CROSS-BORDER INCOME TAX ISSUES IN OUTBOUND ESTATE PLANNING

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Increased Tax Complexity

- Whether between the US and Canada or the US and some other country, cross border transactions raise a host of US federal income tax issues that aren't presented in wholly domestic transactions.

- Many of these rules are aimed at taxing appreciation on US assets before the US loses jurisdiction to tax them or preserving the United States' taxing jurisdiction over certain business operations under "surrogate" foreign ownership where activities and resources essentially remain in the US.

- The results can sometimes be quite surprising to taxpayers.

International Tax Doesn't Just Happen to Large Multinational Corporations

We tend to think of international tax in the context of a "Google" or some other multinational corporate group or as applying to corporate M&A. However, complex and unexpected cross-border implications can also arise in other contexts, such as:

- Estate and financial planning for high net worth resident alien individuals, particularly entrepreneurs or venture capitalists
- Foreigners receiving US green cards through visas designed to encourage US investment (e.g. the E-B5 visa) who later seek to emigrate back to their home countries.

Severe US Income Tax Consequences Can Result without Careful Planning

These can include:

- An **"Exit Tax"** assessed on expatriating individuals --imposed on the fair market value of all assets on departure
- **Immediate income tax** on outbound asset transfers which otherwise would qualify for tax-free treatment under rules applicable to domestic transactions.
- **Recharacterization of a foreign entity acquiring US assets as a US entity** for *all* purposes of the Code going forward.
- **Required current inclusion of income** earned through certain foreign corporations, even if not distributed
- **Adverse US tax rules applicable to US real estate** (including U.S. corporations with substantial holdings in real estate) when disposed of by a foreign person.

ISSUES RAISED SPECIFICALLY BY US LLCs

- LLCs are popular and widely used in the U.S. because of the combined benefits of limited liability and favorable US tax treatment, but are less common in foreign jurisdictions.
- Some jurisdictions, like Canada, don't recognize the LLC entity structure and treat it as a corporation under their tax laws.
- Treaties can operate to eliminate treaty benefits where foreigners invest through a US LLC. The US-Canada treaty denies benefits to Canadians investing through transparent US LLCs.
- Canadian investors lose the benefit of lower treaty rates applicable to income.
- Canadian investors lose the benefit of tie-breaker residency provisions. Therefore, a US LLC wholly owned and controlled by Canadian investors may be treated as a taxable Canadian entity under Canada's residency rules, even though US law treats the LLC as resident in the US.

Hypothetical

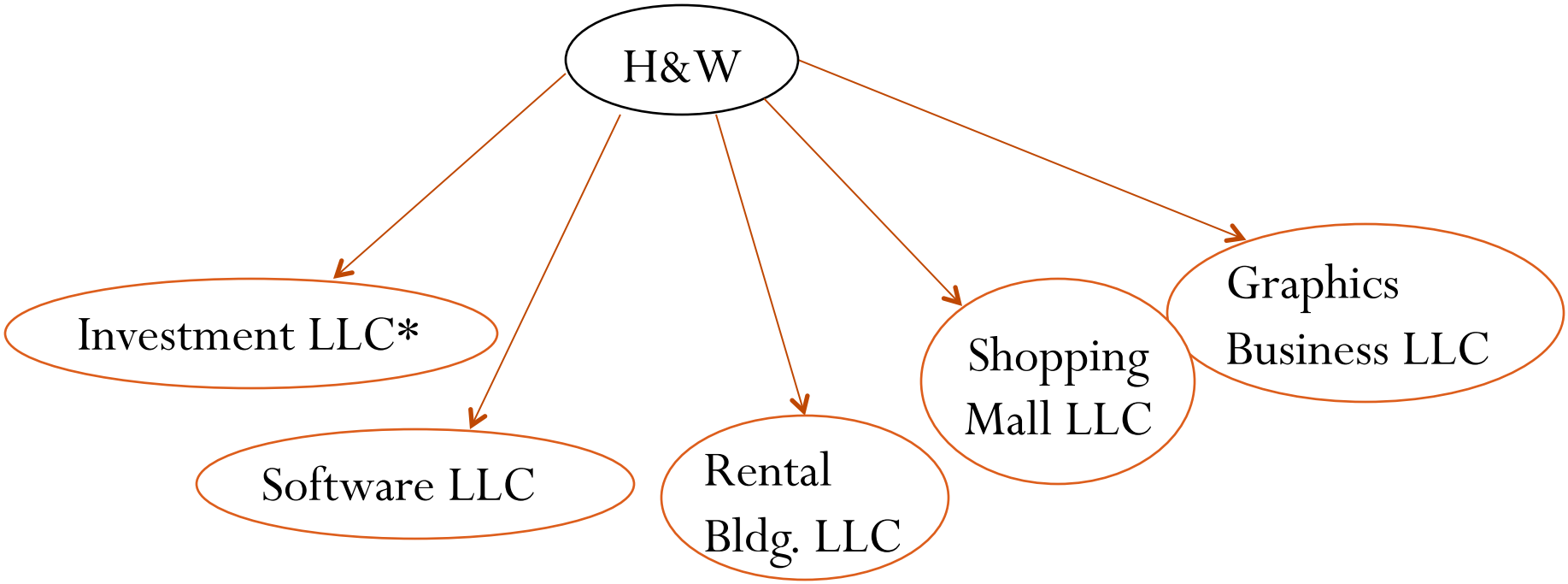
- H & W, a married couple, are Canadian citizens with US green cards. They have been living in the United States since January 1, 2007 and plan to retire in Canada to be near children and grandchildren. They intend to formally relinquish their green cards in connection with the move.

