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INTERNATIONAL TAXATION

US Citizens as Shareholders of Canadian Companies — *Impact on Reorganizations and Other Canadian Tax Consequences*

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Agenda

- Common Canadian Reorganization and Tax Planning Scenarios
- Application of U.S. Tax Rules to Canadian Reorganization Scenarios
- U.S. Income Tax as it Relates to Canadian Shareholders and Beneficiaries
  - U.S. Anti-Deferral Rules
  - U.S. Estate and Gift Tax
  - Outbound Transfers of Foreign Target Stock
- Concluding Comments

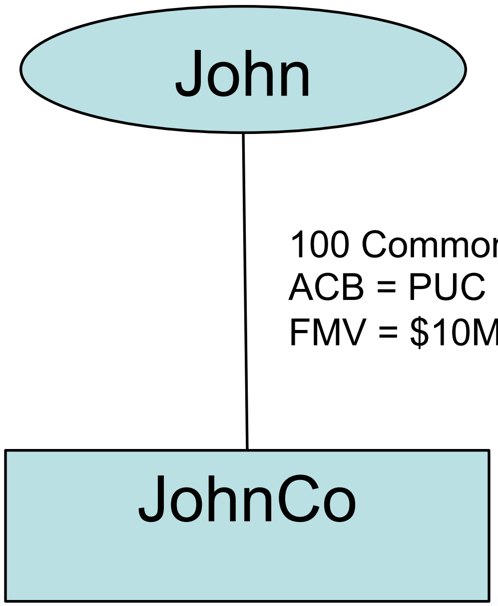
Common Canadian Reorganization Scenarios

Scenario A – Common Estate Freeze

- John is the sole shareholder and owner/manager of JohnCo, a Canadian private corporation
  - Currently one class of issued and outstanding common shares (John owns 100 common shares)
  - Common Shares' aggregate ACB = PUC = $100 ($1/common share)
  - Current FMV of Common Shares estimated at $10M
- John is a resident of Canada and is not a U.S. Person
- Johnco is a CCPC
- John wants to implement an estate freeze under subsection 86(1) of the *Income Tax Act* (Canada)

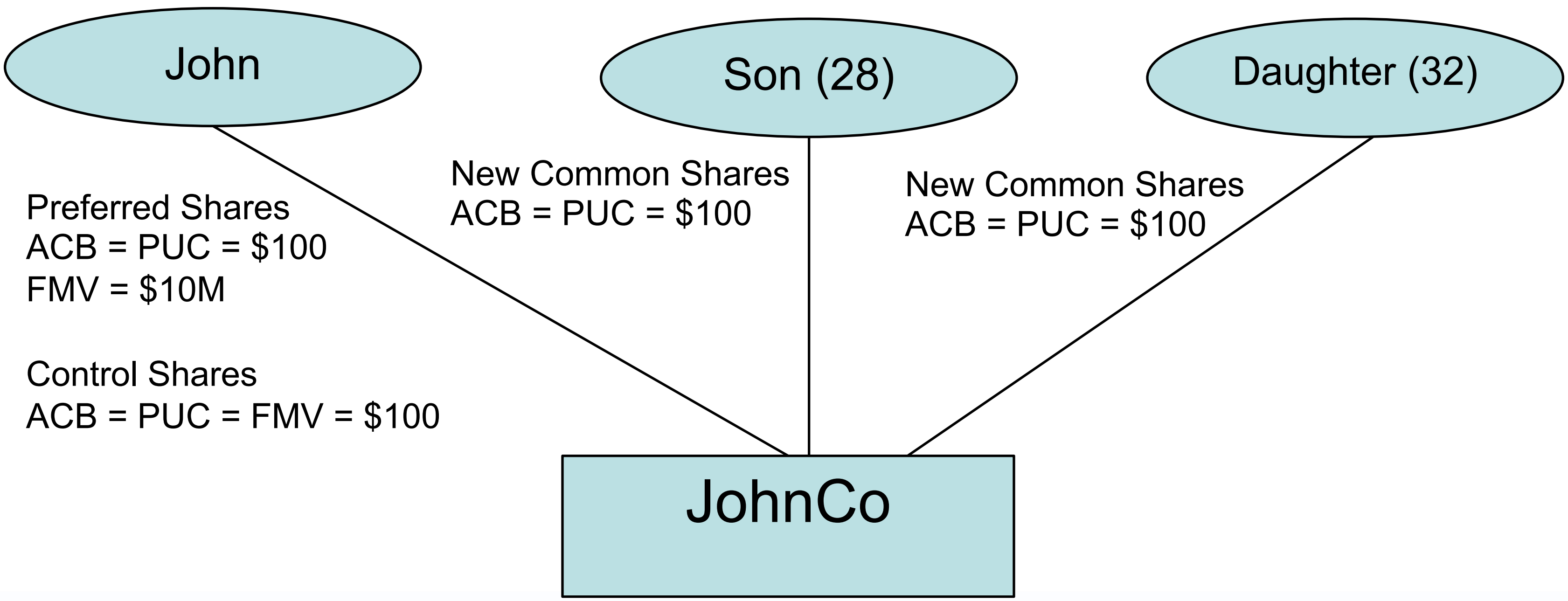
Scenario A – Common Estate Freeze (con't)

