THE LIFE OF AN OUTBOUND INVESTMENT FROM THE U.S. INTO CANADA

U.S. TAX ISSUES COMMONLY ENCOUNTERED

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INTRODUCTION

Introduction – Points to Remember

- **Know your entity**
- **Know tax treatment for transfer of assets**
- **Know when there is access to a tax treaty**
- **Know when cross border losses may not be deductible**
- **Know when phantom income is taxed in U.S.**
- **Putting it al together**

KNOW YOUR ENTITY

Know Your Entity

- Entity classification affects the extent of the U.S. taxing jurisdiction
- Classification rules are found in Regs. §§301.7701-2 and 301.7701-3.
- Two Outcomes:
  - Classification: Regulations classify a form of foreign business organization for U.S. tax purposes; and
  - Election: Allows certain business entities to choose their classification for Federal tax purposes under an elective regime.

Know Your Entity

- **Domestic Entities**
- **By Definition**: Certain business entities are by definition classified as corporations under Reg. §301.7701-2(b).
  - A corporation formed under Federal or State statute
  - An entity otherwise treated as a corporation for Federal tax purposes
  - An insurance company
- **Eligible Entity**: A business entity that is not necessarily classified as a corporation is an "eligible entity" and can elect its classification for Federal tax purposes.
- **Tax Treatment**: Domestic eligible entities are classified as follows in the absence of an election:
  - Partnership: An eligible entity with ≥2 members.
  - Disregarded Entity: An eligible entity with a single member is treated as a branch.
  - Election: Domestic eligible entities may elect treatment as a C-corp, by filing Form 8832.

Know Your Entity

- **Non-U.S. Entities**
- **By Definition:**
  - Foreign entities that are specifically listed in Reg. §301.7701-2(b)(8)(i).
  - These entities must be treated as C-corps and cannot make a classification election.
  - Examples are:
    - A Federal or Provincial corporation in Canada must be treated as a corporation for U.S. tax purposes.
    - An exception exists for an unlimited liability company.

Know Your Entity

- **Non-U.S. Entities**
- **Eligible Entities:** Any entity not on the list.
  - C-Corp: All members have limited liability.
  - Partnership: An eligible entity with ≥2 members and at least one member does not have limited liability.
  - Branch: An eligible entity with a single owner, and owner does not have limited liability.
  - Election: An foreign eligible entity may elect different treatment in a timely filed Form 8833.

Know Your Entity

- **Effective Date For Elective Status**
  - The election of status is first effective not more than 75 days prior to filing nor more than 12 months after filing.
  - Relief for late filings is permitted under Rev. Proc. 2009-41.
    - The late election must not be inconsistent with an existing tax filing position regarding the entity.
    - Reasonable cause must exist for the late filing of election.
      - Example: Mr. X was assigned the task, but for some reason it was not done.
- **T.I.N. Needed**
  - A foreign entity must have a U.S. tax identification number in order to make an election.
  - The election must be signed by a representative of the entity and each person affected by the election.

Know Your Entity

- **<u>Canadian Context</u>**
- **Different treatment**
  - U.S. – L.L.C. is considered a flow-through for purposes.
  - Canada – L.L.C. is considered a corporate entity.
- **Canadian investment into the U.S.**
  - Double taxation without foreign tax credits may be encountered.
  - The L.L.C. may not be viewed to be a resident of the U.S. under the treaty definition and not entitled to treaty benefits.
    - Problem: The mind and management may be at the head office.

Know Your Entity

- **Canadian Context**
- **Treatment of an L.L.C. Investing in Canada**
  - Paragraph 6 of Treaty Article IV (Residence)

    An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where:

    (a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and

    (b) By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.

Know Your Entity

- **<u>Canadian Context</u>**
- **Treatment of a ULC dividend paid to a U.S. resident**
  - Paragraph 7(b) of Treaty Article IV (Residence)

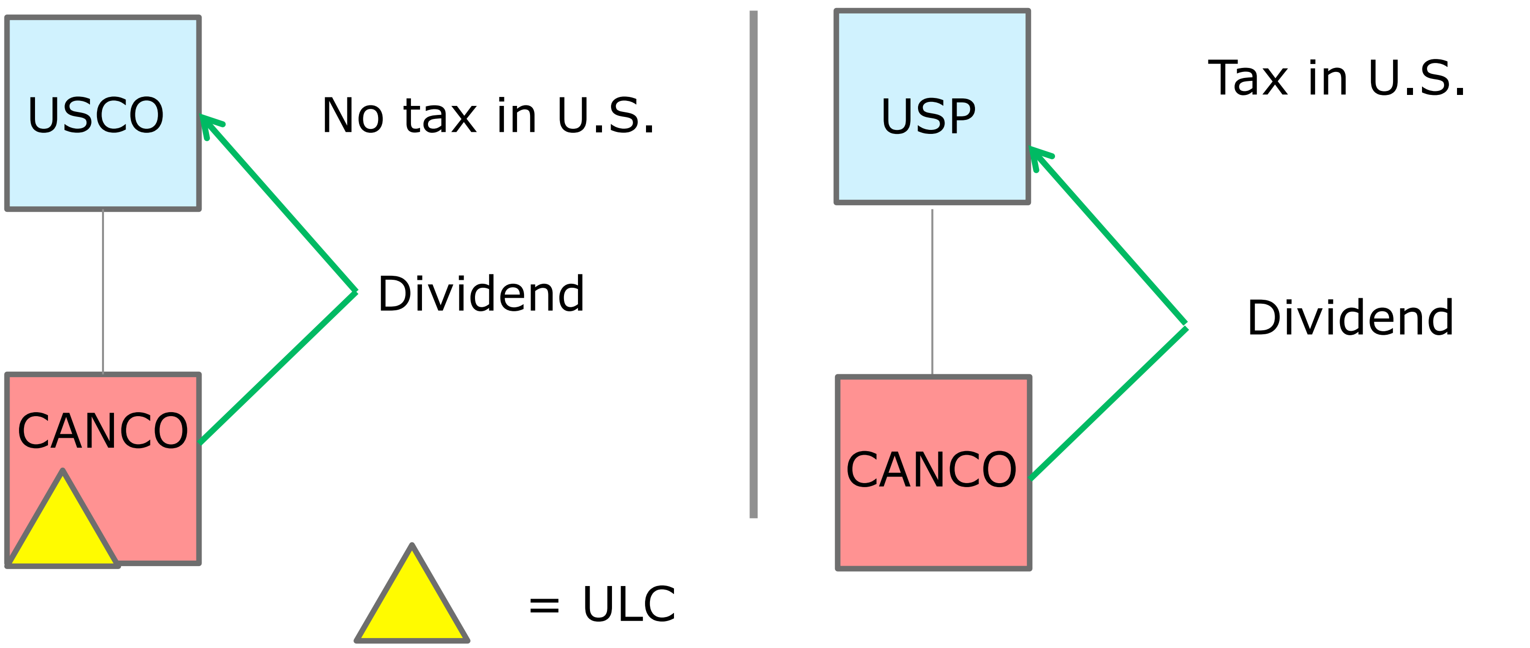
    An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:

    * * *

    (b) The person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

Know Your Entity

- **Canadian Context**
- **Treatment of a ULC dividend paid to a U.S. resident**



KNOW TAX TREATMENT FOR TRANSFER OF ASSETS

Know Tax Treatment for Transfer of Assets

- **Gain Recognition**
- Code §367 was enacted to prevent use of the nonrecognition provisions in Subchapter C as a vehicle to avoid taxation on the transfer of property to C.F.C.'s.
- Code §367(a) generally treats a transfer of property (including stock) by a U.S. person to a foreign corporation (an "outbound transfer") in connection with an exchange described in sections 351, 354, 356 or 361 as a taxable exchange unless the transfer qualifies for an exception.

Know Tax Treatment for Transfer of Assets

- **<u>Assets to be Used in a Business</u>**
- Under Code §367(a)(3), an outbound transfer of assets (other than stock or I.P.) qualifies for an exception from taxation if the assets are to be used in the active conduct of a trade or business outside the United States.
- Limitations on the exception are contained in Regs. §§1.367(a) –4T through –6T.
  - Depreciation recapture for property used in the U.S.
  - Property to be leased must be used in active business outside the U.S.
  - Property expected to be sold is excluded from this exception.