- H is a successful venture capitalist, and H & W own interests in over 40 active businesses operating in the United States, which businesses are held through various Washington LLCs.

- Several of the LLCs hold US real estate.

- H & W want to restructure their asset holdings so as to remove them from US estate tax as part of the relocation to Canada.

H& W's Holdings (simplified)



- All of H &W's WA LLCs are taxed as partnerships or disregarded entities for US federal income tax purposes.

* This LLC holds a number of minority interests in diverse businesses owned by H&W.

Proposed Plan

- Step 1: H & W transfer all of their LLC interests into one or more US corporations (referred to as "USCo") in exchange for 100% of the shares.
- Step 2: H & W transfer all of their shares in the newly formed US corporation(s) to one or more Canadian corporations (referred to as "Canco") in exchange for 100% of those shares.
- Step 3: H&W move to Canada.

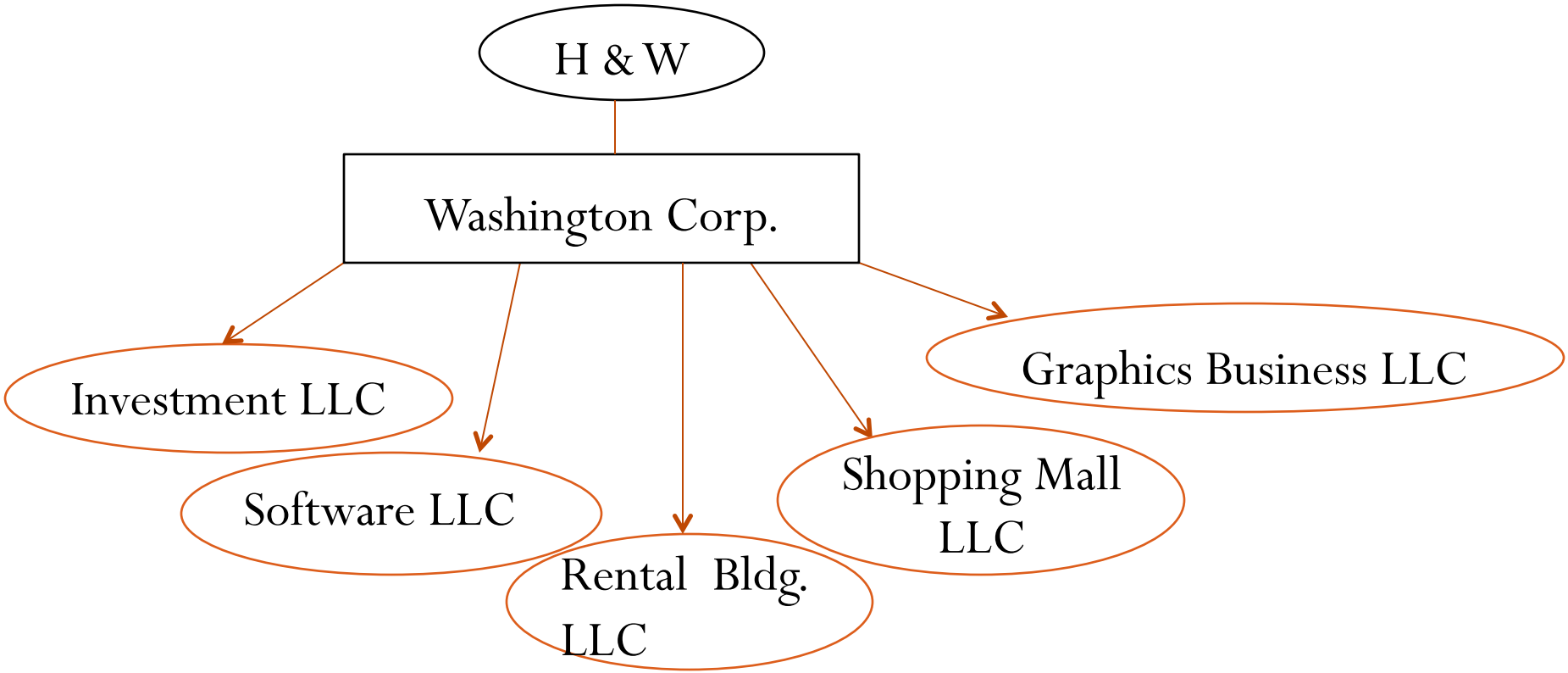
General Rationale for Plan

- Ownership of US situs assets through a partnership, or an LLC taxed as a partnership, leaves a nonresident foreign national subject to US estate tax risk.* Additionally, as mentioned, Canada does not recognize LLCs, a creature of US law, and taxes them as corporations.

- Emigration restructuring for estate planning purposes and Canadian tax planning purposes, therefore, generally contemplates transfer of US situs assets held through US partnerships or US LLCs to a US corporation followed by a transfer of the US corporation shares to a foreign corporation.

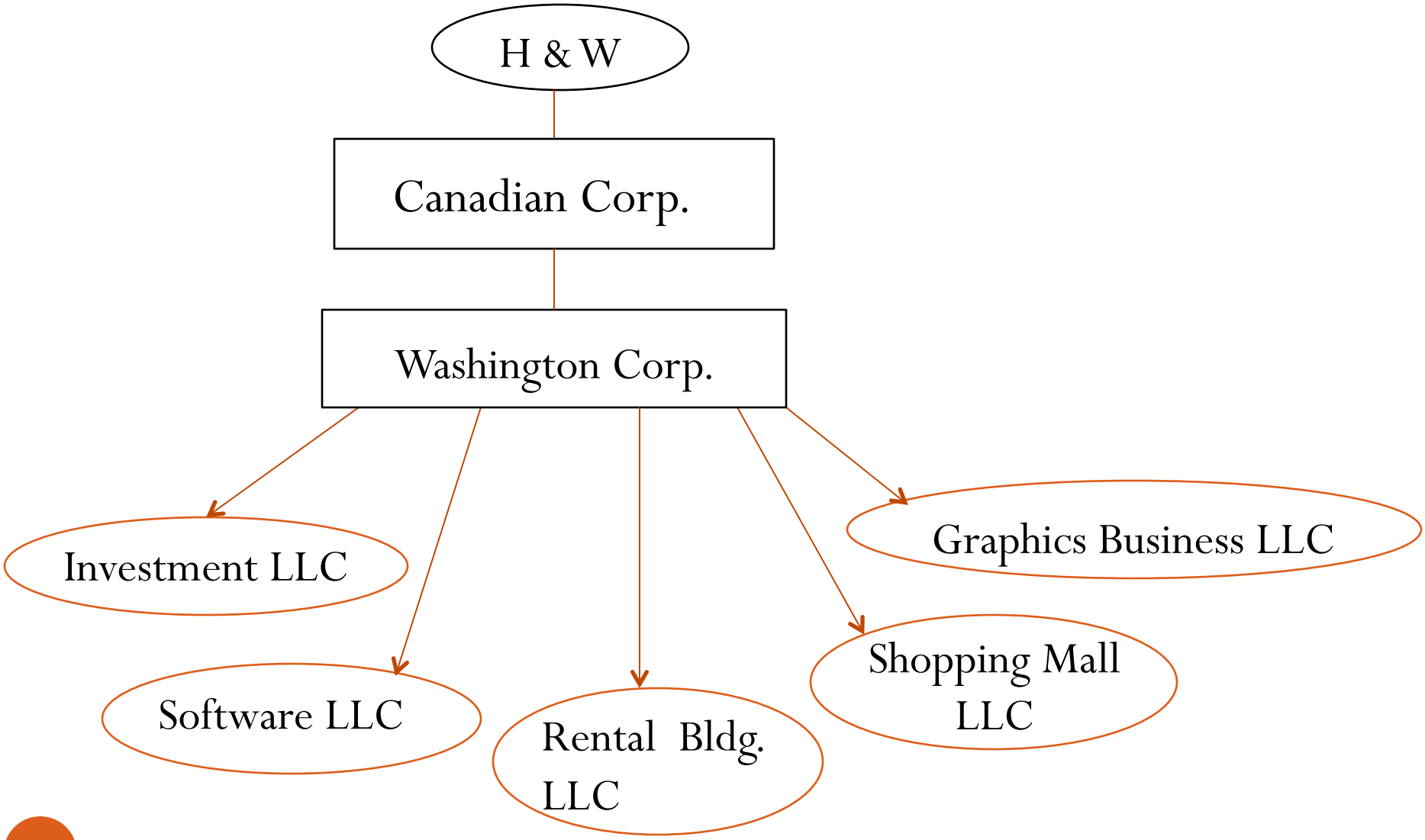
*Understanding is based on discussion with US estate and Canadian tax professionals.