Before Reorganization (Current Structure)



Scenario A – Common Estate Freeze (con't)

After Reorganization (Proposed Structure 1)

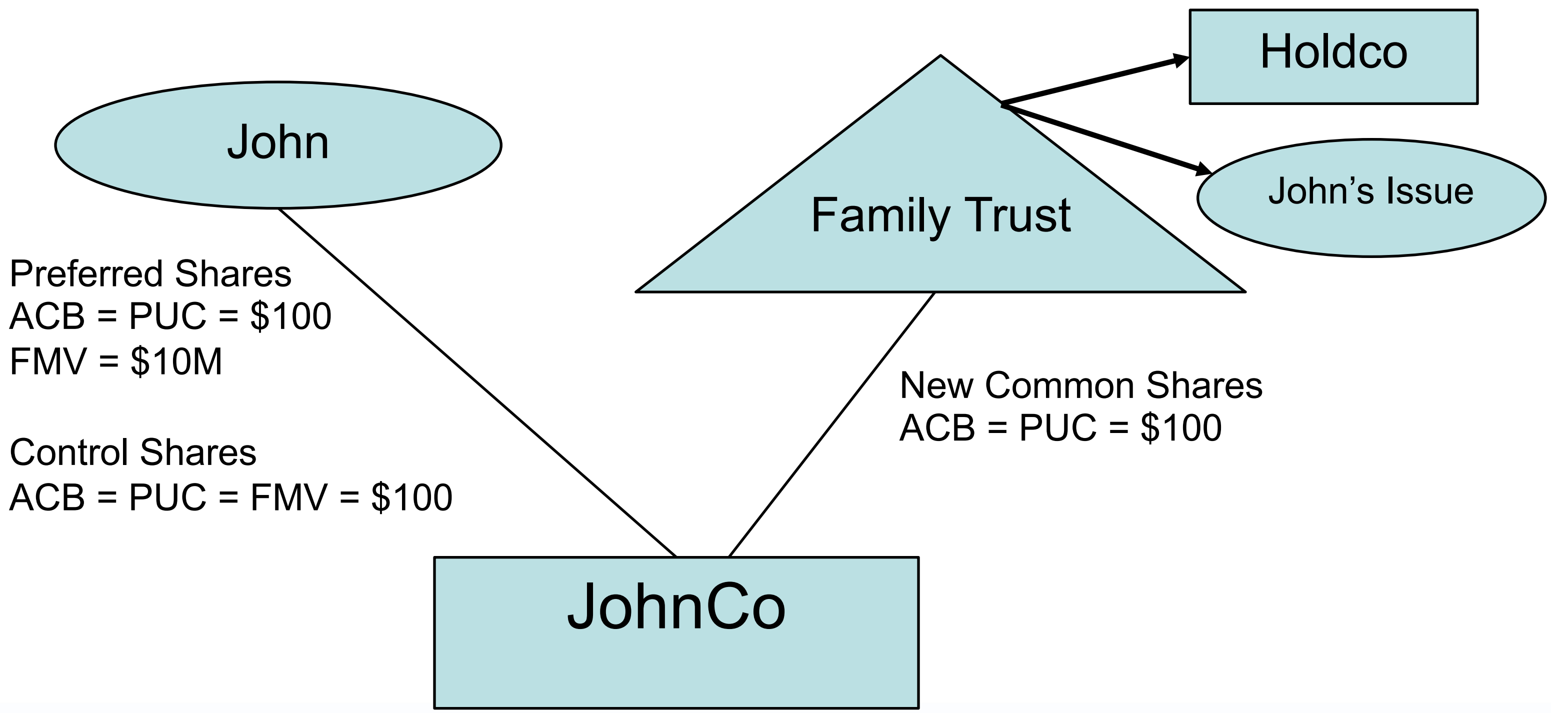


Scenario A – Common Estate Freeze (con't)

- John's spouse is a U.S. citizen. As a result, *both* his son and daughter are U.S. citizens
- Assume:
  - JohnCo generates only active business income
  - JohnCo shares are qualified small business corporation shares
  - Future dividend payments to be made to John's children
  - John retains control through a separate class of control ("skinny") voting shares
  - Preferred shares issued to John meet all the requirements of "freeze" shares
  - Preferred shares are entitled to the payment of a preferential dividend
- What are the U.S. tax implications to John's son and daughter under Proposed Structure 1?

