International Tax Considerations – Special and complex US tax rules aimed at preserving US taxing jurisdiction over appreciation occurring in the United States significantly change the US tax rules otherwise applicable to purely domestic mergers and acquisition transactions. Some rules require gain recognition on otherwise tax-free transactions involving outbound transfers of property and/or stock or securities (section 367 of the Code[1]), others focus on expatriation of business assets across the US border, requiring gain recognition and even treatment of the acquiring foreign entity as a taxable domestic corporation where a certain shareholder continuity level is met (section 7874 of the Code) and still others subject US persons holding shares in foreign entities with substantial passive income and assets to an alternate, generally adverse tax regime (section 1291 et. al.). Foreigners who hold interests in US real estate, directly or through corporations are also subject to special tax rules which can subject them to adverse tax consequences on a sale of such US real estate interests (sections 897 and 1445).

US Rules Normally Applicable to Qualifying Corporate Reorganizations

Nonrecognition treatment is generally accorded to qualifying:

Contributions of property to a controlled corporation - section 351 ("Section 351 transfers");

Complete liquidations of subsidiaries – section 332 ("Section 332 liquidations");

Statutory mergers and consolidations - section 368(a)(1)(A) ("A reorganizations");

[1] All references to the Code are to the Internal Revenue Code of 1986, as amended.

Acquisitions by one corporation of another corporation's stock – section 368(a)(1)(B) ("B reorganizations");

Acquisitions by one corporation of another corporation's assets – section 368(a)(1)(C) ("C reorganizations");

Transfers to controlled corporations - section 368(a)(1)(D) ("D reorganizations") ;

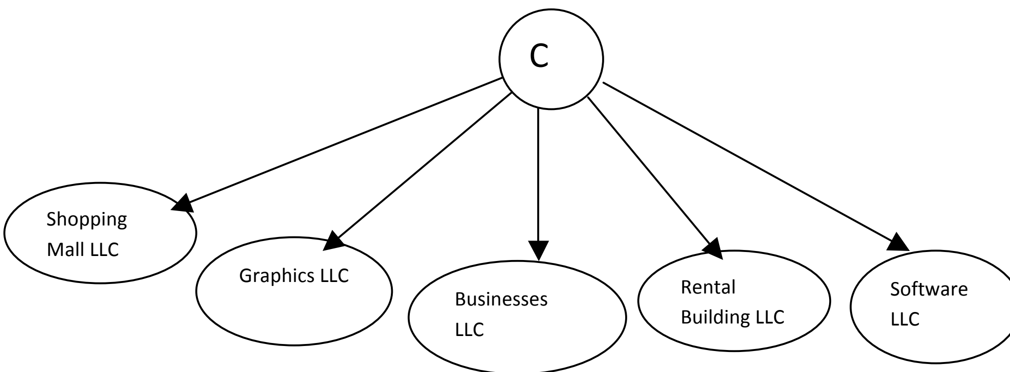
Recapitalizations – section 368(a)(1)(E) ("E reorganizations");

Changes in the form or place of organization - section 368(a)(1)(F) ("F reorganizations")