H & W's Holdings after Step 1



Step 1 would be treated as a tax-free contribution in exchange for stock representing control of the corporation under section 351 of the Code, if this step were viewed in isolation.

H & W's Holdings after Step 2



Tax at the Turnstile -- Section 877A

As part of the Heroes Earnings Assistance and Relief Tax Act of 2008, Congress enacted a broad mark-to-market "exit tax" which taxes covered expatriates as though all of their assets were sold for fair market value on the day before they expatriated.

Codified under section 877A, the tax applies to expatriating U.S. citizens and "long term residents" who:

- have a net worth of $2,000,000 or more,
- had an average annual net income tax of $151,000 (for 2012) for the five years preceding expatriation or
- fail to certify that they have satisfied their U.S. tax obligations for the five preceding years.

Section 877A continued…

- For the purposes of § 877A, a "long-term resident" is defined as any individual who is a lawful permanent resident of the United States for at least 8 of the 15 taxable years prior to expatriation. Foreign nationals who have green cards are "lawful permanent residents" who could become "long term residents."
- H&W have had green cards since 2007 and, assuming continuous residency in the US, they will be treated as long term residents subject to the § 877A "exit tax" if they are still lawful permanent residents of the U.S. at any time during calendar year 2014.
- The remainder of this discussion assumes relocation prior to 2014 and that the exit tax does not apply.
- This exit tax can take people by surprise. Possible contexts include:
  - ❖ foreign nationals who enter the US on EB-5 visas, obtain green cards through investment and later wish to emigrate;
  - ❖ actual or effective abandonment of green cards by permanent residents due to change in residence;

Application of US Tax Rules to Cross Border Transfer as proposed in Step 2

- On its face, step 2 would also meet the technical requirements of a tax-free section 351 transaction – transfer of property to a corporation in exchange for stock representing control.
- However, unlike the previous step where the US retains taxing jurisdiction over appreciation in the corporate assets and stock, this transfer takes the contributed assets and their appreciation completely outside of the United States. Different policy considerations apply.

Section 367- *Transfers of Property from the U.S.*

General rule of section 367(a) (1) -- a foreign corporation shall not be considered to be a corporation in determining whether gain is recognized on a transfer if a United States person transfers property to a foreign corporation in connection with any of transactions below:

- Contributions of property to a controlled corporation - section 351
- Complete liquidations of subsidiaries – section 332;
- Statutory mergers and consolidations - ("A reorganizations");
- Acquisition of another corporation's stock –("B reorganizations");
- Acquisitions of another corporation's assets –("C reorganizations");
- Transfers to controlled corporations - ("D reorganizations") ;
- Recapitalizations – section 368(a)(1)(E) ("E reorganizations");
- Changes in the form or place of organization - ("F reorganizations");
- Insolvency reorganizations – section 368(a) (1) (G) ("G reorganizations").

THIS RULE GENERALLY RESULTS IN TAXABLE OUTBOUND REORGANIZATIONS

Special Rules for Intangibles

- Outbound transfers of intangibles are excluded from the general rule of section 367(a) and, instead, subject to special treatment under section 367(d).
- Section 367(d) deems the sale or exchange of the intangible to be made for contingent payments tied to productivity, use or a disposition of the property over its useful life…e.g., a deemed royalty. The deemed royalty payments must be commensurate with the income attributable to the transferred intangible.
- For transfers of intangible property made in a corporate reorganization after July 13, 2012, Notice 2012-19 requires that any cash or boot received with the corporate stock be treated as prepayment of deemed royalties recognized under section 367(d). The prepayment is required to be taken into income regardless of actual productivity despite the requirement that payments be commensurate with income attributable to the intangible property.

Active Foreign Trade or Business Exception

Section 367(a)(3) provides that a U.S. person's transfer of assets to a foreign corporation will not be subject to section 367(a) ((1) if the assets will be used by the transferee foreign corporation in an active trade or business conducted outside the United States. This is a factual determination.

- A trade or business is deemed to be a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit
- Activities must include all of the steps necessary to earn income in the trade or business, e.g., the collection of income and the payment of expenses.
- Activities related to the business and the assets themselves must be located outside the United States *immediately* after the transfer.

Certain Assets Ineligible for the Active Foreign Trade or Business Exception

Assets ineligible for the foreign trade or business exception include:

- ✓ copyrights;
- ✓ inventions and compositions;
- ✓ installment obligations and accounts receivable,
- ✓ foreign currency,
- ✓ intangible property;
- ✓ depreciable recapture property ; and leased property.