Scenario A – Common Estate Freeze (con't)

After Reorganization (Proposed Structure 1)



Scenario A – Common Estate Freeze (con't)

- What are the U.S. tax implications under Proposed Structure 2, assuming that John's children are *both* U.S. citizens?
- Additional Assumptions:
  - JohnCo generates only active business income
  - JohnCo shares are qualified small business corporation shares
  - Trust is discretionary
  - John retains control through a separate class of control ("skinny") voting shares
  - Preferred shares issued to John meet all the requirements of "freeze" shares
  - Preferred shares are entitled to the payment of a preferential dividend
  - Holdco is owned by John only

Scenario A – Common Estate Freeze (con't)

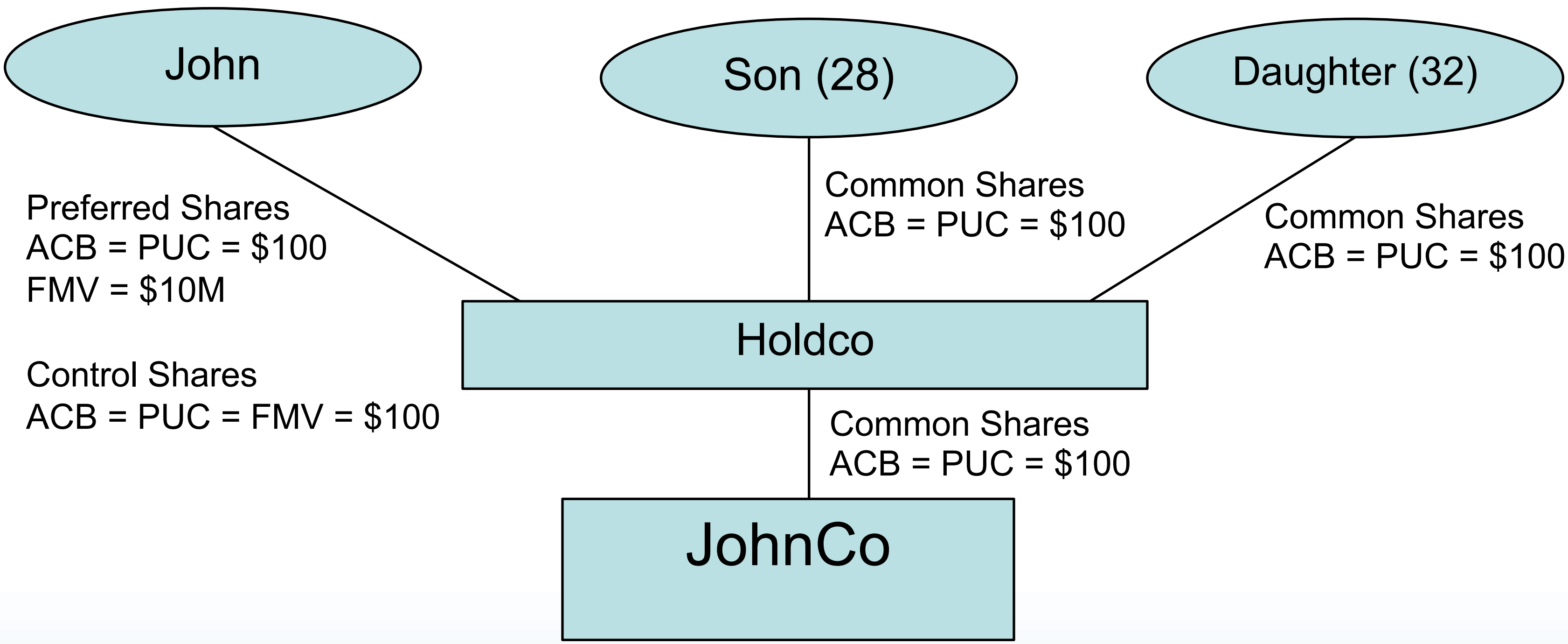
- John's son and daughter are the only beneficiaries of his estate
- What are the U.S. tax implications on John's death, assuming
  - John's Will provides a direct bequest of his shares of JohnCo to his son and daughter, in equal shares?
  - John's Will provides that the shares of JohnCo are to be held in separate testamentary trusts (one trust for each one of the son and daughter)?
- How would the U.S. tax implications change if John was a U.S. citizen?
  - Could he undertake the estate freeze?
- Do the U.S. tax implications change depending on who is a trustee of the trust?
- Do the U.S. tax implications change if JohnCo is not an active business and instead owns only a portfolio of investments (i.e. passive income)?
- Do any U.S. tax implications change if new common shares are issued to John?

Scenario B – Common Holdco Freeze

- A variation to the facts in Scenario A with John wanting to transfer his shares of JohnCo under subsection 85(1) of the *Income Tax Act* (Canada) to a new Holdco incorporated under the laws of the province of John's residence
- What are the U.S. tax implications if John's son and daughter are shareholders of the holding company *or* beneficiaries of a family trust which owns the shares of Holdco?
- How would Scenario B affect John if he was also a U.S. citizen?