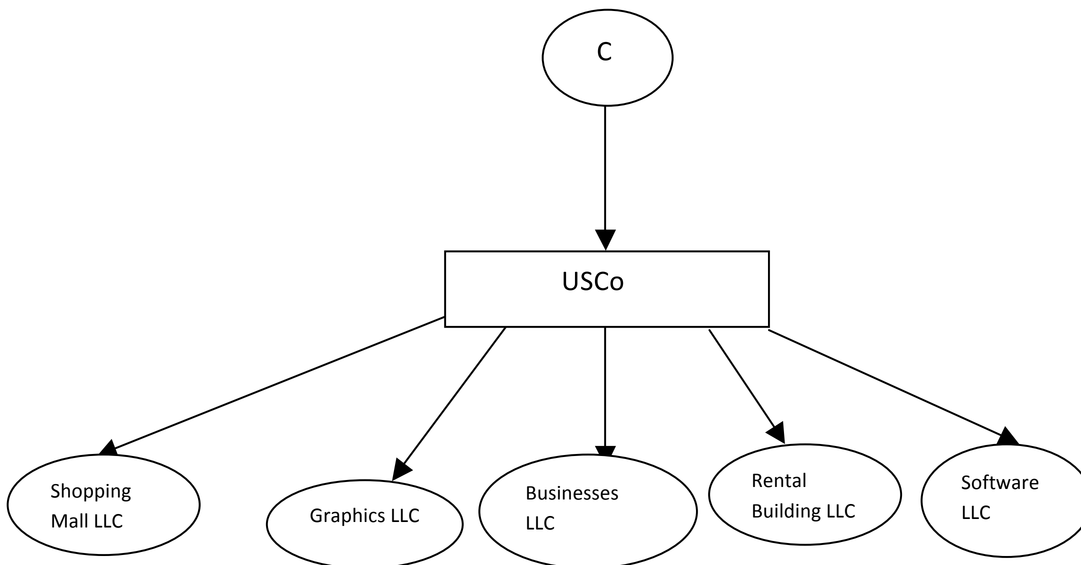
Insolvency reorganizations – section 368(a) (1) (G) ("G reorganizations").

HYPOTHETICAL:

Diagram showing Client holdings, businesses each currently held 100% by Client and spouse ("C").



Step 1: Consolidation of ownership under single US corporation. C transfers interests in each LLC to newly formed USCo in exchange for 100% of USCo shares. After the exchange, C's business holdings look as follows:



Tax Result

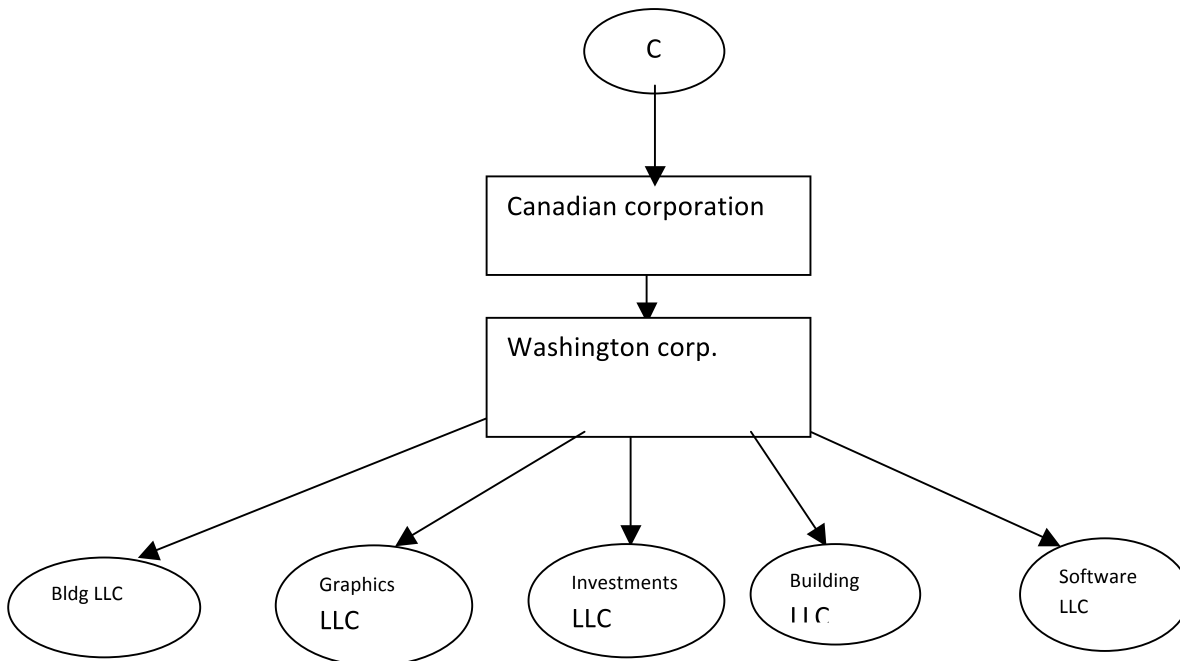
Tax-free contribution of property to a controlled corporation (80% vote and value) under section 351 of the Code:

Client takes a basis in the corporation shares received equal to the aggregate basis in the assets contributed under section 358 of the Code.

