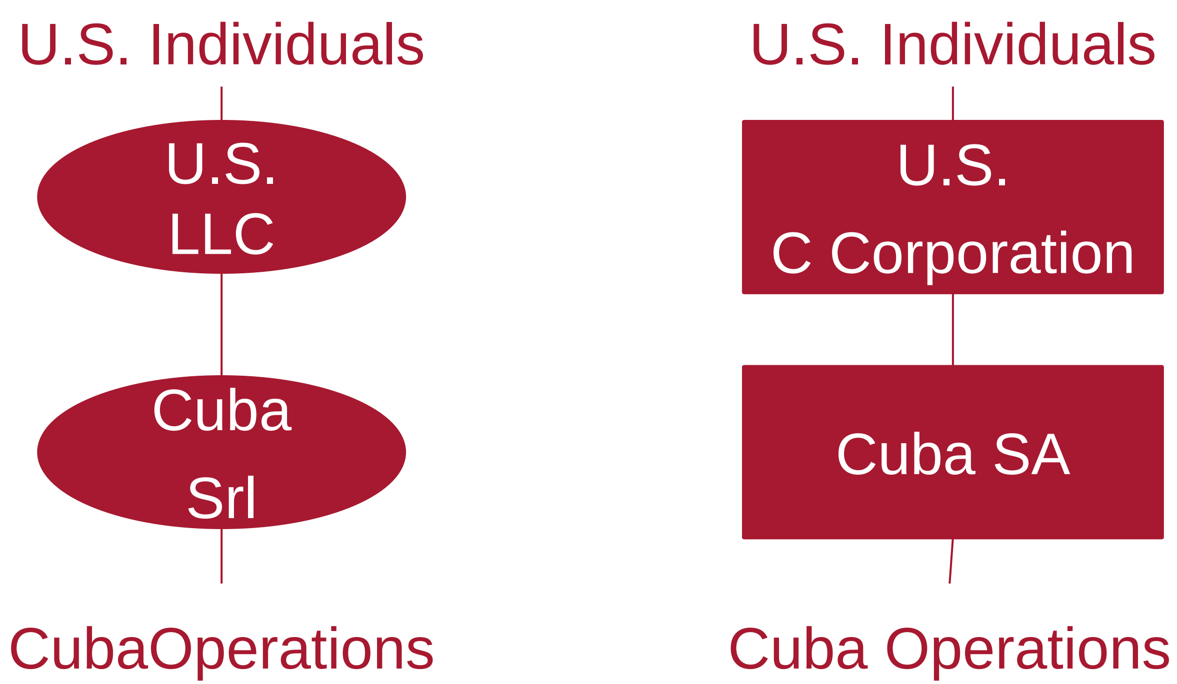
What Has Not Changed?

- **The embargo remains in place** → Helms-Burton still in effect
- Banks continue to be conservative regarding Cuba
- Favorable licensing policy for medical devices/medicine and EAR License Exception Agricultural Commodities still in effect
- No U.S. investments/franchise/licensing agreements for most sectors – e.g., joint ventures, local companies, banking, infrastructure, utilities, hotels, farms, restaurants, manufacturers
- Import ban on various Cuban goods into United States (limited exceptions) or of Cuban goods/services to other countries
- Foreign owned/controlled subsidiaries subject to greater restrictions than U.S. parent companies
- No tourist travel
- Limited Cuban capacity/demand to absorb U.S. business interest

US Tax Issues

Background Concepts

Types of investment vehicles: Flow-through and Corporate



U.S. Foreign Tax Credit (“FTC”) Regime

- The United States taxes U.S. corporations and U.S. individuals on their worldwide income.
- As a result, when a U.S. corporation or U.S. individual earns income in a foreign jurisdiction and is taxed in that jurisdiction, the U.S. corporation or U.S. individual could theoretically be taxed twice on the same income.
- To alleviate this double taxation, U.S. taxpayers generally are entitled to a credit against their U.S. income tax liability for any foreign income tax paid or accrued (or deemed paid or accrued).

US FTC Regime Example

- D is a U.S. corporation and earns $100 through a branch in country X.
- Country X taxes corporations on profits in country X at 25%, whereas the U.S. taxes U.S. corporations at 35% on worldwide income.
- Without the FTC, D’s total tax liability would be 60 (25 plus 35).
- With the FTC, D’s tax liability is 35 (25 owed to X plus 35 owed to U.S. less 25 credited)

US FTC Limitations

– Under § 901(j), no FTC for companies from:
  - Countries which the U.S. does not recognize
  - Countries with which the U.S. does not have diplomatic relations **(FORMERLY CUBA)**
  - Countries with which the U.S. has severed diplomatic relations because of acts, such as terrorism or communism

US FTC Limitation (cont.)

- Until recently, the list under § 901(j) of countries which are state sponsors of terrorism or which the U.S. otherwise does not have diplomatic relations was maintained in Notice 2005-3.
- These included Iran, North Korea, Sudan, Syria, and **Cuba**.

US FTC Limitation (cont.)

- Notice 2016-8 formally amends Notice 2005-3 by removing Cuba from the list of countries under §901(j).
- Therefore, foreign income taxes paid to Cuba by U.S. taxpayers are eligible to be credited against U.S. income tax liability.