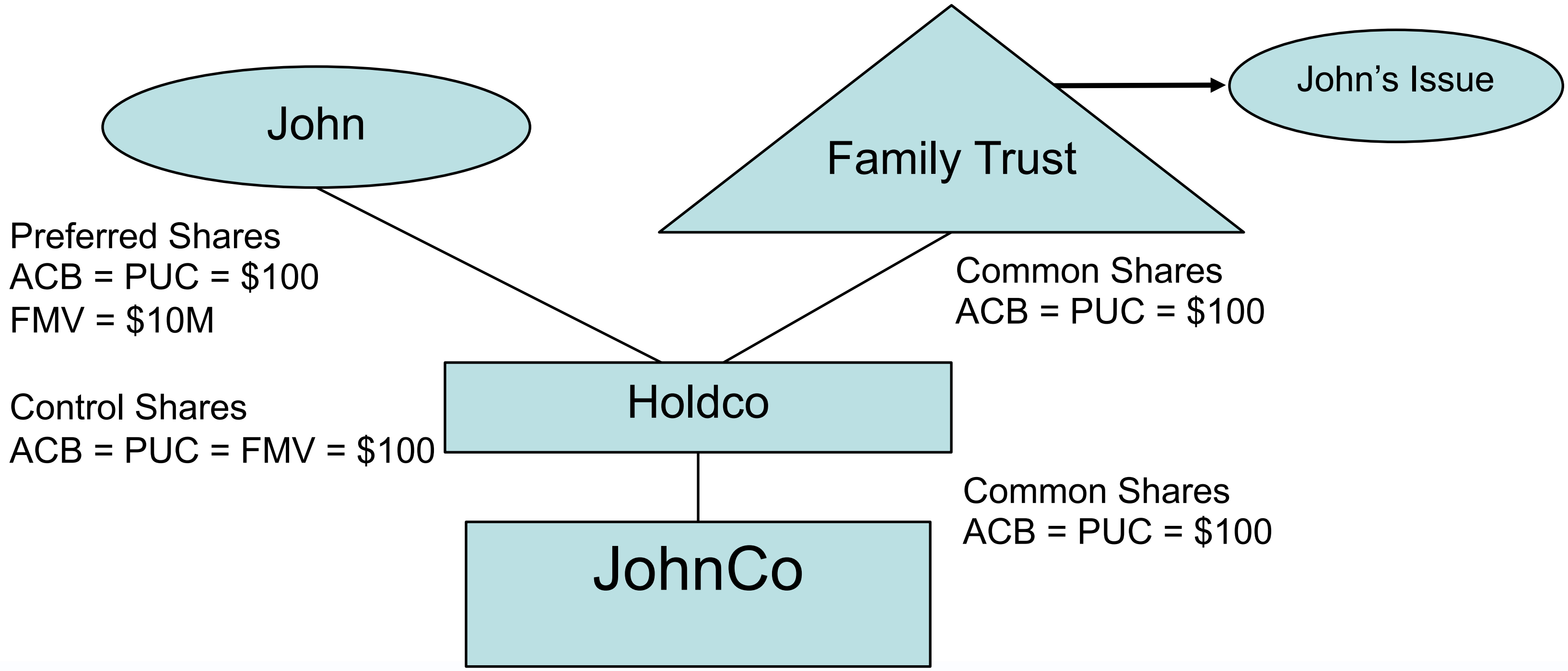
Scenario B – Common Holdco Freeze (con’t)

After Reorganization (Proposed Structure 1)



Scenario B – Common Holdco Freeze (con't)

After Reorganization (Proposed Structure 2)