Know Tax Treatment for Transfer of Assets

- <u>**Assets to be Used in a Business**</u>
- Limitations (cont'd).
  - Property sold pursuant to compulsory local law is included.
  - Inventory.
  - Copyrights held by a creator of the right.
  - Installment obligations.
  - Foreign currency.
  - Branch assets with previously deducted losses.

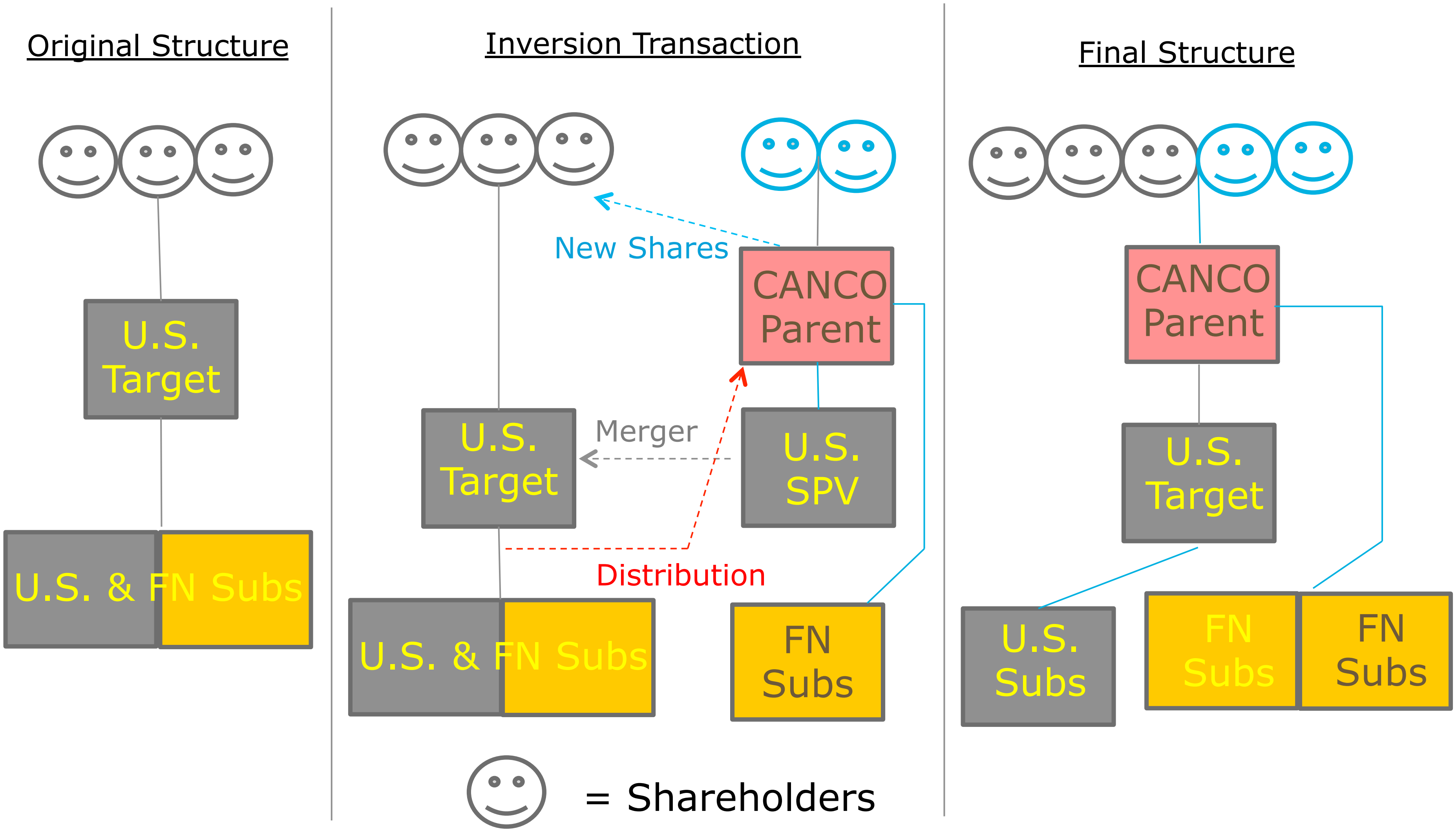
Know Tax Treatment for Transfer of Assets

- A transfer by a U.S. person to a foreign corporation of stock or securities issued by a <u>foreign corporation</u> is not subject to Code §367(a)(1) if—
  - <u>*<5% shareholder.*</u> U.S. person owns <5% of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer or
  - <u>*≥5% shareholder.*</u> U.S. person enters into a 5-year gain recognition agreement with respect to the transferred stock or securities – Reg. §1.367(a)–8.

Know Tax Treatment for Transfer of Assets

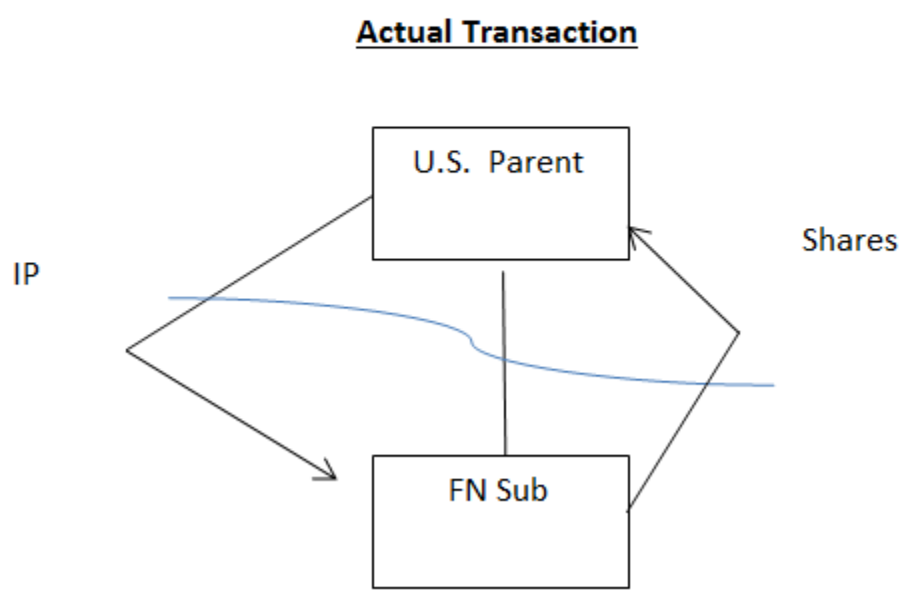
- A transfer by a U.S. person to a foreign corporation of stock or securities issued by a domestic corporation is not subject to Code §367(a)(1) if—
  - The transfer is part of a business combination with a foreign entity, and
  - The value of the foreign corporation ≥ to the value of the U.S. corporation
  - The Mercedes-Chrysler combination of many years ago would meet this test
  - The Burger King-Tim Horton's combination will not meet this test

Know Tax Treatment for Transfer of Assets



Know Tax Treatment for Transfer of Assets

- **<u>Outbound Transfer of I.P.</u>**
- Code § 367(d) treats the transaction as a sale for contingent payments based on the productivity, use, or disposition of such property.



