SPECIAL CONCERNS FOR CROSS-BORDER TAX PLANNING

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Additional Issues

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

These rules are generally aimed at preserving the United States' taxing jurisdiction over appreciated assets and certain business operations under "surrogate" foreign ownership which, however, remain substantially US based. 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 with global operations or as applying to large cross-border corporate M&A, but surprisingly complex issues can arise for private clients in connection with their estate and financial planning.
- In the private client context, we are more apt to encounter LLCs, an extremely flexible and popular creature of US law, but sometimes not accorded particularly favorable treatment under foreign tax systems – Canada, for one.   Because of their hybrid nature, they are subject to special rules under US tax treaties as well.

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 appreciated assets transferred to a foreign corporation, even if the transaction otherwise qualifies for tax-free reorganization treatment.
- Treatment of a foreign entity acquiring US assets as a US entity for all purposes of the Code going forward, including estate tax.
- 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.

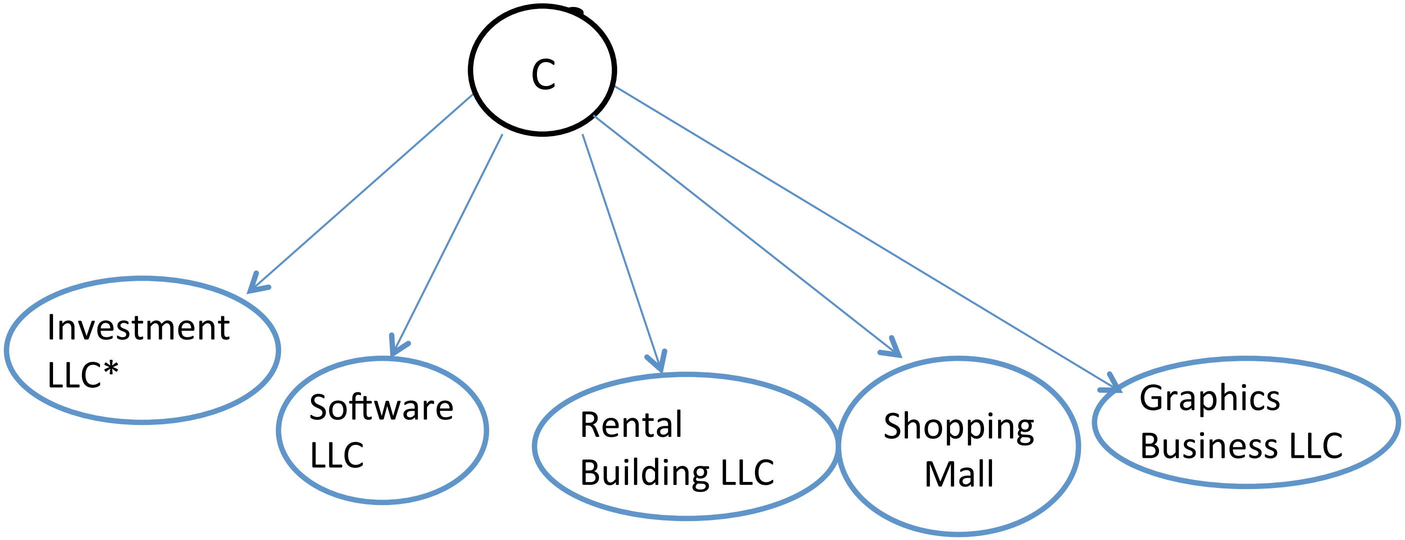
Hypothetical

- A married couple, both Canadian citizens with US green cards, has been living in the United States since January 1, 2007 and plans to retire in Canada to be near children and grandchildren. They intend to formally relinquish their green cards in connection with the move.

- The husband is a successful venture capitalist and they 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.

- Couple wants to restructure their asset holdings so as to remove them from US estate tax as part of their relocation to Canada.

Couple's Holdings (simplified)


C
Investment LLC*
Software LLC
Rental Building LLC
Shopping Mall
Graphics Business LLC

- All of Couples' WA LLCs are taxed as partnerships for US federal income tax purposes.

* This LLC holds a number of minority interests in diverse businesses owned by the Couple.

Proposed Plan

- Step 1: Couple transfers all of its LLC interests into one or more US corporations (individually, referred to as “USCo”) in exchange for 100% of the corporation shares. For business and other reasons, more than one corporation is likely to be used.