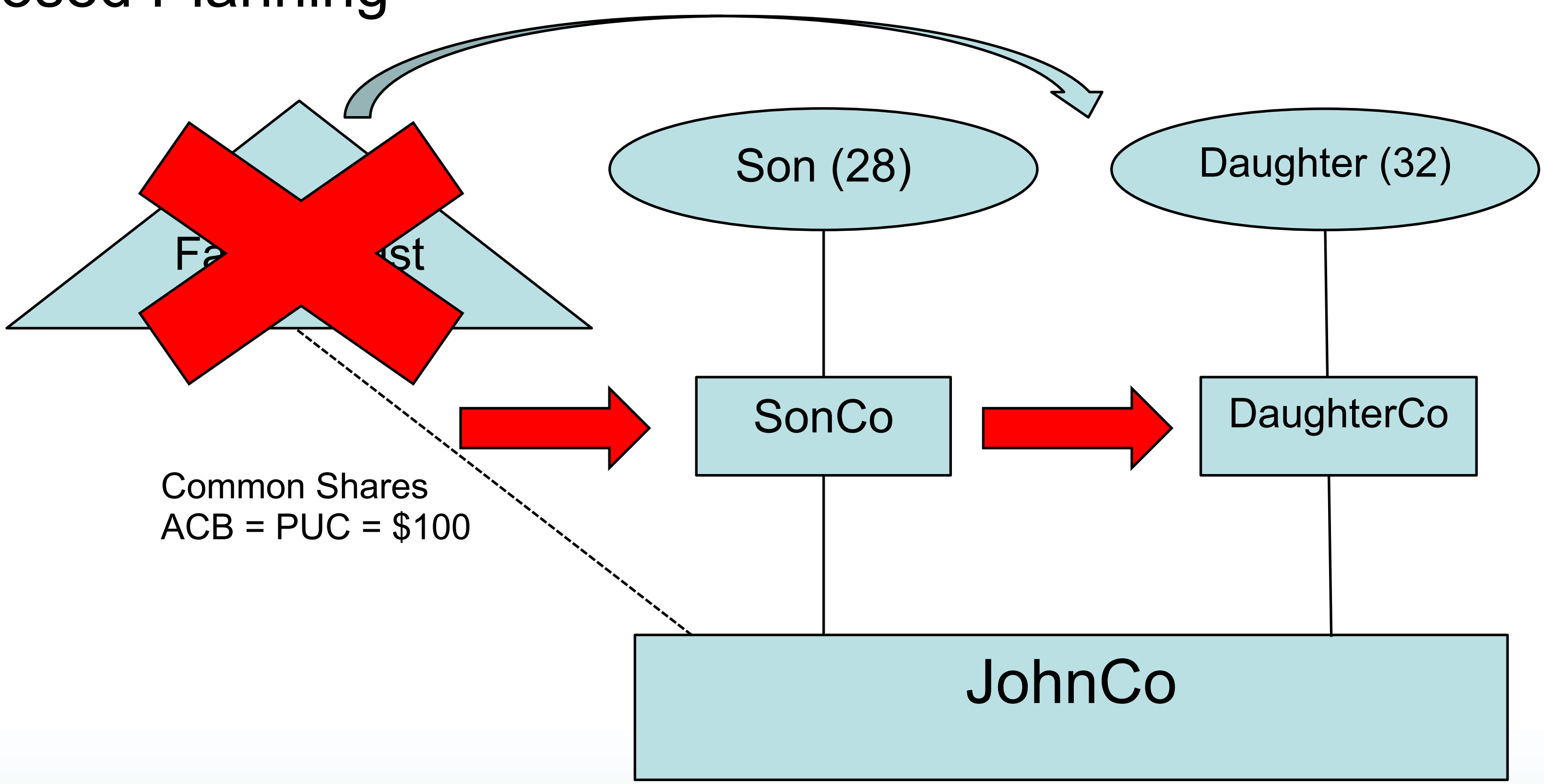


Scenario C – 21-Year Trust Planning

- Another variation to the facts in Scenario A with a family trust owning common shares in JohnCo
- The family trust is approaching its 21st anniversary and deemed disposition under subsection 104(4) of the *Income Tax Act* (Canada)
- Both of John's children are U.S. citizens and (assume) also U.S. tax residents
- What are the U.S. tax implications to the children as beneficiaries of the trust?
- The trustees would like to effect a rollout of shares under subsection 107(2) of the *Income Tax Act* (Canada)
  - Assume rollouts to Canadian corporations owned by the son and daughter are permissible
- What are the U.S. tax implications of the rollout to Canadian corporations (non-ULCs)?
- What are the U.S. tax implications of a rollout to a Canadian ULC?