Application to Hypothetical

- The proposed transfer of USCo stock to CANCo is ineligible for this exception, as stock is intangible property. A transfer of an LLC interest or partnership interest would be similarly treated.

- A direct contribution of the business assets to CANCo would, likewise, not be eligible for the foreign active trade or business exception, as the assets and business operations will remain in the United States immediately after the transfer.

- This exception is not going to be satisfied in a cross-border holding company structure like the one proposed.

Exception for Transfers of Stock in a Recapitalization or Asset Reorganization

Exception for Asset Reorganization Stock Exchanges ("Reorganization Stock Exception")

- An exchange of foreign corporation stock by a US person in connection with a recapitalization under section 368(a) (1) (E) is not subject to tax under section 367(a).
- Likewise, domestic or foreign stock transferred in connection with asset acquisition reorganizations (which are not treated as indirect transfers of stock), e.g., A, C, D, F and G reorganizations, are not be taxable to the US shareholder. **However, the outbound transfer of assets by the US target corporation in connection with any of these reorganizations would be taxable to such corporation under section 367(a).**

Exception for Transfers of Foreign Stock

Certain Transfers of **Foreign Stock** by a US Shareholder to a Foreign Corporation ("Foreign Stock Exception")

- An exception, found in Section 367(a)(2), provides that the general rule of section 367(a)(1) will not apply when a U.S. person transfers stock or securities of a foreign corporation to another foreign corporation pursuant to a reorganization, if: (i) the U.S. person owns less than 5% of the vote and value of the transferee stock immediately after the transfer, or (ii) the U.S. person enters into a 5 year gain recognition agreement ("GRA") with the IRS respect to the transferred stock or securities
- A GRA allows an eligible shareholder to avoid current taxation on gain under section 367, but requires an acceleration of the deferred gain, and resulting tax, upon the occurrence of certain triggering events, such as the transfer of all or part of the stock or securities received from the foreign corporation.

§367 –Limited Stock Exception

The transfer of domestic corporation stock or securities by a US person to a foreign corporation is not taxable under section 367(a) if three requirements are met:

- U.S. transferors receive 50% or less of the vote and value of the transferee stock in the transaction *and* U.S. persons who are officers or directors of the U.S. target or 5% transferee shareholders do not own more than 50% of the transferee stock,
- either the U.S. transferor is not a 5% transferee shareholder, or if the U.S. transferor is a 5% transferee shareholder, it enters into a GRA, and
- the transferee corporation has been actively engaged in business for at least three years

Limited Stock Exception Continued

The 3 Year Active Business Prong requires that:

- the transferee corporation be engaged in an active business outside the United States for the full 3 year period,
- there can be no intent on the part of the US transferor(s) and the transferee corporation to dispose of or discontinue the trade or business, and
- the business be substantial, defined under applicable regulations as having a value which equals or exceeds the value of the domestic transferred corporation at the time of the reorganization.

This exception is very narrow and hard to satisfy.

Exceptions to Application of Stock Transfer to Hypothetical

- The transfer of USCo stock to CanCo is not pursuant to a recapitalization or any of the other reorganizations for which the shareholder exchange of stock is excepted from section 367. Therefore the Reorganization Stock Exception does not apply.
- The Foreign Stock Exception is inapplicable.
- H & W will hold 100% of CANCo after the transfer, and CANCo cannot be said to have been engaged in an active trade or business for any period of time. Therefore the Limited Stock Exception also does not apply.

Application of section 367(a) to Hypothetical

- If effected prior to H&W 's migration to Canada, the proposed transfer of USCo stock to CanCo falls squarely within the parameters of section 367(a).

- Section 367 applies to transfers by "US persons." If at all possible, therefore, the second transfer should take place ***after*** US residency has been abandoned and Canadian residency acquired, ***e.g., when neither H nor W is a taxable US person.*** Then section 367 will not apply.

  This is by far the easiest way to avoid application of section 367.

CONSIDER STEP TRANSACTION RISK

- It is also important to guard against treatment of the transfers as one transaction occurring while H & W are US residents under "step transaction" principles.
- Ideally, steps 1 and 2 should occur in different tax years with as much time in between H & W's relocation and step 2 as possible.
- Where optimal results depend on a steps being treated as occurring separately, or in a particular order, separate the steps as much as possible to support this treatment.

Section 367(b)

- Section 367(b) is aimed at capturing tax on foreign earned income which is being repatriated into the United States without tax, such as through liquidation of a foreign corporation into its US parent, or an acquisition by a domestic corporation of its foreign subsidiary's assets in a tax-free reorganization. Section 367(b) can apply even if section 367(a) does not
- Section 367(b) can operate to require shareholders transferring foreign corporation stock to recognize gain in what would otherwise be a tax-free transaction, denying carryover treatment for basis, E&P and attributes.
- As the hypothetical does not involve an in-bound transfer of assets or of shares in a foreign corporation, section 367(b) does not apply.

