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SPECIAL REPORT

An Overview of the Taxation of U.S. Investment Into Cuba

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In this article, the authors discuss the Cuban tax system and summarize recent changes to U.S. tax law regarding Cuba as well as permitted activities under the U.S. embargo.

It was not long ago that the idea of large-scale U.S. investment in Cuba was unthinkable. Much has changed in a short period. Restrictions have been eased from both a U.S. and Cuban perspective. In Cuba, the government has allowed its citizens and foreign investors to operate privately in the country. In fact, in 2014 the Cuban government released legislation that included a 168-page portfolio outlining various opportunities for foreign investment in the country.

Meanwhile, President Obama has visited Cuba and the U.S. government has eased restrictions on travel to, trading with, and conducting business in Cuba. Commercial transportation between Cuba and the United States by air and sea has begun. Further, several U.S. companies have announced plans to expand into Cuba.

Although Cuba is not an extremely investor-friendly jurisdiction, it certainly provides intriguing investment opportunities. The new investment rules and related portfolio make clear that the economy will remain state driven and that most investments will be structured as joint ventures with the state. That said, Cuba has highly educated citizens, relatively low levels of corruption, no significant problems with drugs and violence, and an excellent healthcare system. Opportunities for investment, including tourism, agriculture, construction, transportation, renewable energy, and mining, abound.

In the United States, the embargo of Cuba is still law. Many aspects of the embargo have been codified by Congress, limiting the Obama administration's ability to completely remove the restrictions. The administration has called for repeal and has lifted many restrictions. Except for some industries (for example, telecommunications and internet-based service providers, exporters of authorized products, and travel service providers), the U.S. embargo continues to prohibit most Cuba-related transactions, including investing, establishing local subsidiaries or other operations, exporting, and hiring employees in Cuba. Even business operations authorized under the embargo face practical challenges in trying to expand into Cuba.

I. The Cuban Tax System

To conduct business in Cuba, approval by the Cuban government must occur before any activities begin. Operating a business in Cuba requires authorization by the Council of State, the Council of Ministers, or another authority appointed by the Council of Ministers. Some types of businesses can operate independently of the government; however, the more common arrangement is a joint venture between the Cuban government and the foreign investor.

Moreover, unlike in most jurisdictions, the labor force needed by joint ventures and fully owned companies in Cuba is selected and provided by a government employment agency. Unless allowed by the Cuban government, no foreign investor can hire labor directly except for some top management or technical positions to be held by nonpermanent residents. The Cuban government has been negotiating with foreign non-U.S. investors since the mid-1990s and is a sophisticated negotiator. The law on foreign investment provides that all benefits agreed to in the authorization will remain in place during the entire agreement. Thus, the initial meetings with the government are of critical importance and should not be taken lightly.

The Cuban tax system provides attractively low tax rates for foreign investment. The tax imposed on foreign investors is governed by Cuba's foreign investment law, updated and published April 16, 2014. The law was purportedly designed to attract foreign capital into the country and calls for an eight-year exemption on tax for joint ventures. Thereafter, the tax rate would increase to 15 percent on profits; in some instances, a higher rate would apply.

On the other hand, wholly owned enterprises would be subject to tax at a rate of at least 15 percent from inception. Further, operations incorporated in the so-called Mariel economic zone would receive a 10-year tax exemption and would be subject to a 12 percent tax on profits thereafter. Cuba does not impose a withholding tax on dividends. Additional taxes that may be applicable include sales tax, services tax, local development taxes, and customs duty.

According to the investment law, foreign investments are protected from expropriation without due process of law. Moreover, should there be a government taking, the law provides for the payment of commercial value agreed to by the parties or as determined by a third-party valuation expert chosen by the parties. That said, Cuba is party to 39 bilateral investment treaties (BITs), which generally should provide added protection to investors from treaty partners.

Cuba has signed double tax treaties with 12 countries, including Barbados, Italy, and Venezuela. Those treaties generally follow the form of the OECD model tax convention. Cuba has not entered a tax treaty with the United States, so dividends received by a U.S. individual from a Cuban corporation would not qualify for the reduced 20 percent qualified dividends rates provided by IRC section 1(h)(11).

II. U.S. Taxation of Cuban Investment

Historically, the U.S. government had treated Cuba as a blacklisted country for several important IRC provisions addressing foreign tax credits, subpart F income, and the foreign earned income exclusion. In light of the country's restored diplomatic relationship with Cuba, on March 1 the U.S. Treasury and IRS issued Rev. Rul. 2016-8, 2016-11 IRB 426, modifying several key tax provisions intended to discourage U.S. taxpayers from engaging in Cuban-connected activities. With those recent modifications, planning for investment into Cuba has become similar to planning for any other outbound investment.