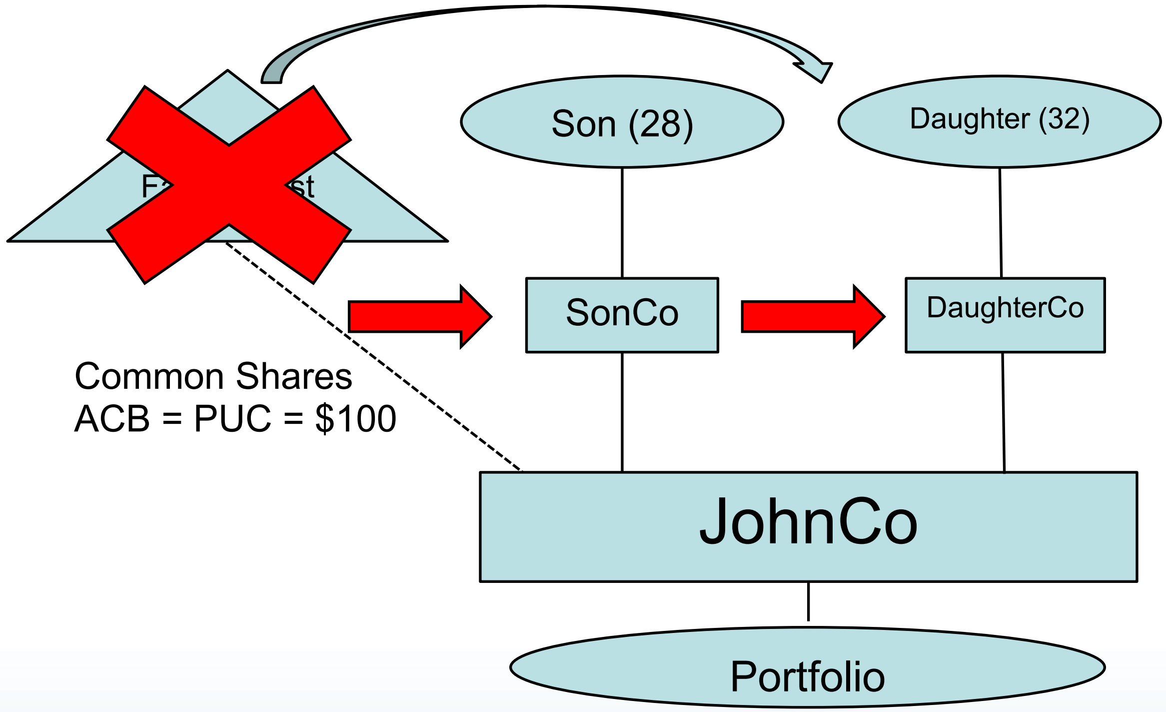
Scenario C – 21-Year Trust Planning (con't)

Proposed Planning



Scenario D – 21-Year Trust Planning (con't)

- A variation to the facts in Scenario C, assume that JohnCo owns only a portfolio of investments and that it is not an active business.



Scenario E – Common Butterfly Transactions

- Another variation to the facts in Scenario A, assuming that JohnCo is 50% owned by John and by his daughter, a U.S. citizen
- JohnCo has two business divisions. John's daughter is responsible for division 2.
- What are the implications to the daughter of a common Canadian single-wing butterfly transaction implemented under paragraph 55(3)(a) of the *Income Tax Act* (Canada) in order to have the assets relating to division 2 of JohnCo spun-out to a new corporation owned entirely by the daughter?

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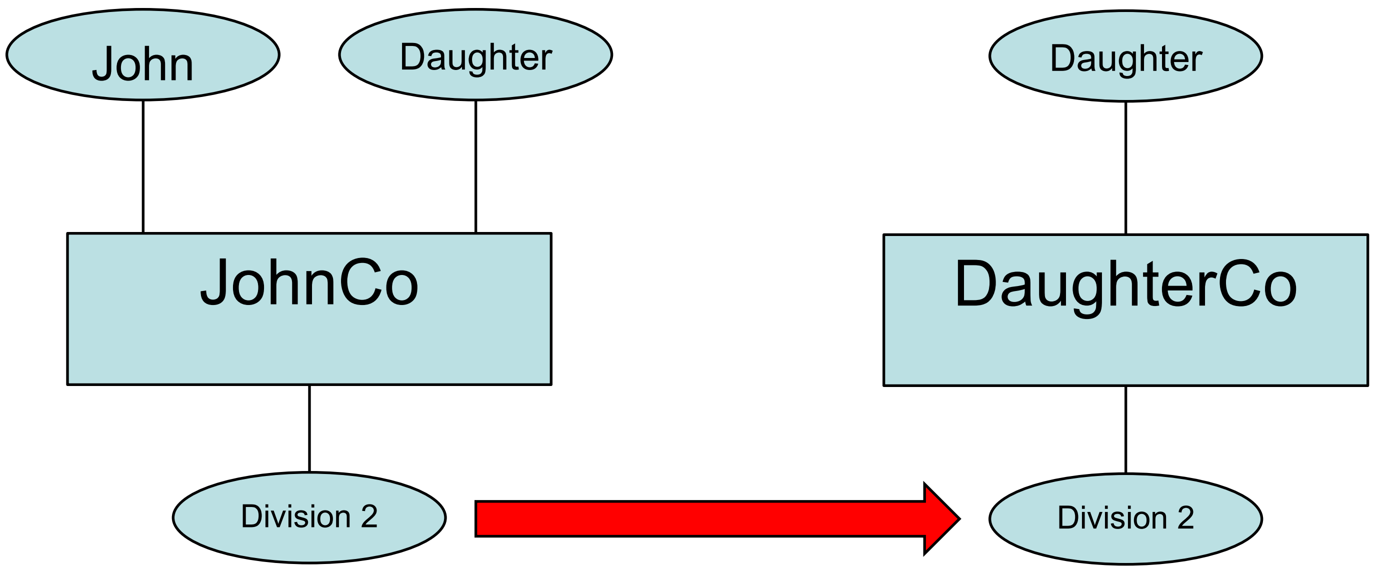
Scenario E – Common Butterfly Transactions

After Reorganization (Proposed Structure)



Scenario F – Common Bare Trustee Planning

- Common Canadian property ownership planning with numbered corporation owning legal title to property
- Declaration of trust/nominee agreement evidences bare trustee relationship between the corporation and the beneficial owners
- Beneficial owners are responsible for the payment of ongoing expenses related to the property (i.e. municipal taxes, insurance, utilities)
- What are the U.S. tax implications to the beneficial owners if they are U.S. Persons?