USCo takes a basis in the assets received equal to the basis of Client in the transferred assets under section 362.

Appreciation preserved at the shareholder and corporate level for taxation by the US at a later time.

Step 2: The next step proposed is a transfer by Client of his shares in USCo to a newly formed Canadian corporation ("CANCo") in exchange for CANCo shares. After this transfer, Client's holdings would look as follows:



Technically, this step would also meet the requirements of a section 351 transfer. However, unlike the previous step where the US retains taxing jurisdiction over appreciation inherent in the contributed assets at the corporate and shareholder level, this transfer takes the contributed assets and their appreciation outside of the United States. Different policy considerations and tax rules apply to "outbound" transfers.

Section 367 ***Transfers of Property from the United States***

General rule of section 367(a) (1). If a United States person transfers property to a foreign corporation in connection with any of the transactions below:

Contributions of property to a controlled corporation - section 351 ("Section 351 transfers");

Complete liquidations of subsidiaries – section 332 ("Section 332 liquidations");

Statutory mergers and consolidations - section 368(a)(1)(A) ("A reorganizations");

Acquisitions by one corporation of another corporation's stock – section 368(a)(1)(B) ("B reorganizations");

Acquisitions by one corporation of another corporation's assets – section 368(a)(1)(C) ("C reorganizations");

Transfers to controlled corporations - section 368(a)(1)(D) ("D reorganizations") ;

Recapitalizations – section 368(a)(1)(E) ("E reorganizations");

Changes in the form or place of organization - section 368(a)(1)(F) ("F reorganizations")

Insolvency reorganizations – section 368(a) (1) (G) ("G reorganizations").

such foreign corporation shall not be considered to be a corporation for purposes of determining the extent to which gain shall be recognized on the transfer.

This has the result of causing the transfer to be taxable, because corporate status of

the transferee entity is required for tax-free treatment of the transactions enumerated above.

Against this backdrop are various exceptions with very specific requirements, often hard to satisfy.

Exception for Assets Used in an Active Foreign Trade or Business

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 assets must be located outside the United States immediately after the transfer.
>
> Certain assets are ineligible for the foreign trade or business exception:
> copyrights; inventions and compositions;
> installment obligations and accounts receivable,
> foreign currency,
> intangible property;
> depreciable recapture property
> and leased property.

Application of Foreign Trade of Business Exception to hypothetical: The proposed transfer of USCo stock to CANCo is ineligible for this exception, as stock is intangible property. A direct contribution of the LLC business assets to CANCo would, likewise, not be eligible for the foreign active trade or business exception as the assets and business operations remain in the United States. This exception is difficult to satisfy.

Exchanges of Stock by US Shareholder Pursuant to Certain Reorganizations

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 would be taxable to such corporation under section 367(a).

Certain Transfers of **Foreign Stock** by a US Shareholder to a Foreign Corporation

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) (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.

Certain Transfers of **US Stock** by a US Shareholder to a Foreign Corporation

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

(i) U.S. transferors receive 50% or less of the vote and value of the transferee stock in the transaction,

(ii) 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,

(iii) 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

(iv) the transferee has been actively engaged in business for at least three years.

The "actively engaged in business" prong requires that

a) the transferee be so engaged outside the United States for the full 3 year period,

b) there can be no intent on the part of the transferor and transferee to dispose of or discontinue the trade or business, and

c) 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.

Application of US stock exception to hypothetical: This exception is not applicable to the hypothetical, as Client 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.

Application of section 367(a) to hypothetical: Client's proposed transfer would appear to fall squarely within the parameters of section 367(a). If Client's timing and business plan allows, it might be possible to have the second transfer take place after US residency has been abandoned and Canadian residency acquired. Section 367 applies to transfers by "US persons". Care needs to be taken to avoid treatment of the transfers as one transaction occurring while Client is a US resident under "step transaction" principles of US tax law.