US Shareholders in Foreign Corporations

If step 2 occurs while H &W still reside in the US, H&W may be treated as owning shares in controlled foreign corporations ("**CFCs**") after Step 2, or in some cases, passive foreign investment companies ("**PFICs**").

Current income inclusion.

- Because shareholders in a corporation are not generally taxable until they receive dividend distributions from the corporation, investment in foreign corporations (not subject to US tax) by US persons presents an opportunity for tax deferral and/or avoidance.
- Both Subpart F of the Code, applicable to CFCs, and the rules applicable to PFICS, are intended to address potential deferral, and operate to require that US shareholders in these entities pay current US income tax on certain types of undistributed income. It is possible that the CFC regime, and perhaps the PFIC rules, would apply to H & W with respect to their ownership of one or more of the Canadian corporations created to acquire the US businesses, if step 2 occurs before the H & W have migrated to Canada.

CFC Regime (General)

- Subpart F of the Code (sections 951-964) requires holders of a CFC to include income derived by the corporation from certain sources on a current basis, whether or not such amounts are distributed.
- U.S. anti-deferral rules (Subpart F of the Code) primarily target passive income and certain active income, such as sales and service income, earned through related party transactions that separate the earnings from the activity creating business value – generally moving the profits to a lower tax jurisdiction.
- A foreign corporation is a CFC if: **50%** or more of the vote and value is owned by US shareholders holding **10%** or more of the stock (e.g., **5 or fewer 10% shareholders**).
- Most active income earned by CFCs will not be subject to current inclusion under the CFC regime.

PFIC Regime

- The PFIC rules are contained in sections 1291-1298 of the Code and apply to US holders in foreign corporations which meet a certain threshold of passive income or assets.
  A foreign corporation is a PFIC if for any tax year either:
  - **75%** or more of gross income is passive
  - **50%** or more of total assets are passive (determined on a quarterly basis and averaged)

Passive income generally includes: dividends, interest, gain from the sale of stock or securities, rents and royalty income (tied to definition of CFC foreign personal holding company income).

Passive assets generally are assets which generate passive income.

PFIC Regime Continued

- Under the PFIC rules, distributions which exceed 125% of the prior 3 year average are "excess distributions" subject to tax and potential interest penalty.
- The amount of these distributions is allocated pro rata over the taxpayer's holding period for the PFIC shares and tax (at rates applicable to ordinary income for the period(s) in question); interest is assessed as if the tax was due and owing over this period and not paid.
- Gain from the sale of PFIC stock is treated as an excess distribution subject to the same treatment as excess distributions which has the added effect of converting capital gain into ordinary income.
- Certain elections, if available, can mitigate the impact of these rules.

Section 7874 -- Rules Relating to Expatriated Entities and Their Foreign Parents

Section 7874 was added by the American Jobs Creation Act of 2004 to discourage tax-motivated inversion transactions (i.e. outbound migrations of U.S. companies to avoid U.S. federal income taxation).

Depending on the level of shareholder continuity, section 7874 either requires:

- recognition of gain from the inversion transaction over a 10 year period following the transaction with limited availability of offsetting credits and deductions,
- or, in its harshest form, treatment of the acquiring foreign corporation as a US corporation for all purposes of the Code (including estate and gift tax!).

Three Requirements of Section 7874

- ***An Acquisition.*** *Pursuant to a plan, (or series of related transactions)*, a foreign corporation "directly or indirectly" acquires substantially all of the properties held directly or indirectly by a U.S. corporation. Acquisition of stock of a domestic corporation is treated as an acquisition of a proportionate portion of the corporation's underlying assets.
- ***At least 60% Continuity.*** After the acquisition, former shareholders **(whether foreign or US)** of the U.S. corporation own at **least 60%** of the acquiring foreign corporation "by reason of" their previous interest in the U.S. corporation. Where former shareholders own **80% or more** of the acquiring foreign corporation, section 7874 treats for foreign corporation as *a US corporation for all purposes of the Code* even though the entity is organized and taxable in the foreign jurisdiction.
- ***No Substantial Business Activities in Foreign Country.*** After the acquisition, the "expanded affiliated group" ("EAG") which includes the acquiring foreign corporation does not have substantial business activities in the foreign country under which the acquiring corporation was organized, when compared to the total business activities of the "expanded affiliated group."