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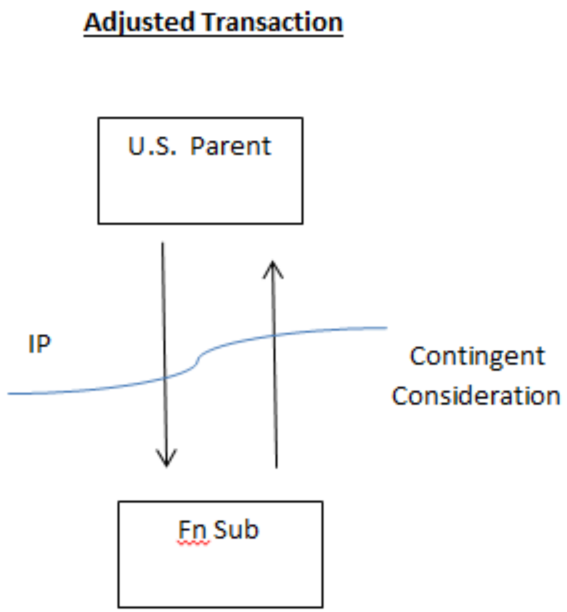


Know Tax Treatment for Transfer of Assets

- **<u>Outbound Transfer of I.P.</u>**
- The income stream continues over the useful life of I.P., which cannot exceed 20 years
- If the I.P. is transferred by the Canadian entity or if the shares of the Canadian entity are transferred, a lump sum payment is deemed to have been received
  - Both the contingent consideration and the lump sum payment must be "commensurate with income." This means they must meet the arm's length standard of Code § 482.
- The deemed stream of contingent payments reduces the E&P of the foreign sub for U.S. tax purposes.
- If payment is deferred, the regulations allow the parent to establish an account receivable for the deferred payment so that payment is not taxed on receipt.

Know Tax Treatment for Transfer of Assets

- **Outbound Transfer of I.P.**
- Code §936(3)(B) defines intangible property:
  - Patent, invention, formula, process, design, pattern;
  - Copyright, literary, musical, or artistic composition;
  - Trademark, trade name, or brand name;
  - Franchise, license, or contract; or
  - Program, system, procedure, study, forecast, customer list, or technical data.

KNOW WHEN THERE IS ACCESS TO A TAX TREATY

Know When There is Access to a Tax Treaty

- **Limitation on Benefits**
- Virtually all income tax treaties of the U.S. with major trading partners contain L.O.B. provisions.
- Article XXIXA provides several objective tests; at least one must be met in order for treaty benefits to be granted.
- In addition, where a U.S. taxpayer seeks relief under the Treaty, Canada may apply its G.A.A.R. rules as a condition for granting treaty relief.

Know When There is Access to a Tax Treaty

- **Limitation on Benefits**
- Broad themes for qualification —
  - Individual residents qualify
  - Governmental entities qualify
  - Publicly traded companies qualify
  - Subsidiaries of publicly traded companies qualify
  - Companies that are > 50% locally owned or owned by U.S. residents qualify if base erosion is absent

Know When There is Access to a Tax Treaty

- **<u>Active Trade or Business</u>**

  Where a person is * * * not a qualifying person, and that person, or a person related thereto, is engaged in the active conduct of a trade or business in that State * * *, the benefits * * * shall apply to that resident person with respect to income derived * * * in connection with or incidental to that trade or business (including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of that other State), but only if that trade or business is substantial in relation to the activity carried on in that other State giving rise to the * * * .

Know When There is Access to a Tax Treaty

- **Derivative Benefits From Parent**

  A company that is a resident of [the U.S.] shall also be entitled to the benefits of Articles X (Dividends), XI (Interest) and XII (Royalties) if:

  (a) Its shares that represent more than 90 percent of the aggregate vote and value of all of its shares * * * are owned, directly or indirectly, by * * * a person who:

    i. Is a resident of a country with which [Canada] has a comprehensive income tax convention and is entitled to all of the benefits * * * under that convention;

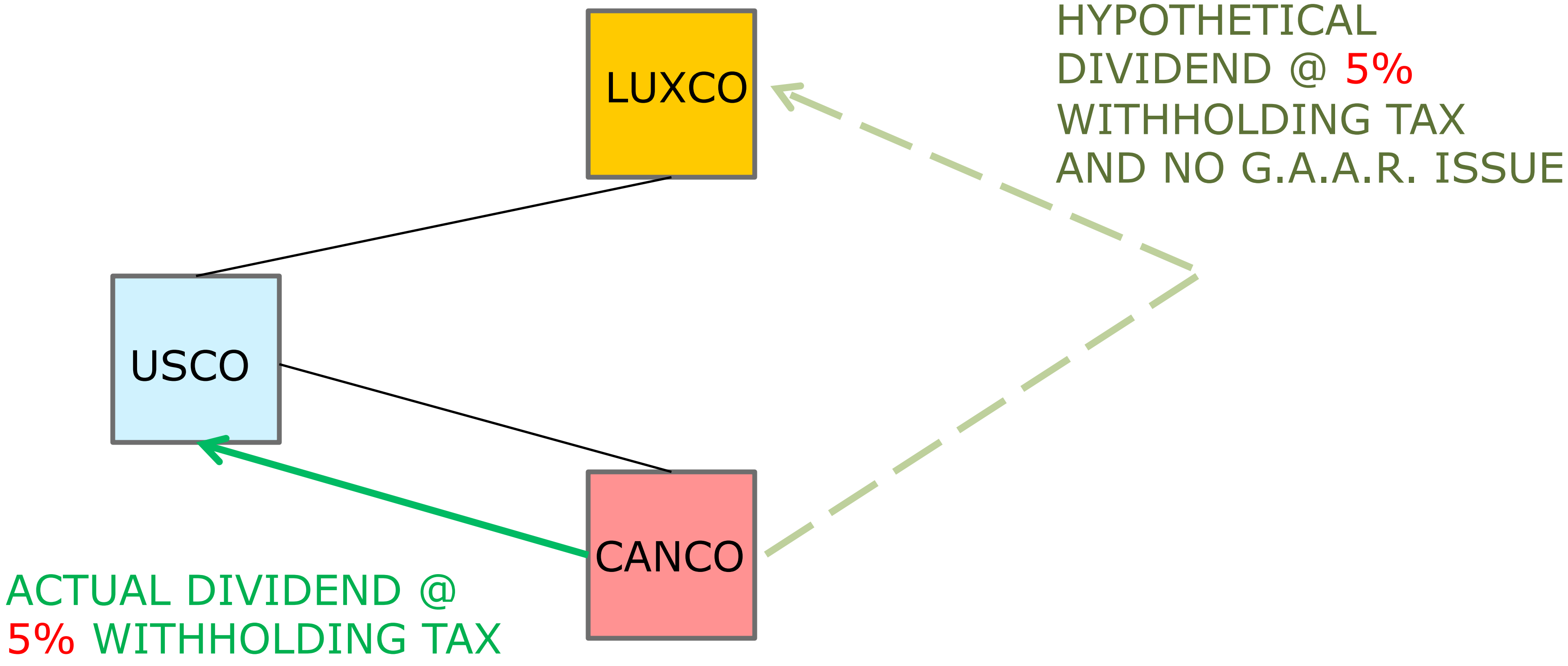
    ii. Would qualify for benefits under [the Canada-U.S. Treaty] if that person were a resident of the [U.S.]; and

    iii. Would be entitled to a rate of tax in [Canada] under the convention between that person's country of residence and [Canada], in respect of the particular class of income * * * that is at least as low as the rate applicable under this Convention; and

  (b) The amount of the expenses deductible from gross income * * * that are paid * * * for its preceding fiscal period * * * to persons that are not qualifying persons is less than 50 percent of the company's gross income for that period.