- Step 2: Couple transfers all of its shares in the corporation(s) to one or more Canadian corporations (individually, referred to as “Canco”) in exchange for 100% of its shares.

General Rationale for Plan

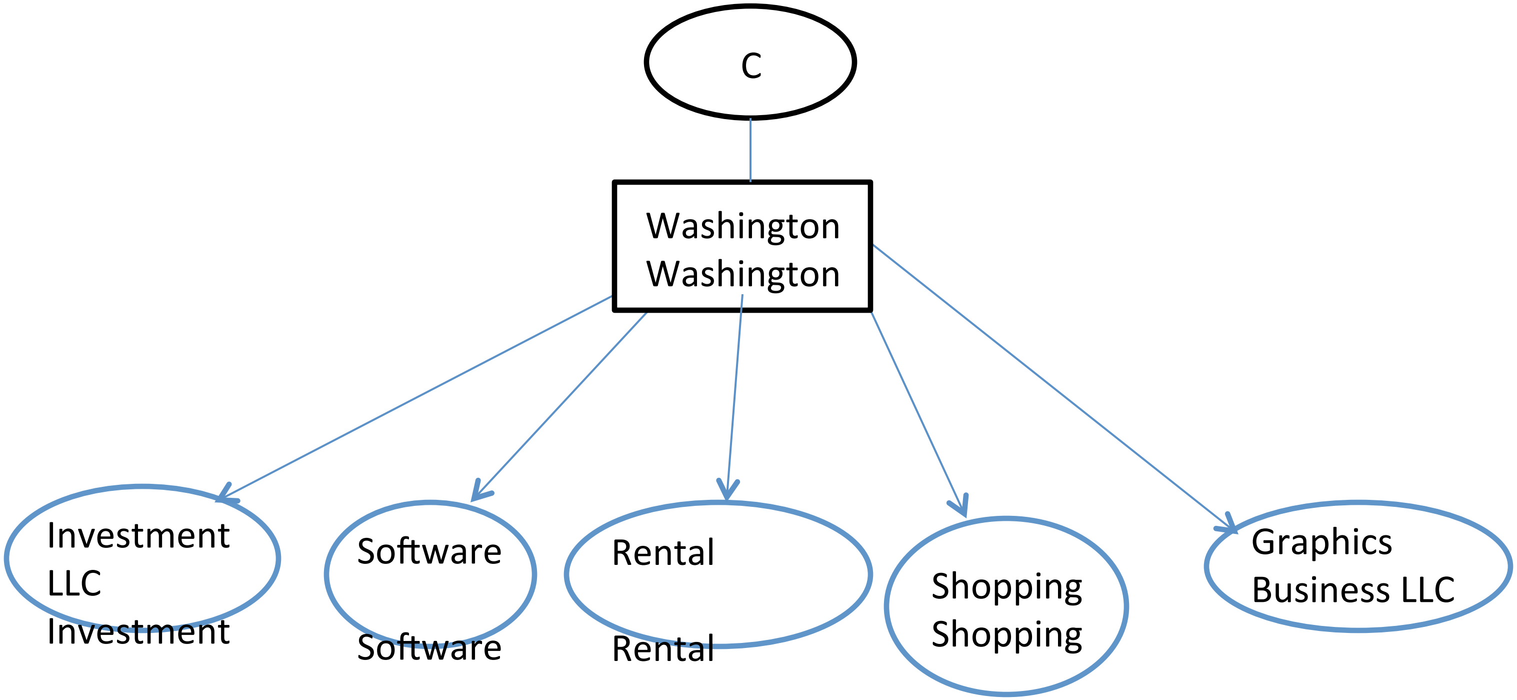
- Ownership of US situs assets through a partnership or an LLC taxed as a partnership creates US estate tax risk*, so restructuring generally contemplates transfer of assets held in partnerships or LLCs to a US corporation followed by a transfer to foreign corporate ownership.

- Canada does not recognize LLCs, a creature of US law, and taxes them as corporations, and furthermore, may treat them as Canadian corporations if "mind and management" is deemed to be in Canada. **

* Based on my understanding from discussions with estate tax counsel.