U.S. persons[1] are subject to U.S. federal income taxation on their entire worldwide income, regardless of source. When looking to invest outside the United States, the investment is generally conducted in either corporate form or in the form of a flowthrough entity. Flowthrough entities are either partnerships with more than one member or a disregarded entity with only one member in the company. Under the U.S. check-the-box rules, an entity formed in Cuba can generally elect to be treated as a corporation or a flowthrough entity.[2] Thus, U.S. taxpayers have broad leeway to choose the form in which they want to operate.

As a general matter, a foreign corporation is subject to two layers of tax. A U.S. person who is a shareholder of a foreign corporation is subject to tax on dividends received from its interest in the foreign corporation.[3] Further, a foreign corporation is taxable in the jurisdictions in which it operates. The subpart F regime and passive foreign investment company rules provide an additional layer of complexity that, depending on the corporation's activities, could apply to certain foreign corporations.

The subpart F regime imposes immediate U.S. taxation to the U.S. shareholders on their shares of the controlled foreign corporation's subpart F income.[4] For a foreign corpration that is a PFIC, a punitive interest surcharge on excess distributions from the foreign corporation would apply.[5] Thus, a foreign corporation can be subject to low or no income tax if it operates in a low-tax jurisdiction (such as Cuba), is not a PFIC, does not operate a U.S. trade or business or otherwise generate U.S.-source income, and does not generate subpart F income. Therefore, the corporate structure can provide significant tax benefits when operating in low-tax jurisdictions. On the other hand, the flowthrough structure provides a single layer of tax, and all income earned by a foreign partnership is deemed to flow through to the U.S. partners and is immediately subject to U.S. tax.

A dollar-for-dollar FTC is generally available to offset U.S. income tax on foreign income taxes paid on

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[1] For U.S. federal income tax purposes, the term ''U.S. person'' includes U.S. corporations and individuals who are either U.S. citizens, U.S. green card holders, or who are considered substantially present in the United States. *See* IRC section 7701(a)(30) and (b)(1)(A). Nonresident aliens and foreign corporations (foreign persons) are not considered U.S. persons. *See* section 7701(a)(5) and (b)(1)(B).

[2] U.S. Treas. reg. section 301.7701-2(b).

[3] *See* section 61(a)(7).

[4] *See* sections 951, 957, and 958.

[5] *See* section 1291.

foreign-source income. For FTC purposes, a domestic corporate shareholder that owns at least 10 percent of a foreign corporation's voting stock is deemed to have directly paid a proportionate amount of the corporation's foreign income taxes in any year in which dividends were paid.[6] Thus, the ability to use an FTC to offset Cuban income taxes is an important aspect of investing in Cuba.

A. FTC Rule Modification as Applied to Cuba

As a means of mitigating double taxation, under some circumstances and subject to some limitations, a U.S. taxpayer may credit the amount of foreign income taxes paid on income derived from operations or investments in a foreign country against its U.S. income tax liability. Sections 901, 902, and 960 generally allow U.S. taxpayers to claim against their U.S. income tax liability an FTC for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued) to any foreign country or to any U.S. possession.

The FTC is, however, subject to numerous limitations. One of those is section 901(j), which denies credits for foreign income taxes paid or accrued (or deemed paid or accrued) to countries the United States does not recognize, does not conduct diplomatic relations with (for example, North Korea), or has severed diplomatic relations with because of acts such as terrorism or communism.

Historically, the IRS has included Cuba on the list of countries in which taxes paid were not creditable under section 901(j).[7] Therefore, if a U.S. taxpayer generated income from Cuban business activities — which would be subject to U.S. federal income tax — and paid Cuban taxes on the income generated, he could not credit the Cuban taxes paid against his U.S. income tax liability.

Rev. Rul. 2016-8 states that taxpayers are eligible to claim U.S. FTCs for creditable Cuban taxes paid. It has retroactive effect on transactions that occurred after December 21, 2015, and modifies a 2005 ruling by removing Cuba from the list of covered countries under section 901(j). Therefore, U.S. taxpayers generating income from Cuban business activities are now able to credit against their U.S. income tax liability any Cuban taxes paid.