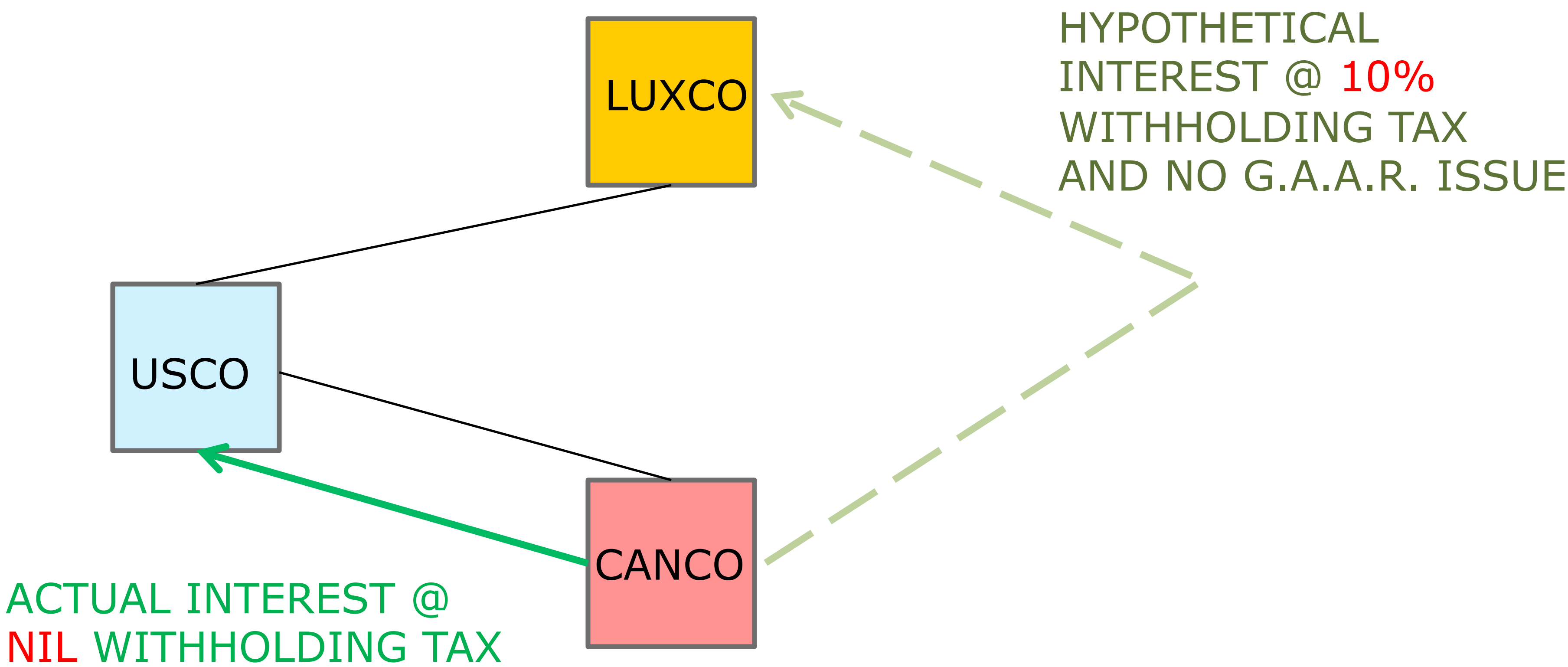
Know When There is Access to a Tax Treaty

- **Derivative Benefits From Parent**



Know When There is Access to a Tax Treaty

- **<u>Derivative Benefits From Parent</u>**



Know When There is Access to a Tax Treaty

- **Discretionary Relief**

  Where a person that is a resident of [the U.S.] is not entitled * * * to the benefits provided under this Convention * * *, the competent authority of [Canada] shall * * * determine on the basis of all factors including the history, structure, ownership and operations of that person whether:

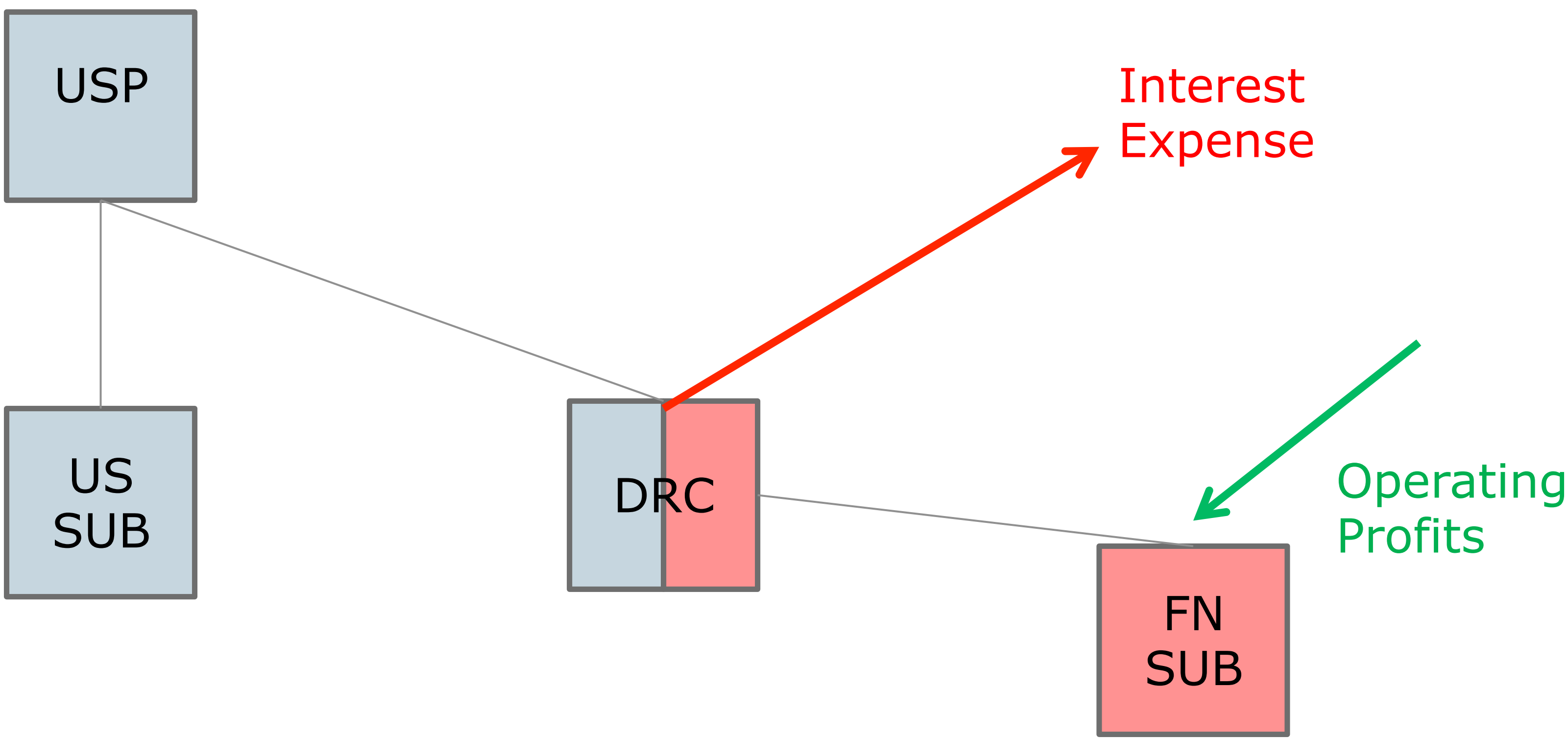
  (a) Its creation and existence did not have as a principal purpose the obtaining of benefits under this Convention that would not otherwise be available; or

  (b) It would not be appropriate, having regard to the purpose of this Article, to deny the benefits of this Convention to that person.

KNOW WHEN CROSS BORDER LOSSES MAY NOT BE DEDUCTIBLE

Know When Cross Border Losses May Not be Deductible

- **Dual Consolidated Loss**



Know When Cross Border Losses May Not be Deductible

- Where losses can be carried forward and can stay with a company after a sale of its shares, a dual consolidated loss can arise even if the U.S. group does not have another entity that can use these losses currently.
- Thus, the necessary certifications must be considered whenever one is deducting on a U.S. tax return a loss that also can be deducted elsewhere.

Know When Cross Border Losses May Not be Deductible

- A U.S. taxpayer may elect to use a DCL if its tax return includes an agreement that the DCL has not been nor will be used to offset the income of another person under the laws of a foreign country.
- The agreement must provide for recapture of the DCL in the event that a “triggering event,” as defined therein, arises in one of the following five taxable years.
- Every year in the 5-year period following the taxable year, the U.S. taxpayer must certify that there has not been, any forbidden “foreign use” of the DCL.

KNOW WHEN PHANTOM INCOME IS TAXED IN U.S.

Know When Phantom Income is Taxed in U.S.