Scenario G – Certain Trusts and U.S. Property

- Trusts (could be *alter ego* or joint partner trusts, for Canadian planning purposes) in which settlor/grantor maintains control of trust capital
  - Settlor has beneficial interest in respect of trust capital
  - Settlor has the ability to appoint/replace trustees or to otherwise direct the capital to certain beneficiaries as if he or she retained ownership interest
- 75(2) of the *Income Tax Act* (Canada) could apply to the trusts in question
- Assuming that the trusts own U.S. *situs* investments (i.e. shares of U.S. corporations) what are the U.S. tax implications to the settlor? Can such trusts be used as a means of avoiding the implication of U.S. estate tax on death?

U.S. Income Tax As It Relates To Canadian Shareholders and Beneficiaries

U.S. Anti Deferral Rules

Controlled Foreign Corporation ("CFC")

- A U.S. Shareholder of a Controlled Foreign Corporation ("C.F.C.") must include in her income currently her share of Subpart F Income of the C.F.C.
- A CFC is a corporation organized outside the U.S. that is more than 50% owned by U.S. Shareholders, measured by vote or value
- A U.S. Shareholder is a U.S. person that directly, indirectly, or constructively owns shares holding at least 10% of the total combined voting power of the foreign corporation

Passive Foreign Investment Company ("P.F.I.C.")

- A non-U.S. corporation meeting either the income test or the asset test is a P.F.I.C.
  - Income Test: 75% or more of the FC's gross income is passive income (defined under the foreign personal holding company income rules)
  - Asset Test: 50% or more of FC's average assets could or does produce passive income
- Overlap test with C.F.C. rules and 10% U.S. Shareholders

P.F.I.C. (Cont'd)

- Three regimes of taxation for a U.S. person that is a shareholder of a P.F.I.C.:
  - Excess Distribution Regime
  - Q.E.F. Regime
  - Mark-to-Market Regime

P.F.I.C. (Cont'd)

- Excess Distribution Regime
  - An excess distribution is (i) any distribution (ii) received from a P.F.I.C. during the taxable year (iii) that exceeds 125% of the average of the distributions (iv) received over the preceding 3 taxable years
  - Taxation of excess distribution
    - Thrown back to each year in the holding period
    - Taxed as ordinary income in at the highest rate applicable in each throwback year
    - Deemed late tax payment subject to interest charge
  - Gains from a direct or indirect disposition of shares in a P.F.I.C. are treated as excess distributions

P.F.I.C. (Cont'd)

- Look-thru rule applies if HoldCo owns more than 25% of a lower-tier company
  - Dividends disregarded; shares are disregarded
  - HoldCo is deemed to receive directly its share of the income of lower-tier entity, not dividend income
  - HoldCo is deemed to own directly its share of the assets of lower-tier entity
- C.F.C. rules trump P.F.I.C. rules for 10% U.S. Shareholders
- Once a P.F.I.C. always a P.F.I.C., except as provided

P.F.I.C. (Cont'd)

- Q.E.F. Election
  - A P.F.I.C. shareholder may elect to treat the P.F.I.C. as a Q.E.F. -- the shareholder is taxed annually on a ratable share of corporate earnings (similar to a partnership)
  - If Q.E.F. election is made after first year of ownership, a purging election is required to protect future gain from excess distribution rule
    - The shareholder takes into account all earnings of a P.F.I.C. that is a C.F.C. or
    - The shareholder takes into account the appreciation of shares the over their holding period
    - The excess distribution rules applies

P.F.I.C. (Cont'd)

- Mark-To-Market election for publicly traded funds
  - Gain or loss recognized each year based on increases or decreases in value of fund
  - Losses are limited to previously recognized gains

Attribution Rules

- Shares owned by a trust, family members, and entities (or their members) may be attributed to others
- Stock owned by a foreign trust is considered to be owned proportionately by its beneficiaries
  - If fixed interest, look to actuarial values
  - If discretionary, look to distribution pattern
  - If no distributions in a discretionary trust, look to rules of intestacy

Attribution Rules

- Stock owned by attribution may be reattributed under rules for family, corporations, and other entities
- Stock owned by an individual may be attributed up and down a family line, but not attributed a second time to another family member
- Stock owned by a nonresident alien individual is not attributed to a U.S. individual
- Stock owned by a corporation or partnership is attributed to shareholders or partners
- Stock owned by shareholders or partners are attributed to a corporation or partnership
- Option holders are deemed to have exercised options

P.F.I.C. Attribution

- Stock owned, directly or indirectly, by or for a trust is considered to be owned proportionately by its beneficiaries. Section 1298(a)(3)
- Distribution from trust of P.F.I.C. shares may be treated as a recognized transaction
- Distribution from P.F.I.C. to trust is treated as being a distribution from P.F.I.C. to U.S. beneficiaries

Unlimited Liability Corporations (U.L.C.)