B. Subpart F Modification as Applied to Cuba

Under subpart F, some types of income earned by a CFC[8] are taxable to the CFC's U.S. shareholders in the year earned, even if the CFC does not distribute the income to its shareholders that year. Subpart F treats a U.S. shareholder as if it had actually received the income from the CFC. The income of a CFC that is currently taxable to its U.S. shareholders under the subpart F rules is referred to as subpart F income.

Section 952(a)(5) provides that the term ''subpart F income'' includes, for any CFC, the sum of the CFC's income derived from any foreign country during any period during which section 901(j) applies to that country. Because the section 901(j) restriction previously applied to Cuba, it also caused section 952(a)(5) to apply to treat any Cuban income earned by a CFC to be subpart F Income. As a result, U.S. shareholders of a CFC that earned Cuban-source income would be currently taxable as if they had actually received the income from the CFC.

As a result of Rev. Rul. 2016-8 and the removal of the section 901(j) restriction on Cuba, section 952(a)(5) also no longer applies to treat Cuban income earned by a CFC as subpart F income. Therefore, Cuban income earned by a CFC will no longer automatically be characterized as subpart F income, meaning it would have to qualify under another provision of the subpart F rules to be treated that way.

C. Foreign Earned Income Exclusion

Because U.S. individuals are subject to U.S. federal income taxation on their worldwide income, if they receive income from performing services outside the United States, that income generally will be subject to U.S. tax. However, the foreign earned income exclusion provides an exception by entitling an eligible U.S. individual taxpayer to exclude an amount of up to $101,300 (for 2016, adjusted annually for inflation) in eligible foreign earned income from her taxable income for U.S. federal income tax purposes. Eligible income includes wages, salaries, professional fees, compensation, plus some housing costs. Individuals are eligible provided they are either a bona fide resident of the foreign country for the entire tax year, or present in the foreign country or any other foreign country for 330 days over any 12 months.[9]

The foreign earned income exclusion does not apply to amounts earned in restricted countries, which are generally countries to which travel by U.S. citizens and

[6] *See* section 902.

[7] *See* Rev. Rul. 2005-3, 2005-1 C.B. 334 (still in effect).

[8] A foreign corporation is a CFC if more than 50 percent of its stock (by vote or value) is owned by U.S. persons (as defined in section 7701(a)(30)), each owning or deemed to own at least 10 percent of the stock (by vote or value). *See* IRC sections 951, 957, and 958. If the CFC rules apply, the U.S. person is treated as receiving annually a deemed distribution of his pro rata share of the foreign corporation's net subpart F income, whether or not those earnings are actually distributed to him. He must pay tax at ordinary income tax rates (up to 39.6 percent) on that deemed distribution. Thus, if a U.S. person owns an interest in a CFC, and the CFC earns specific types of passive income, he would be subject to tax on his pro rata share of that income earned during the calendar year.

(Footnote continued in next column.)

[9] Section 911(b)(2)(D) and (d); Notice 2016-21, 2016-12 IRB 465.

residents is prohibited.[10] If travel to a foreign country (or a transaction in connection with that travel) is proscribed by regulations during any period:

- foreign earned income does not include income from sources in that country attributable to services performed during that period;
- housing expenses do not include any expenses during that period in that country, or for housing of the taxpayer's spouse or dependents in another country while the taxpayer is in that country; and
- an individual is not treated as a bona fide resident of, or as present in, a foreign country for any day during which she was present there.[11]

Cuba is listed as the sole remaining restricted country covered by that limitation.[12] Unlike Libya and Iraq, which were identified as restricted countries by Rev. Rul. 92-63, 1992-2 C.B. 195, and later removed from the restricted listing by Rev. Rul. 2005-3, 2005-3 IRB 1, the IRS has not formally issued a ruling that removes Cuba from the restricted country list.

However, an exception to the restriction may apply if the taxpayer's activities are not in violation of the Trading With the Enemy Act or the International Emergency Economic Powers Act. For example, a U.S. individual may be lawfully present in Cuba to visit close family members, to engage in journalistic activity, or to perform research.[13] In Notice 2006-84, 2006-41 IRB 1, the IRS said U.S. individuals who earned income from performing services at the U.S. Naval Base at Guantanamo could claim the foreign earned income exclusion because they were exempt from the limitation under IRC section 911(d)(8)(A).[14]

Similarly, any U.S. taxpayer individual who legally resides and works in Cuba would not be in violation of the Trading With the Enemy Act or the International Emergency Economic Powers Act and, thus, should receive the benefits of the foreign earned income exclusion. However, the IRS has not provided any clarification on that point, and it remains unclear when it will issue guidance to remove the section 911(d)(8) limitation on the foreign earned income exclusion for U.S. individuals living and earning income in Cuba.