- Two principal anti-deferral regimes impose tax on U.S. taxpayers on a current basis when foreign subsidiaries generate certain income:
  - Controlled Foreign Corporation (“C.F.C.”) regime under Code §§951-964, also known as the “Subpart F” provisions; and
  - Passive Foreign Investment Company (“P.F.I.C.”) regime under Code §§1291-1298.

Know When Phantom Income is Taxed in U.S.

- **<u>Subpart F</u>**
  - Code §951(a) provides that if a foreign corporation is a C.F.C. for an uninterrupted period of 30 days or more during any taxable year, every person that is:
    - A "U.S. Shareholder," and
    - Owns, within the meaning of Code §958(a), stock in C.F.C. on the last day in a year during which the foreign corporation is a C.F.C.
  - Must include in gross income a pro rata share of Subpart F Income of the C.F.C. and certain investments made by the C.F.C. in "U.S. Property."

Know When Phantom Income is Taxed in U.S.

- **<u>Subpart F</u>**
- **U.S. Shareholder:** A "U.S. person" that owns directly, indirectly, or by attribution, stock representing 10% or more of the total voting power of all classes of the foreign corporation's stock that is entitled to vote.
- **C.F.C.:** A foreign corporation in which stock representing more than 50% of either the total combined voting power or the total value of shares is owned, directly, indirectly, or by attribution, by "U.S. Shareholders" on any day during the foreign corporation's taxable year.

Know When Phantom Income is Taxed in U.S.

- **Subpart F**

- **Foreign Base Company Income**:
- Foreign Personal Holding Company Income,
- Foreign Base Company Sales Income,
- F.B.C. Services Income.

Know When Phantom Income is Taxed in U.S.

- <u>**P.F.I.C. Provisions**</u>
- A U.S. shareholder of a P.F.I.C. is taxed on excess distributions received from a P.F.I.C. and on direct or indirect gains derived from the sale, exchange or other disposition of the shares of the P.F.I.C.
- The tax is increased by an additional interest charge based on any deferred U.S. taxes to which the distribution relates.

Know When Phantom Income is Taxed in U.S.

- **P.F.I.C. Provisions**
- **P.F.I.C.**: a foreign corporation meeting either of the following tests:
  - 75% or more of the corporation's gross income is passive income, as defined. Under the asset test, a foreign corporation is a P.F.I.C.; or
  - 50% or more of the average value of the corporation's assets (on a gross value basis) consists of assets that ordinarily produce passive income.

Know When Phantom Income is Taxed in U.S.

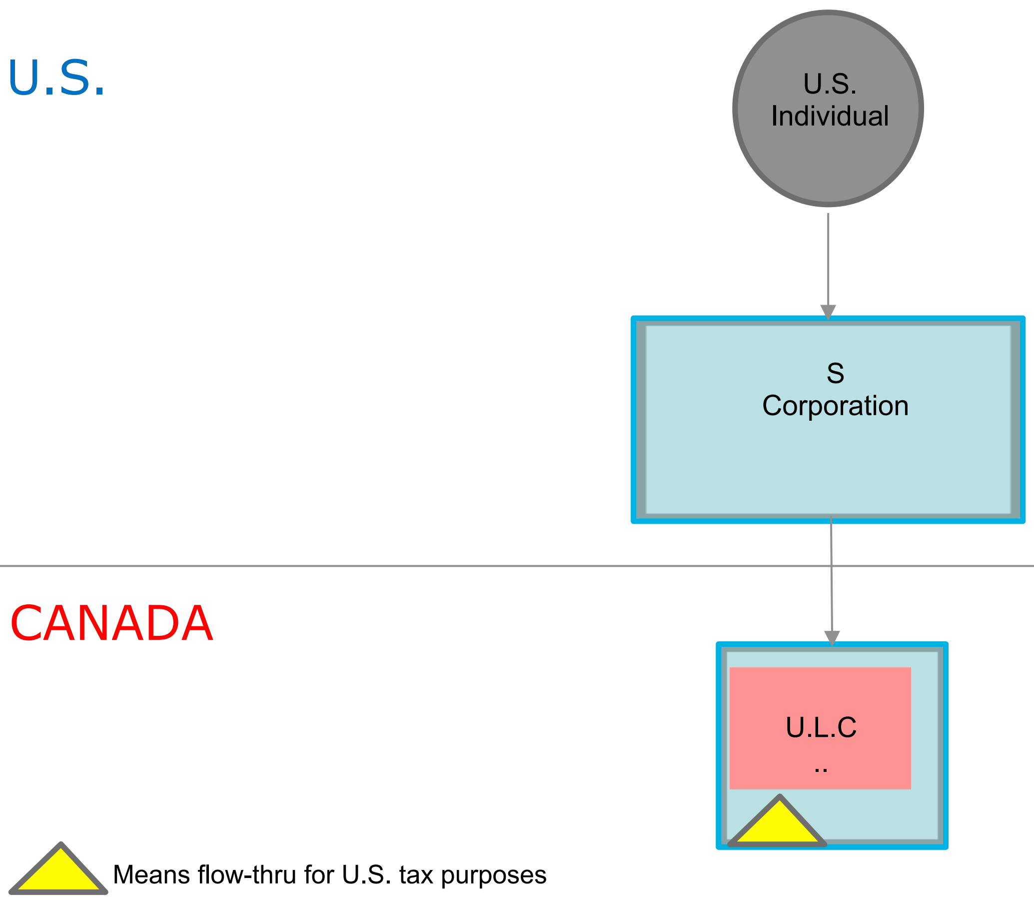
- **<u>P.F.I.C. Provisions</u>**
- **Excess Distribution**: Either:
  - A distribution that exceeds 125% of the average distribution for the prior 3 years; or
  - Gain from a direct or indirect disposition of shares in a P.F.I.C.

- **Tax Treatment of Excess Distribution**:
  - Throwback rule
  - Q.E.F. election
  - Mark to market