Note: Section 367(b), which is aimed at capturing tax on foreign earned income which is being repatriated into the United States without tax can come into play

even if section 367(a) does not apply. Section 367(b) may require recognition of certain amounts of gain if the foreign corporation is currently, or has been in the past, a CFC (basically, a foreign corporation closely held by US shareholders -- more than 50% of the total vote and value is owned by U.S. persons who each own 10% or more of the voting power of the corporation) and any of the exchanging shareholders have been such a 10% holders of the CFC during the 5-year period leading up to the exchange.

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 a10 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.

Section 7874 applies when three specific conditions are present:

1. **Acquisition of Substantially All of the Properties of a U.S. Entity by a Foreign Entity**

   A foreign corporation makes a "direct or indirect" acquisition of

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 assets of such corporation);

2. **Continuity of Ownership by Former Shareholders of U.S. Corporation**
   After the acquisition, former shareholders 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;

   If, after the acquisition, former shareholders own **80% or more**, 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.

3. **No Substantial Business Activities Conducted in the foreign jurisdiction by the Corporate Group**
   After the acquisition, the "expanded affiliated group" 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." This is a facts and circumstances determination, with no relative weighting given to factors listed as relevant in regulations issued under section 7874:
   - Historical presence. 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. (Surprise, surprise…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.

Application of section 7874 to hypothetical: The transfer of USCo stock to CANCo will be treated under section 7874 as a transfer of 100% of the assets held in USCo. The Canadian corporation was formed for purposes of the acquisition and therefore cannot be said to have substantial business activity in Canada. Under section 7874, CANCo would be taxable for all purposes of the US Code as a

domestic corporation even though it is organized and taxable in Canada.

If feasible, Client could have one or more entities with active business operations in Canada acquire the US business assets.

Sections 1291- 1298 ***Treatment of Certain Passive Foreign Investment Companies***

The PFIC rules were enacted in 1986 to address an abuse perceived in US investment through offshore investment vehicles which do not distribute income on a current basis. Thus, the rules impact US investors in companies with predominately passive income and/or assets. Foreign corporations earning primarily passive investment income or corporate businesses which are not generating revenue but have some investment income may be characterized as PFICs. Once an entity is characterized as a PFIC, it will continue to be treated as a PFIC with respect to its US shareholders, absent certain purging elections being made. This is referred to as the “Once a PFIC, always a PFIC” rule.

A foreign corporation will be treated as a PFIC if it satisfies either **a passive income test** or **a passive asset test**. Section 1297.

- Income test. A foreign corporation will be treated as a PFIC if 75% or more of its gross income is passive income. “Passive income” includes, for example, dividends, interest, certain rents and royalties, certain gains from the sale of stocks and securities, and certain gains from commodities transactions. Passive income is defined with reference to the definition of

passive income for purposes of the controlled foreign corporation rules in section 954.

- Asset test. A foreign corporation will be treated as a PFIC if the average percentage of its assets that produce passive income, or are held for the production of passive income, measured on a quarterly basis, is at least 50%.

A U.S. shareholder of a foreign corporation treated as a PFIC generally will be subject to adverse U.S. federal income tax consequences under the PFIC rules when such U.S. shareholder either

(i) disposes of its shares or

(ii) receives an "excess distribution" (generally, distributions for the year which in the aggregate exceed 125% of the average distributions received by such U.S. shareholder during the 3 preceding years or shorter share holding period). Under the PFIC rules, there can be an excess distribution even if the corporation does not have sufficient "earnings and profits" for a distribution under US accounting principles (such that the distribution would be a nontaxable return of capital).

Unless an election has been made, a shareholder subject to these rules is required to pro rate excess distributions or gain over his/her entire holding period for the PFIC shares and will be taxed at the highest ordinary income tax rates in effect during those prior years on such amounts. Additionally, the holder will be required to pay interest on the resulting tax liability as if it had been due in those prior years and not timely paid. These rules essentially penalize US investors

holding shares in corporate foreign investment vehicles which do not pay out income on a current basis, unless the holder elects out of the default PFIC regime.