III. Prohibited and Permitted Activities

The U.S. embargo against Cuba is implemented primarily under the Cuban Assets Control Regulations (CACR), administered by the U.S. Treasury Department Office of Foreign Assets Control (OFAC), and the Export Administration Regulations (EAR), administered by the U.S. Commerce Department Bureau of Industry and Security. It prohibits a range of activities. However, under the change in U.S. policy announced in December 2014, many aspects of the embargo have been relaxed, with several activities now allowed under a general or specific license.

A. U.S. Sanctions Under the CACR

The CACR apply principally to the activities of U.S. persons and non-U.S. entities owned or controlled by U.S. persons (collectively, CACR parties). Under the embargo, CACR parties are prohibited from engaging in virtually any transaction involving Cuba, the government of Cuba, or a Cuban national (whether an entity or individual), unless an exemption or authorization applies.

Prohibited transactions include exports, imports, investments, and dealing in Cuban-origin goods. If property in which Cuba, the government of Cuba, or a Cuban national has an interest comes into the United States or the possession or control of a CACR party, it generally must be blocked and reported to OFAC. CACR parties are also prohibited from facilitating any transaction by a non-U.S. person that would be prohibited if conducted by a CACR party.

Authorization under the CACR comes in two forms:

- a general license, which is an authorization published in the regulations that any parties may take advantage of if they meet its conditions; or
- a specific license, which is an authorization issued by OFAC in response to an application to cover a particular set of transactions.

Much of the U.S. sanction relief implemented by OFAC since December 2014 has taken the form of general licenses published in the CACR. Some of the changes include relaxation of the restrictions on the travel and telecommunications industries, authorization of various types of financial transactions, and approval of specific imports into the United States from independent Cuban entrepreneurs.

In conjunction with that easing of the CACR restrictions, OFAC has authorized industries such as telecommunications and internet-based service providers, exporters of authorized products, and travel service providers to establish a business presence in Cuba, including local subsidiaries or joint ventures and the employment of Cubans. Further, press reports indicate that the Obama administration has used its licensing authority for additional Cuban business proposals aligned with its current policy that are not covered by CACR general licenses. Thus, specific licenses can be obtained to conduct business that might otherwise be limited under the general licenses.

[10] *See* section 911(d)(8).

[11] Section 911(d)(8)(A).

[12] Rev. Rul. 92-63; Rev. Rul. 2005-3; Instructions for Form 2555.

[13] *See* Joint Committee of Taxation, ''General Explanation of the Tax Reform Act of 1986'' (1987), at 1010.

[14] 2006-85, 2006-2 C.B. 677.

B. U.S. Export Controls Under the EAR

The EAR apply principally to the export, re-export, and transfer of items subject to them, including commodities, software, and technology. For purposes of exports and re-exports to Cuba, items subject to the EAR are defined to include items of U.S. origin, items exported from the United States, and foreign-produced items incorporating more than a de minimis percentage of controlled U.S. content. The rules generally apply to both U.S. and non-U.S. persons.

Under the EAR, all items subject to the rules require a license for export or re-export to Cuba. There have always been several exceptions, however, including to authorize exports to Cuba of agricultural commodities. The new, relaxed policy added several more, including for the telecommunications industry and for temporary exports for exhibitions and demonstrations. It also expanded one license exception to authorize the use of aircraft and vessels between the United States and Cuba.

Further, the Bureau of Industry and Security may issue licenses for some categories of exports, including medicine and telecommunications items, and for exports that meet the needs of the Cuban people. Other Cuban-related license applications are generally subject to a policy of denial.

IV. Conclusion

Based on the low income tax rates in Cuba, U.S. investors should consider a corporate structure. Generally, a foreign corporation's non-subpart F income should defer Cuban-source income from U.S. taxation until it is repatriated to the United States. Dividends received by a U.S. individual from a Cuban corporation should not benefit from the reduced 20 percent qualified dividends rate in IRC section 1(h)(11) because Cuba has not yet entered a tax treaty with the United States.

However, for an individual who has structured her multinational business through a treaty country holding company, there may be an opportunity for that company to invest in the Cuban operation directly. Dividends received from the treaty country holding company may be subject to the reduced 20 percent tax rate. ◆