PUTTING IT TOGETHER

Simple Plan-Outbound Investment Into Canada

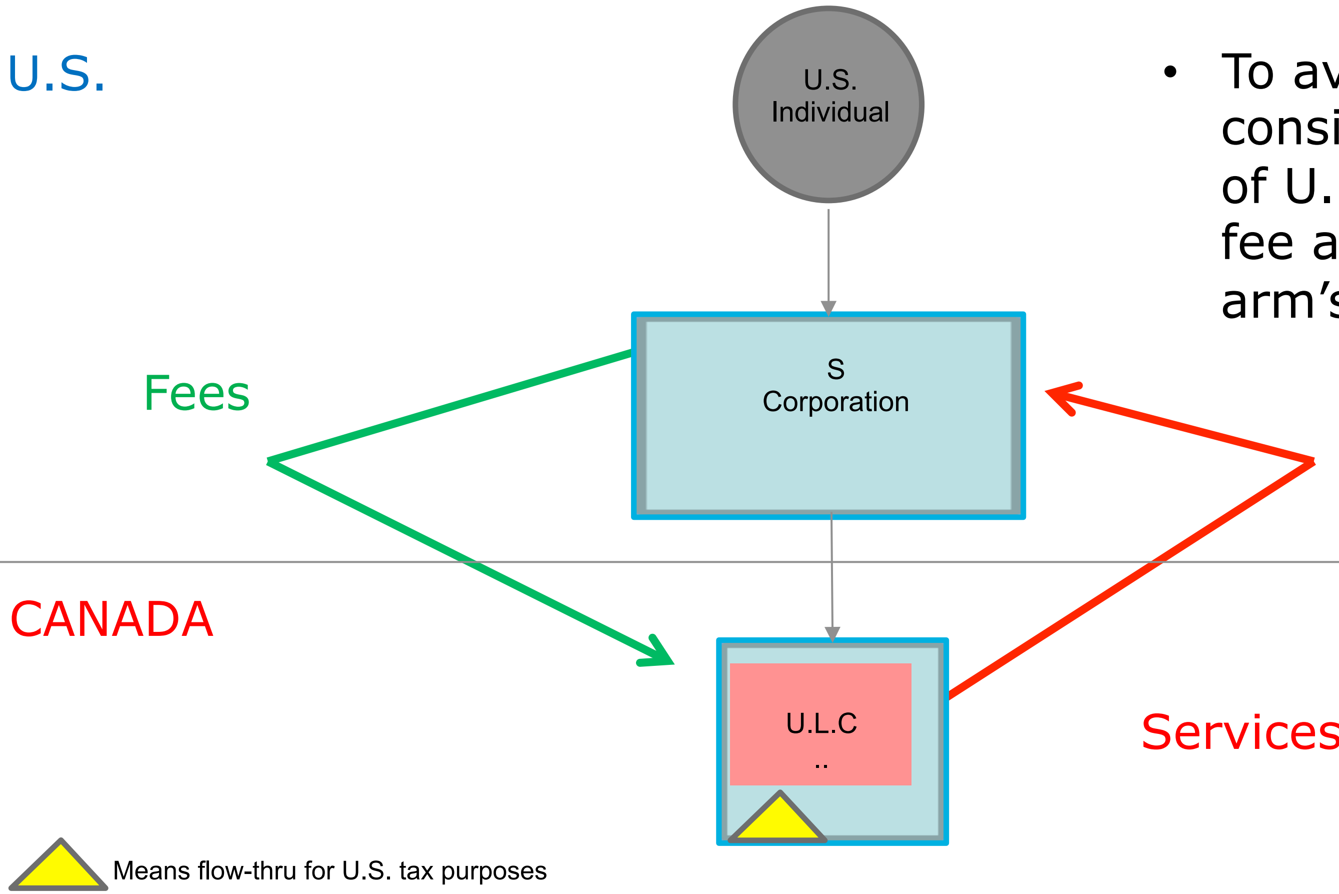
OUTBOUND U.S. INVESTMENT



- Withholding Tax Rate To 5%. FTC Available for U.S. Individual
- Flow Through From S-Corporation To U.S. Individual (Including Losses)
- Individual Protection of U.S. Individual from Liabilities of U.L.C.

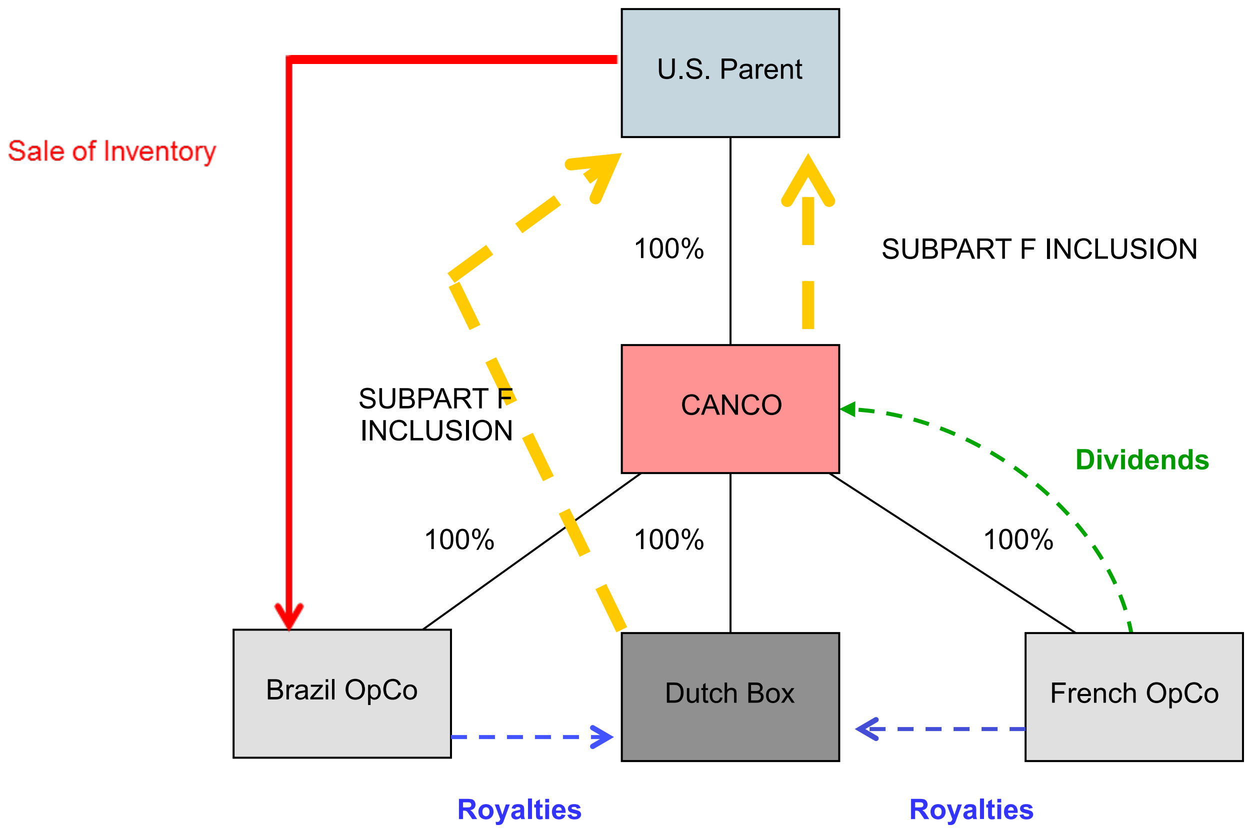
Simple Plan-Outbound Investment Into Canada

OUTBOUND U.S. INVESTMENT



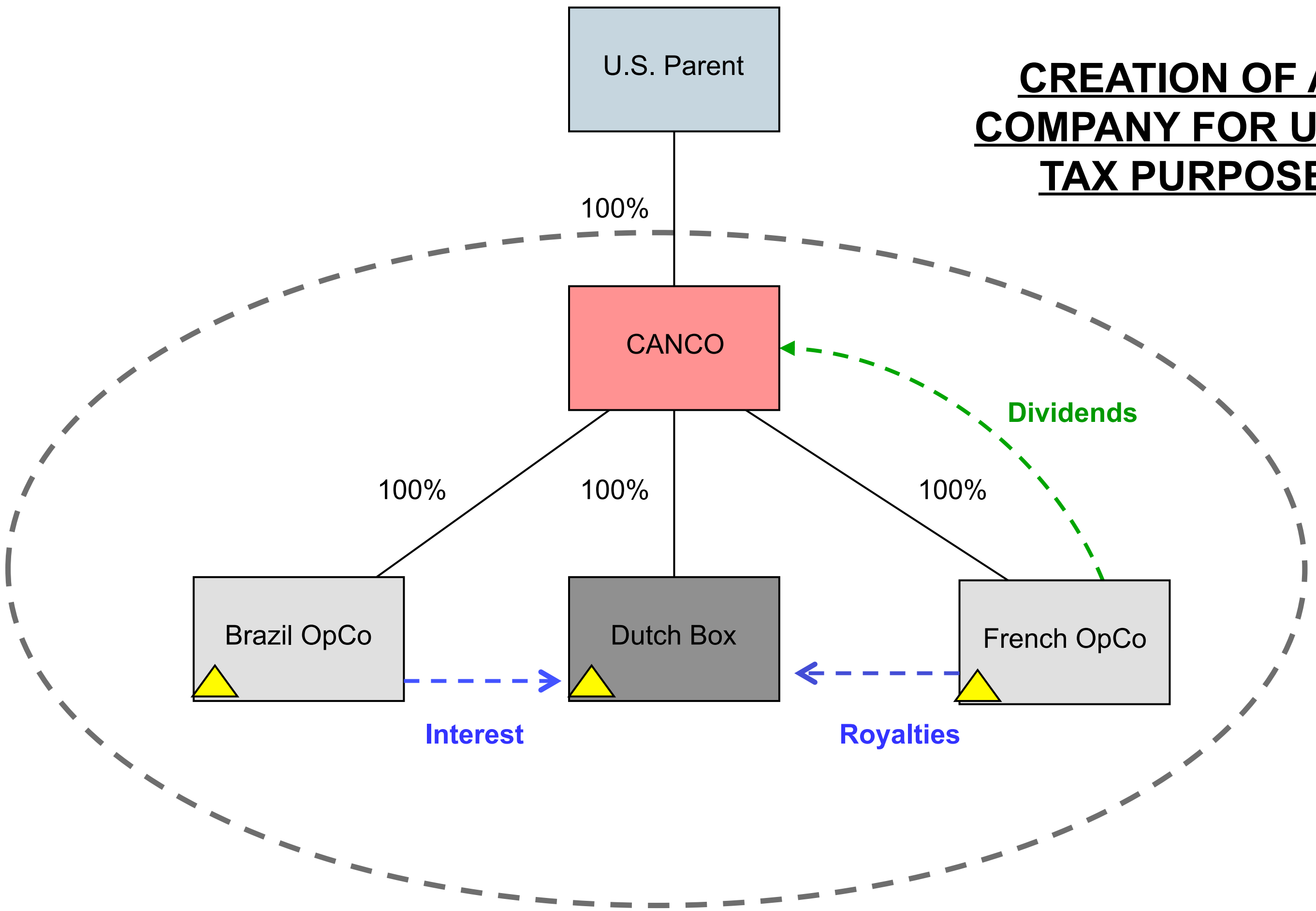
- To avoid DCL rules, consider eliminating losses of U.L.C. through service fee arrangements that are arm's length