When a foreign corporation owns 25% or more of a subsidiary entity, it is treated as directly receiving its proportionate share of the subsidiary's income and owning a proportion share of the subsidiary's assets for purposes of determining whether it is a PFIC under the income or asset test. Section 1297(c). There are certain other look-through rules that may or may not come into play depending on the circumstances.

The PFIC rules apply to any disposition of shares in a PFIC, including dispositions in connection with otherwise tax-free acquisition transactions, property contributions and corporate liquidations. Thus, these provisions must be considered in addition to sections 367 and 7874. There is, however, an exception for reorganization transactions involving an exchange of PFIC stock for stock in another corporation which is also a PFIC (known as the "PFIC for PFIC Exception").

MITIGATING ELECTIONS[2]

Qualified Electing Fund ("QEF") Election. If certain timing and other requirements are met, a holder of PFIC stock can elect out of the default PFIC tax regime pursuant to section 1293 of the Code but would be required to currently include income and gain from the corporation (calculated under US tax and

[2] Both elections are subject to various technical requirements and complications which are beyond the scope of this discussion.

accounting principles) on his or her US federal income tax return as if the corporation were a flow-through entity.

Mark to Market Election. Under section 1296, if certain requirements are met, a holder of PFIC shares can elect out of the default PFIC tax regime and mark his or her shares to market on a yearly basis (i.e., treat them as if they were sold for fair market value on the last day of the year) and pay tax on the resulting gain or account for the loss.

Application of PFIC to hypothetical: The contribution of USCo shares to CANCo in exchange for CANCo shares does not immediately implicate PFIC, since USCo is a domestic corporation. Additionally, if Client's loss of US residency and status as a taxable US person occurs before the outbound transfer of USCo, Client will not be subject to the PFIC rules because they only apply to US persons. If, however, this second transfer occurs while Client is still a US resident (either on the facts, or because the IRS deems this to be the case under the step transaction doctrine or otherwise), the PFIC rules could be implicated depending on the asset composition of CANCo and USCo. Under the look-through rule previously described, CANCo will be deemed to receive directly 100% of the income of USCo and to hold directly 100% of its assets for purposes of assessing PFIC status.

Possibly none of the LLCs are making money and the only income flowing up to CANCo from the transferred assets is from the investment LLC. Assuming CANCo has no other income, then passive income would represent 75% or more of CANCo's income. Or, alternatively under the asset test, if the non-investment

assets have depreciated and/or the investment assets have appreciated such that the investment holdings represent 50% of the total assets CANCo owns through USCo and otherwise, there is also a risk of PFIC status for CANCo. If Client were a US resident, he would need be advised of the potential consequences of owning and disposing of shares in CANCo and informed of the potential mitigating elections available.

Section 897. ***Disposition of investments in United States Real Property***

Foreign Investment in Real Property Act "FIRPTA") Rules

Section 897(a) states the general rule that gain or loss realized by a nonresident alien or foreign corporation from the disposition of a "U.S. real property interest" ("USRPI") will be treated as income effectively connected with the conduct of a trade or business in the United States. Nonresident individuals and foreign corporations not otherwise engaged in a US trade or business would not ordinarily be taxable in the United States on a sale of capital assets located in the United States under normal US income sourcing and tax rules.

USRPIs include land, growing crops and timber, and mines, wells and other natural deposits (including, oil and gas properties and deposits) located in the United States. An exclusion from the definition of a USRPI is provided for any class of stock of a domestic corporation which is "regularly traded on an established

securities market," but only if held by a person who, during the applicable test period, did not actually or constructively own more than 5% of that class of stock.

Section 1445 enforces the FIRPTA tax by requiring the transferee of a USRPI to deduct and withhold 10 percent of the amount realized on the disposition. US treaties generally preserve the authority of the United States to tax the disposition of a USRPI by a foreign resident.