New Bright-line Test for Substantial Activity

- Under Treas. Reg. 1.7874-3T(b)(1)), effective for acquisitions completed on or after 6/7/12, substantial business activity for an EAG will be deemed to exist after an acquisition *only if* a bright-line 25% threshold of presence is met:
  - ***Employees.*** At least 25% of the group employees are located in the relevant foreign country. To meet this condition: (i) on the "applicable date," at least 25% of the total number of group employees must be based in the relevant foreign country; and (ii) at least 25% of the total compensation of all group employees must be paid to group employees based in the relevant foreign country during the one-year testing period;
  - ***Assets.*** At least 25% of the value of the group's total assets. (i.e., tangible personal or real property used or held in the active conduct of a trade or business by EAG members, including certain rented property) is located in the relevant foreign country on the applicable date; and
  - ***Income.*** 25% of the group's income (i.e., gross income of EAG members from transactions occurring in the ordinary course of business with unrelated customers) is derived in the relevant country during the one-year testing period.

Bright-Line Test --Concepts

- The preamble to the temporary regulations indicates that income will be treated as derived in a foreign country only if the customer is located in such country.
- The applicable date is either the date on which the acquisition is completed or the last day of the month immediately preceding the month in which the acquisition is completed.
- The testing period is the one-year period ending on the applicable date.
- When the applicable date is the last day of the month immediately preceding the month in which the acquisition is completed, group employees, employee compensation, group assets, and group income consist of those items or amounts of members that comprise the EAG determined at the close of the acquisition date.

Prior Facts and Circumstances Test

The bright-line test replaces a purely facts and circumstances approach for determining whether substantial business activity exists in the foreign jurisdiction. For acquisitions completed **prior to June 7, 2012**, the facts and circumstances test still applies. The prior regulations enumerated factors considered indicative of substantial business activity:

- ***Historical presence*** as evidenced through the conduct of continuous business activities in the foreign country by members of the corporate group prior to the acquisition;
- ***Operational activities.*** Business activities of the corporate group in the foreign country occurring in the ordinary course of the active conduct of one or more trades or businesses, involving— (1) property located in the foreign country which is owned by members of the corporate group; (2) the performance of services by individuals in the foreign country who are employed by members of the corporate group; and (3) sales to customers in the foreign country by corporate group members;
- ***Management activities.*** The performance in the foreign country of substantial managerial activities by corporate group members' officers and employees who are based in the foreign country;
- ***Ownership.*** A substantial degree of ownership of the corporate group by investors resident in the foreign country. ("substantial degree" is not defined)
- ***Strategic factors.*** The existence of business activities in the foreign country that are material to the achievement of the corporate group's overall business objectives.

Hypothetical – Insufficient Activity in Canada

- The Canadian corporation is being formed for purposes of the acquisition, and, at the time of creation has no employees, assets or income in Canada. Therefore, it fails to meet the 25% threshold of presence and activity in Canada and thus the expanded affiliated group cannot be said to have substantial business activity in Canada currently.
- Therefore, if section 7874 is to be avoided on the basis of substantial business activity in Canada, effort would have to be directed towards developing sufficient Canadian based business activities and operations through CanCo such that the substantial business activity requirement could be met. Alternatively, H & W would have to acquire one or more Canadian based businesses with sufficient employees, assets and income to satisfy the 25% requirement.

Section 7878 – Presumption of a "Plan"

- Section 7874 applies to outbound migrations of U.S. businesses where "pursuant to a plan (or series of related transactions)" a foreign corporation acquires property of a domestic corporation or partnership.
- A "plan" is deemed to exist if a foreign corporation acquires directly or indirectly "substantially all of the properties of a domestic corporation or partnership" during the 4 year period starting 2 years before the foreign corporate stock is acquired and ending two years after this date.
- Unlike other rules in the Code which create the rebuttable presumption of a plan under certain circumstances and time periods, the presumption created under 7874 is irrebutable if substantially all of the properties of a domestic corporation or partnership are transferred to a foreign surrogate within the stated time period.

Application of Section 7874 to Hypothetical

- The transfer of USCo stock to CANCo is treated under section 7874 as a transfer of 100% of the assets held in USCo.

- Absent development of substantial business activity in Canada, or alternative ownership structures for CanCo where H & W retain less than 80% ownership, CANCo will be treated for *all purposes of the US Code* (including estate and gift tax) as a domestic corporation even though it is organized and taxable in Canada.

Planning Around Section 7874

- Section 7874 would presume the existence of a plan for any asset transfer meeting its conditions occurring within 2 years after H & W receive stock in CanCo. There is no authority saying the converse is true, e.g., that transfers outside this window would *not* be considered pursuant to a plan. However, it is advisable for H & W to wait at least two years after acquiring their CanCo stock before transferring USCo stock to CanCo pursuant to step 2.
- As soon as H & W move to Canada, they should either start developing active business with active business assets in Canada to acquire USCo or, alternatively, acquire an existing Canadian business which will be used effect the acquisition of USCo.
- Another option is to structure the reorganized holdings such that over 40% of CanCo is owned by others so as to break continuity and avoid application of section 7874. Possibly, this could be achieved through gifts to family members for whom stock ownership would not be attributed back to the H & W (e.g., son-in laws, daughters-in law, or other non lineal descendants) under existing stock attribution rules (§318)

Special Considerations for Real Estate

- In 1980, the Foreign Investment Real Property Tax Act ("FIRPTA") amended the Code to add section 897, a regime designed to tax foreign persons on gain from the sale of U.S. real property.