FTC must be "Creditable"

- Code § 901 allows a FTC for taxes paid on "income." Code § 903 allows for a foreign tax credit for any taxes paid "in lieu of a tax on income."
  - Must be imposed on ***income*** or ***in lieu of*** *a tax on income.*
    - Examples: taxes in Brazil, Ecuador.
  - Must be ***compulsory***. See Treas. Reg. § 1.901-2(a)(2), (d)(1).
- Imposed on **"Income"**
  - *Predominant character* of the foreign tax must be that of an "income" tax in the US sense. See Treas. Reg. § 1.901-2(b).
    - Tax must be likely to reach net gain:
      - Realization: tax must be imposed in connection with events resulting in realization of income.
      - Gross receipts: tax must be imposed on the basis of gross receipts.
      - Net income: tax must be computed by reducing gross receipts by significant expenses and costs attributable to these gross receipts.
- **"Compulsory"** Tax
  - Legal liability for the tax under local law. [see Treas. Reg. § 1.901-2(f)(1)]
  - Exhaustion of all effective and practical remedies. [see Treas. Reg. § 1.901-2(e)(5)]
  - Not a tax to extent payor receives "specific economic benefit" / Dual capacity taxpayers. [see Treas. Reg. § 1.901-2(a)(2)]
  - No soak up taxes. [see Treas. Reg. § 1.901-2(c)(1)]
  - No subsidies. [see Treas. Reg. § 1.901-2(e)(3)]
  - Penalties, fines, interest, etc. not taxes. [see Treas. Reg. § 1.901-2(a)(2)]

Subpart F Regime

- Typically, a shareholder of a foreign corporation is not taxed until the corporation makes a distribution of cash or other property, e.g. a dividend.
- However, a certain type of income earned by controlled foreign corporations ("CFCs"), which is known as "Subpart F" income, is taxable to a CFC's U.S. shareholders in the year earned, regardless of whether any distributions are made to the shareholders.

Subpart F Regime (cont.)

- A CFC is a foreign corporation more than 50% owned by vote or value by U.S. shareholders.
- A U.S. shareholder is a U.S. person who owns 10% or more of the combined voting power of all classes of stock of a foreign corporation.
- Subpart F Income includes:
  - foreign base company income
  - insurance income
  - international boycott income
  - amounts paid for bribes
  - income derived from a foreign country described in § 901(j)

Subpart F Regime (cont.)

- Foreign Base Company Income is composed of
  - foreign personal holding company income
  - foreign base company sales income
  - foreign base company services income
  - foreign base company oil related income

Subpart F Regime (cont.)

- **<u>Any</u>** income earned by a CFC in a jurisdiction on the “bad list” in § 901(j) automatically was treated as Subpart F income.
- Notice 2016-8 removes Cuba from this list.

Foreign Earned Income Exclusion

- Individual U.S. taxpayers are typically eligible to exclude an inflation adjusted amount ($101,300 in 2016) of income earned for services performed in foreign countries and housing costs.
- Must be a bona fide resident of the foreign country for entire taxable year or present at least 330 days.

Foreign Earned Income Exclusion (cont.)

- Code § 911(d)(8) generally denies the exlcusion for income earned and housing costs in countries where the U.S. restricts travel.
  - Currently, such countries are listed in Notice 2005-3, with Cuba the only remaining country.
- Further, an individual will not be treated as a bona fide resident of Cuba, nor will such individual be treated as present in Cuba on any day actually present in Cuba.
- Limited exceptions exist, e.g. individuals visiting close family, engaging in journalism, or performing research.

Foreign Earned Income Exclusion (cont.)

– Moreover, there is a specific carve out from the general prohibition for individuals performing services on the naval base in Guantanamo Bay.

– Notice 2016-8 does not modify those parts of Notice 2005-3 relating to limitation on the exclusion of foreign earned income under §911(d)(8).

Cuban Tax Consequences

– Foreign Tax Credits for US Investors in Cuba now available

– Income earned in Cuba no longer automatically included under Subpart F

– Foreign earned income exclusion under §911 currently not available

Eight Questions RE: Cuban Tax System

1) What taxes are there for a foreign business operating in Cuba?
2) What are the effective income tax rates for corporations and individuals?
3) When does Cuba consider a foreign company to be taxable in Cuba (i.e. permanent establishment principles)?
4) Is it important to negotiate terms of taxation with the Cuban government for a foreign entity before beginning business?

Tax Consequences of Permitted Activities in Cuba

5) Does Cuba have free trade zones and what are the general benefits to operating in them?
6) Does Cuba have witholding taxes on dividend, interest, royalty and management fee payments?
7) What is the rate for the Cuban VAT/Sales tax?
8) For income tax purposes, what are the principal limits to deductions of interest, royalties and management fees?

Cuba Income Tax Treaties as of June 1, 2011

Partner	Type of agreement	Date of signature
Argentina	Sea Transport	15-Dec-78
Austria	Income and Capital	25-Jun-05
Barbados	Income and Capital	17-Jun-99
China	Income	13-Apr-01
Italy	Income and Capital	17-Jan-00
Lebanon	Income and Capital	4-Feb-01
Netherlands	Air and Sea Transport	3-Feb-93
Portugal	Income	1-Oct-00
Spain	Income and Capital	3-Feb-99
Ukraine	Income and Capital	25-Jun-05
Venezuela	Income and Capital	25-Jun-05
VietNam	Income	26-Oct-02