Subpart F Income Planning in the Absence of §954(c)(6)



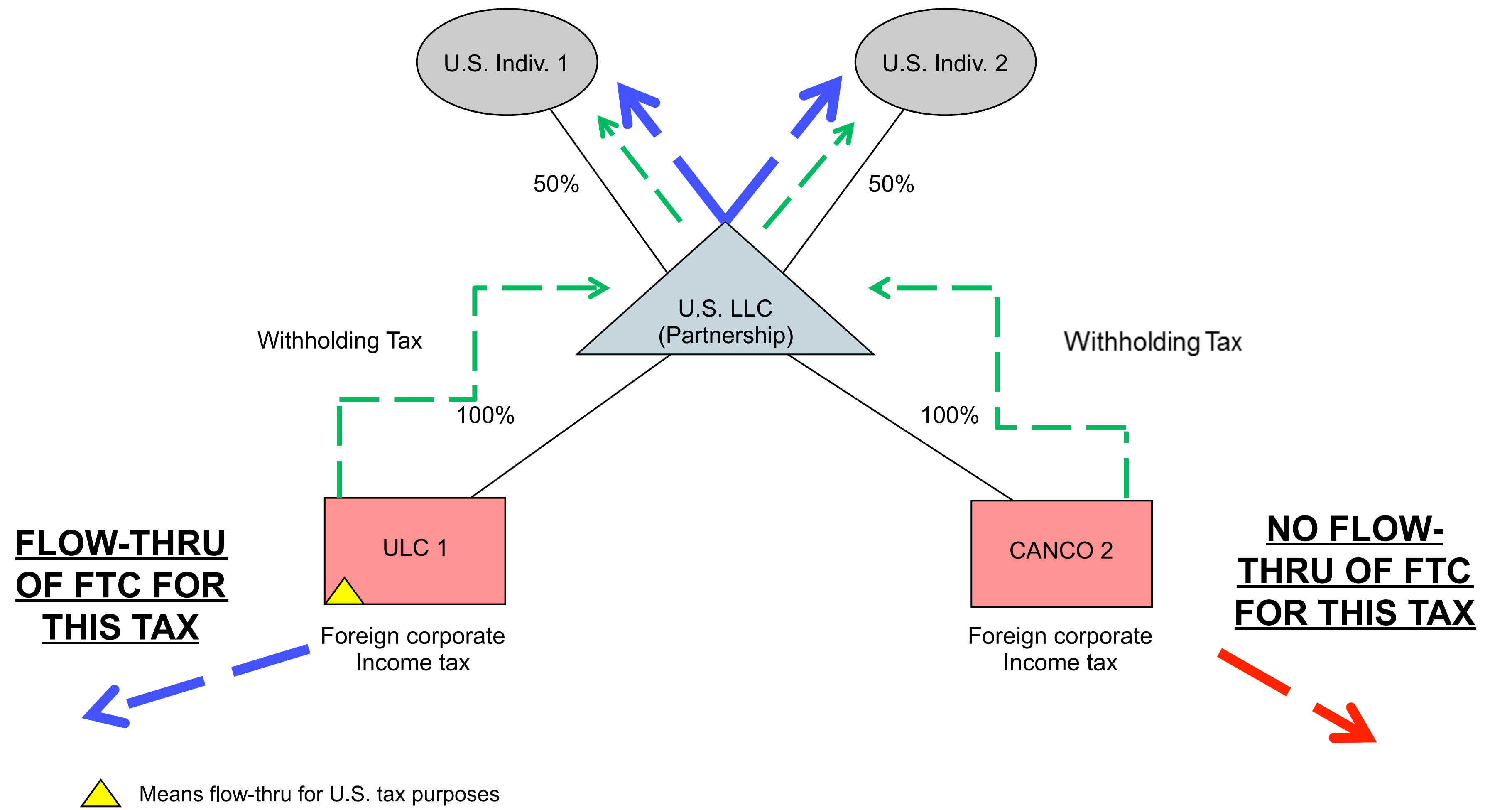
Subpart F Income Planning

CREATION OF A SINGLE COMPANY FOR U.S. INCOME TAX PURPOSES ONLY



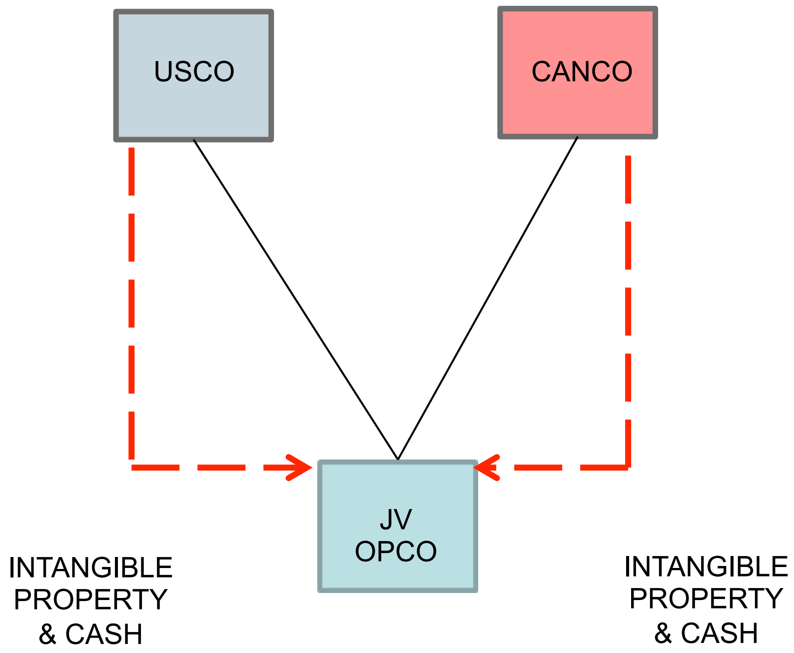
Means flow-thru for U.S. tax purposes

Foreign Tax Credit Planning: Converting 902 tax to 901 tax



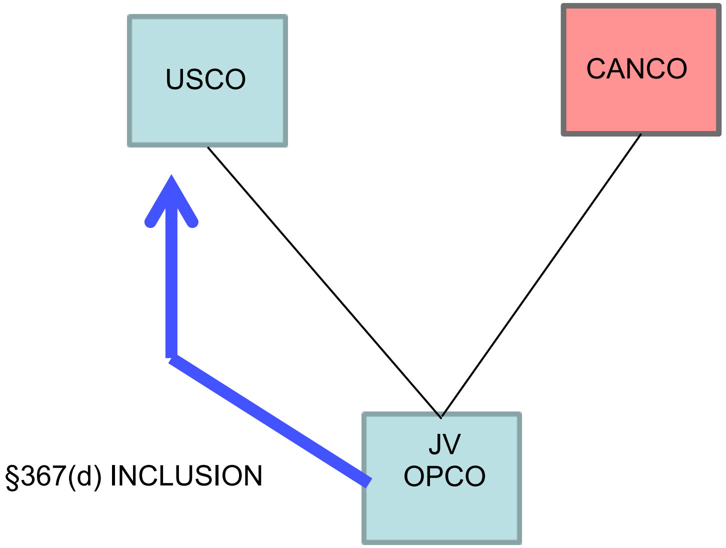
International Joint Venture

BUSINESS TRANSACTION



- TWO COMPANIES WITH IP
- JOINT DEVELOPMENT AGREEMENT
- CONTRIBUTION OF CASH & IP
- FOREIGN LAW REQUIRES LOCAL OPCO

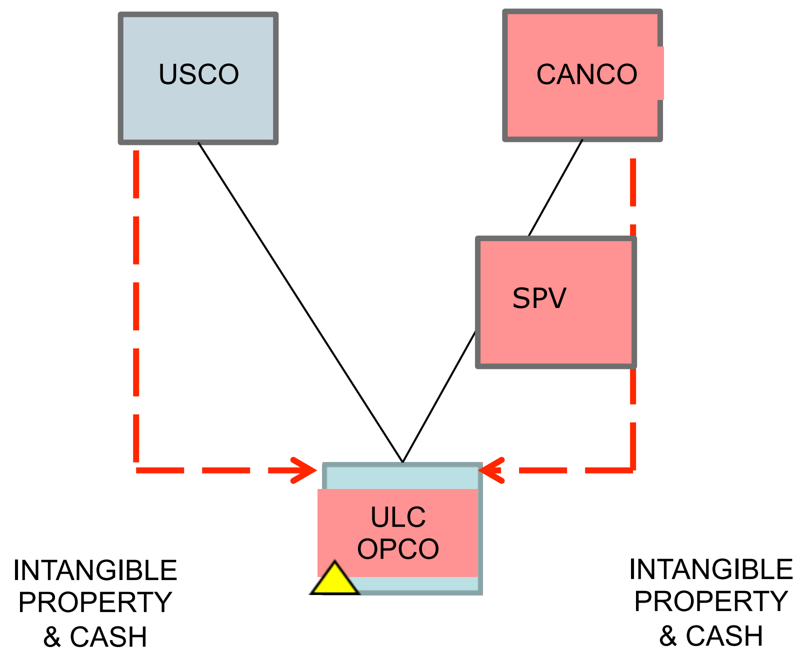
U.S. TAX TRANSACTION



- RESTRUCTURED UNDER § 367(d)