- Under these rules, gain or loss recognized by a foreign person on the disposition of a United States real property interest (a "USRPI") is taxable in the United States as income or loss effectively connected with a U.S. trade or business, taxable at graduated ordinary income rates applicable to US taxpayers.

- The FIRPTA rules supersede the general rules which would not tax the sale of personal property located in the United States by nonresident aliens and foreign corporations.

FIRPTA Rules continued

- Generally, a USRPI includes interests in:
  - real property located in the U.S.; *and*
  - interests in United States real property holding corporations ("USRPHCs").
- A domestic corporation is a USRPHC if at any point within the five prior years ("Five Year Look-Back Rule"), 50% or more of its total asset value consists of USRPIs.

FIRPTA Rules continued

- The FIRPTA tax is imposed through a mechanism of withholding requiring the transferee of a USRPI to deduct and withhold 10 percent of the amount realized on the transfer.
- US treaties preserves the authority of the United States to tax the disposition of a USRPI by a foreign resident.
- The burden of showing that shares in a domestic corporation are not USRPIs falls on the taxpayer. Therefore, for *any* transfer of US corporate stock by a nonresident alien or foreign corporation, certification that the corporation is not a U.S. real property holding corporation must be delivered to the transferee in order to avoid 10% withholding on the transfer. Certificates allowing for reduced withholding may be obtained from the IRS in some circumstances.

FIRPTA CLEANSING

- If a USRPHC disposes of all of its property in a taxable transaction in which the full amount of gain is recognized, stock in the corporation ceases immediately to be a USRPI and the gain realized by foreign shareholders on a sale of such stock will not be subject to FIRPTA.
- This "cleansing" sale of assets by the USRPHC effectively functions as an exception to the Five Year Look-Back Rule.
- When shareholders receive distributions in liquidation of a U.S. corporation, they are treated as receiving payment in exchange for their shares (i.e., selling their shares).
- Therefore, a foreign shareholder receiving a liquidating distribution from a former USRPHC that has just sold all of its USRPI assets should be able to avoid US tax and application of FIRPTA to its receipt of these proceeds from the sale of US real estate.

Application of FIRPTA to hypothetical

- For business and tax reasons, H & W's real estate assets will likely be placed in one or more corporations separate from the other LLC assets. These U.S. corporations which hold real estate will, therefore, qualify as USRPHCs after the first step.
- Consequently, if step 2 takes place after H & W have given up US residency and acquired Canadian residency, as recommended, the transfer of shares in the US corporations holding the real estate will trigger FIRPTA withholding and potential FIRPTA tax, unless an exception applies.
- It is possible a reduced withholding certificate could be applied for and acquired from the IRS if the FIRPTA tax would be less than the required 10% holding, or if the acquisition of USRPHC shares can be structured to come within an exception from FIRPTA tax and withholding for nonrecognition transfers.

FIRPTA Planning

- There is some opportunity to plan around the FIRPTA rules. The FIRPTA rules apply to sales of USRPIs by foreign persons. Therefore, a sale of a USRPI by a U.S. taxpayer, such as a U.S. corporation, would not, itself, trigger the application of FIRPTA.
- Furthermore, where a USRPHC sells all of the USRPIs it has owned during the past five years in a taxable transaction, its status as a USRPI ceases immediately and the Five Year Look-Back Rule no longer applies. The US corporation then is essentially cleansed of its status as a USRHC
- If the proceeds are distributed to H & W in liquidation of the respective USRPHCs after a sale of the underlying real estate, these amounts will not be subject to FIRPTA. Such amounts will, likewise, also escape US taxation under section 871, as they would be considered received in exchange for H & W's shares in a corporate liquidation, and therefore would not be subject to US tax.
- While this approach leaves H & W subject to increased US estate tax risk, the avoidance of section 7874 and FIRPTA arguably the risk worth it.

Recommendation

- CANCo's acquisition of the non-real estate assets needs to occur at least 2 years after receipt of C's Canco stock such that transfers are not presumed to be part of a plan.
- In the interim, active business satisfying the new 25% threshold for employees, assets and income into which the U.S. businesses can be absorbed should be developed or acquired in Canada.
- More than one Canco-USCo holding structure may be used for the non-real estate assets, as business needs warrant.
- US real estate should be held in separate US corporations directly owned by H &W to plan around FIRPTA.

Recommended Holding Structure