- Entity Classification Rules
- A corporation that is on a list published by the I.R.S. is treated as a corporation
  - Special treatment for U.L.C.'s
- Other entities
  - Default treatment
    - Treatment as a corporation if no member has unlimited liability
    - Treatment as a partnership or disregarded if at least one member has unlimited liability

Unlimited Liability Corporations (ULC)

- Tax Treatment under residence provision of treaty for hybrid entities such as an L.L.C.
  - An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a U.S. where:
    - The person is considered under the taxation law of the U.S. to have derived the amount through an entity (other than an entity that is a resident of the Canada) and
    - By reason of the entity being treated as fiscally transparent under the laws of the US, the treatment of the amount under the taxation law of the U.S. is the same as its treatment would be if that amount had been derived directly by that person.

Distribution From Foreign Trusts

- If a foreign trust distributes its current year's distributable net income ("D.N.I.") on a current basis, flow-thru treatment is allowed to beneficiaries
- If distribution is in excess of D.N.I., U.S. beneficiaries will be subject to taxation under the throwback rule
  - Distribution is allocated to each year in accumulations period
  - Taxed at ordinary tax rates pursuant to a shortcut formula that produces average tax increase over a sample period
  - Average increase is allocated to each year
  - Interest charge is imposed for each year on late payment

U.S. Estate & Gift Tax

Estate Tax Inclusions for a Foreign Person

- All tangible personal property, intangible personal property, and real property are subject to U.S. estate tax if the property is situated in the U.S.
- Equity and debt securities are situated in the U.S. if the issuer is a U.S. entity
- U.S. situated property given away during lifetime for less than FMV measured in money or moneys worth can be included in a taxable estate of a foreign person in two instances:
  - Donor retains right to income/determine income - § 2036
  - Donor retains_right to revoke/amend trust – § 2038
- A U.S. situated asset over which a foreign individual has a general power of appointment may be included – § 2041

Section 2701-Estate Freeze Rules

- Creation of preferred interest and junior interests in a corporation, as in a freeze, are subject to the rules of § 2701
  - Value of “senior” interests is subtracted from the total value of the entity
  - The remainder is allocated to the junior interests
  - As senior interests retain value, the value of the junior interest is reduced, thereby reducing the gift tax value of the transferred interest and increasing estate tax of senior interest retained
  - Targets are U.S. persons in older generation

Section 2701-Estate Freeze Rules

- In making a determination in the context of a discretionary trust, it is assumed that the maximum exercise of discretion in favor of the person is made by the trustee
- Solely for purposes of determining whether a transfer of an interest to or for the benefit of a member is a gift – the value of certain distribution, liquidation, put, call, or conversion rights is determined as if exercised in the manner resulting in the lowest value being determined for all such rights

Outbound Transfers of Foreign Target Stock

Change of C.F.C. Status in Rollover

- Context is an exchange of shares in a C.F.C.
- Although the transaction may meet standards of a domestic rollover, because the issuer is a foreign corporation, Code § 367(a) and (b) add additional requirements to achieve tax-free treatment

Change of C.F.C. Status in Rollover

- U.S. transferor of shares of a Canadian target to a Canadian acquirer in an otherwise tax-free rollover
- Two provisions can apply
  - One addresses gain recognition
  - One addresses a toll charge as a condition of tax-free treatment

Change of C.F.C. Status in Rollover

- Nonrecognition of gain is allowed in the following circumstances:
  - The U.S. transferor owns less than 5% of vote and value of stock – rules of attribution apply
  - The U.S. transferor owns 5% or more of vote or value of stock and enters into a 5-year Gain Recognition Agreement
- Toll charge applies if:
  - The Canadian corporation loses status as C.F.C. or
  - The U.S. transferor loses status as a § 1248 person (no longer a U.S. Shareholder of a C.F.C.),
- Toll charge is the inclusion in income of the § 1248 amount attributable to stock transferred

Concluding Comments

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- This presentation covered often-asked U.S. tax questions related to common Canadian tax and estate planning matters
- The U.S. tax matters discussed in this presentation provide an overview of general issues to be considered when a Canadian restructuring involves U.S. shareholders and beneficiaries
- Each case will turn on its own individual facts and circumstances
- U.S. tax law differs from Canadian tax law and timely advice and assistance from competent U.S. tax counsel can be helpful