- SALE OF IP FOR CONTINGENT CONSIDERATION

International Joint Venture

BUSINESS TRANSACTION



Means flow-thru for U.S. tax purposes

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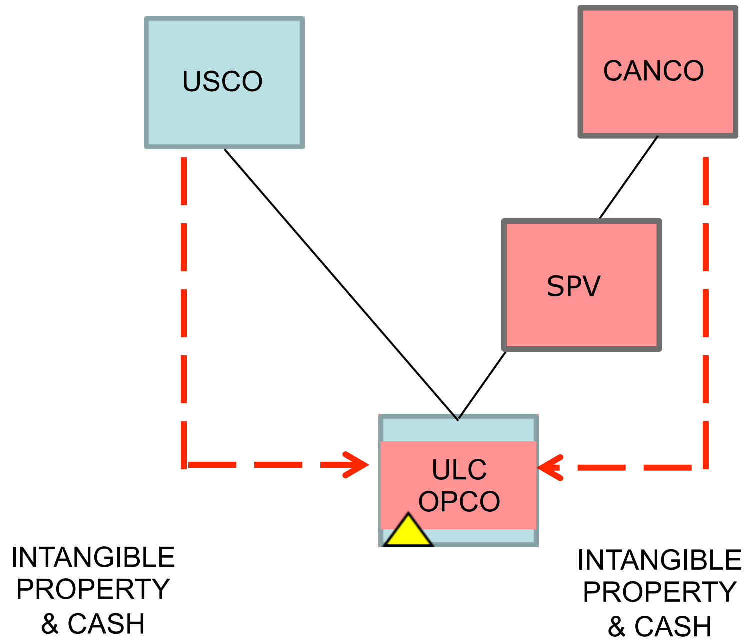

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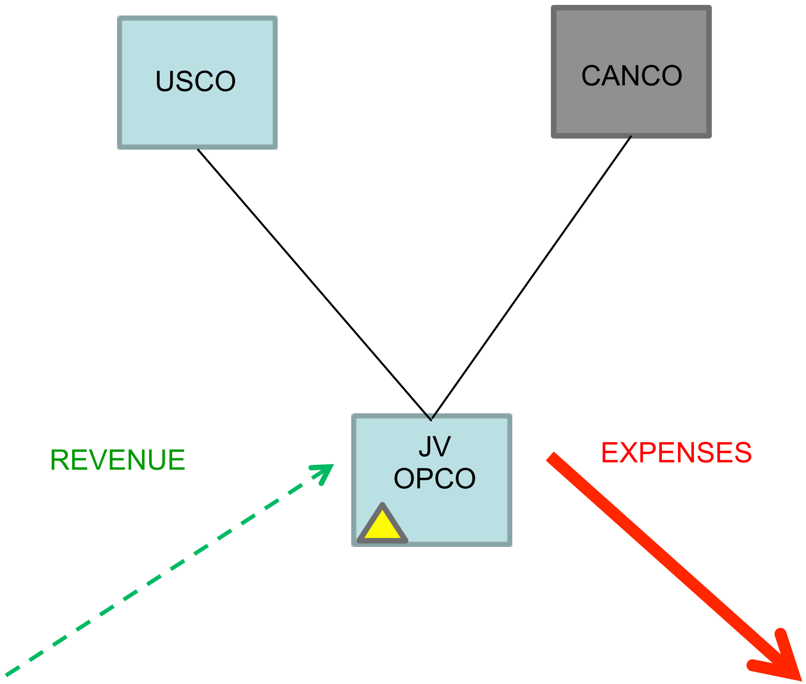
International Joint Venture

PITFALL



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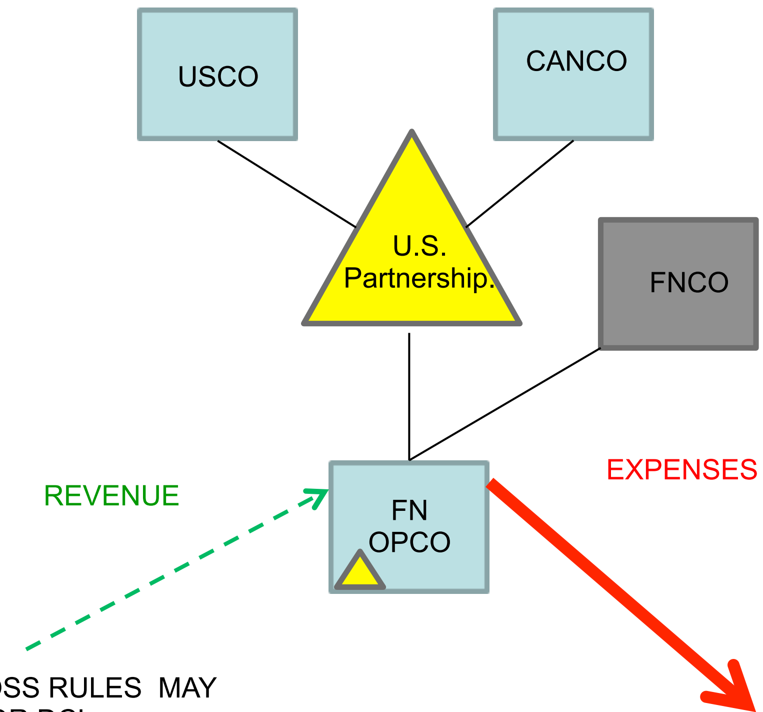

Means flow-thru for U.S. tax purposes

- DUAL CONSOLIDATED LOSS RULES MAY PREVENT DEDUCTION FOR DCL
- SOLUTION -- §1.1503(d)-6(b) ELECTION – DOMESTIC DEDUCTION ONLY

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