A USRPI is defined broadly under section 897(c) as

- an interest in real property located in the U.S. or
- any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer disposing of the interest establishes that such corporation was at no time a United States real property holding corporation (a "*USRPHC*") during the 5 year period (or taxpayer's holding period, if shorter) ending on the date of disposition. The rules place the burden of demonstrating that a corporation has not been a USRPHC on the foreign person selling the interest.

A "USRPHC" is defined as a domestic corporation in which the fair market value of the USRPIs owned by such corporation equals or exceeds fifty percent of the sum of the fair market values of (a) the USRPIs owned by such corporation, (b) the foreign real estate owned by such corporation, and (c) the other trade or businesses assets owned by such corporation. As the statutory framework above indicates the burden of showing that an interest in a domestic corporation is not a USRPHC falls on the foreign transferor. The transferor does this by requesting a statement from

the corporation stating that it is not a USRPHC, which it then provides to the transferee in order to avoid withholding from the proceeds payable.

Exemptions from requirement to withhold 10% of the amount realized by a transferor on the disposition of a USRPI:

Transferor furnishes nonforeign affidavit.

Unless a special rule applies, withholding isn't required with respect to the disposition of a USRPI, if the transferor furnishes an affidavit to the transferee stating, under the penalty of perjury, the transferor's U.S. taxpayer identification number and that he isn't a foreign person

U.S. corporation furnishing affidavit as to non-U.S. real property holding corporation (non-USRPHC) status.

Unless a special rule applies, withholding isn't required on the disposition of an interest, other than an interest solely as a creditor, in a U.S. corporation, if the U.S. corporation furnishes an affidavit (non-USRPHC affidavit) to the transferee of the interest stating, under the penalty of perjury, that the corporation isn't and hasn't been a U.S. real property holding corporation (USRPHC) during the FIRPTA base period, i.e., the shorter of (1) the period during which the transferor held the interest or (2) the five- year period on the date of the disposition of the USRPI.

Stock transferred on an established securities market.

No withholding is required with respect to a disposition of shares of a class of stock that is regularly traded on an established securities market if it is being

transferred by a holder who has not held more than 5% of the fair market value of shares in that class of traded shares during the previous five years.

Withholding certificate obtained.

No withholding is required if the transferee is provided with a withholding certificate that so specifies. These are obtained from the IRS and delivered to the transferee to avoid withholding, or to obtain a refund of tax withheld from the IRS. Assuming adequate documentation, the IRs will grant a reduced withholding certificate if the ***amount realized is zero or tax on the gain is less than 10% withholding.***

The IRS states a general policy of issuing such certificates within 90 days of receipt of the application, but can request additional information and the process can take longer. In you want to rely on such withholding certificate to avoid 10% FIRPTA withholding on a transfer, you must plan around the time it takes to obtain the certificate. There are rules about how to handle withholding and payment of tax when certificates have been applied for but not yet obtained at closing, or are applied for and obtained within various periods of time after closing.

Nonrecognition transactions. No withholding is required when the transfer is a nonrecognition transaction, and certain notification and other requirements are met.

Application of FIRPTA to hypothetical:

If the value of Client's real estate holdings exceeds 50% of the total assets transferred to USCo, USCo would be a USRPHC. Assuming transfer of USCo shares after Client has acquired Canadian residency, then FIRPTA would apply to the transfer. As with the PFIC rules, there is an exception provided for nonrecognition transactions in which shares in a USRPHC are transferred for shares in a foreign corporation which would be a USRPHC if it were a US corporation. This exception is potentially available for Client, assuming no other assets are held by CANCo and other requirements are met.

Conclusion

As technical as I'm sure these rules sounded, we've only scratched the surface of the nuances and workings of some extremely complex Code provisions and regulations that can apply to cross-border transfers. There are obviously other potential areas for discussion in the cross-border corporate transaction area….such as transfer pricing, the treatment of various types of income and income allocation under treaty provisions, among other things. But the rules I've discussed are areas of tax focus that come up routinely in cross-border M&A, and it would be a good idea to consult a tax lawyer practicing in this area if you think your transaction might raise any cross-border tax issues and/or require specialized tax planning along these lines.