** Based on my understanding from discussions with Canadian tax professionals.

Couple's Holdings after Step 1



C

Washington
Washington

Investment LLC
Investment

Software
Software

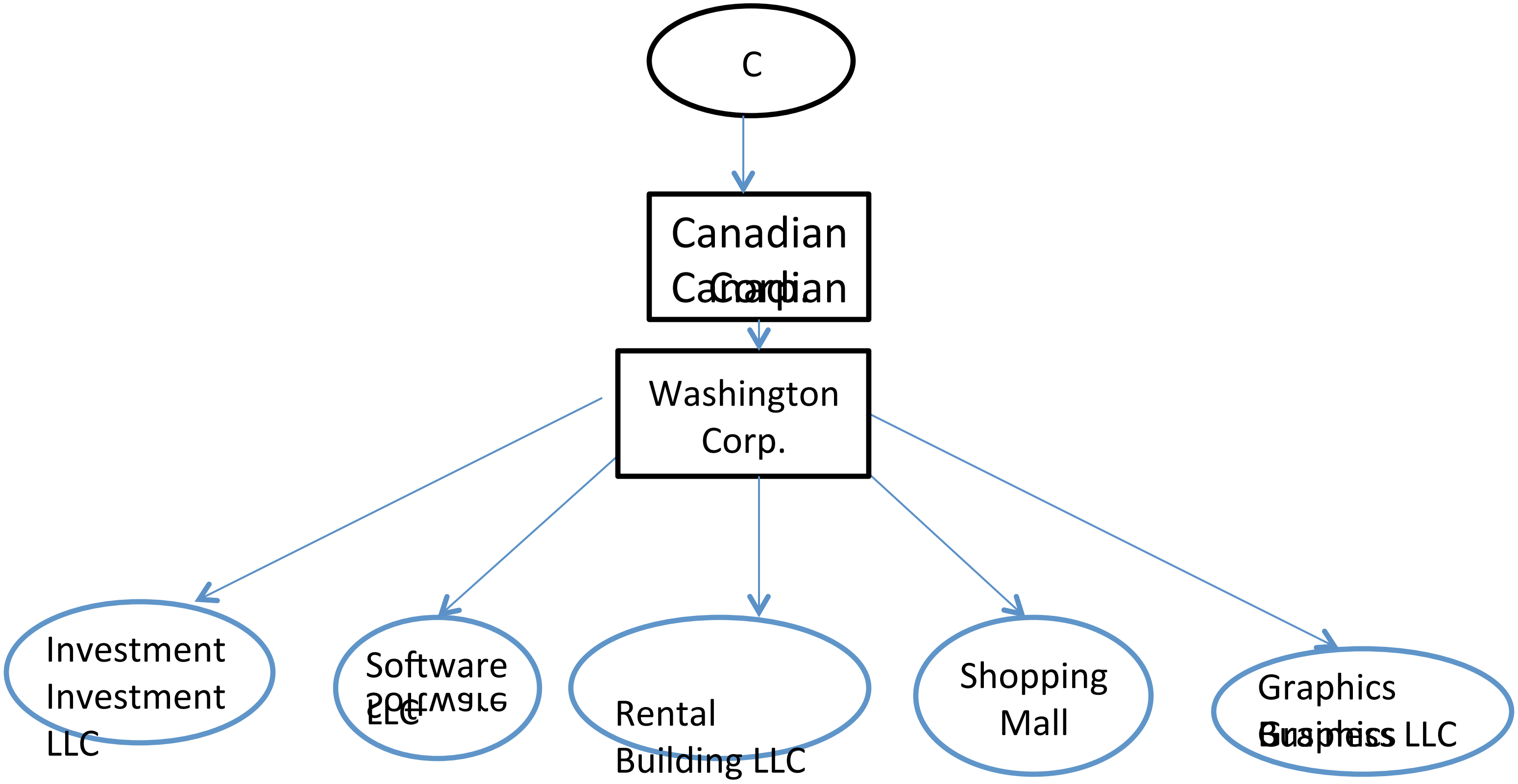
Rental
Rental

Shopping
Shopping

Graphics Business LLC

This step 1 should be free from current tax under US rules applicable to domestic transactions as a contribution of property to a domestic corporation in exchange for stock representing control of

Couple’s Holdings after Step 2



C

Canadian Corp.

Canadian

Washington Corp.

Investment LLC

Investment

Software LLC

Software

Rental Building LLC

Shopping Mall

Graphics Business LLC

Graphics

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Application of Rules to Hypothetical

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Section 877A

As part of the Heroes Earnings Assistance and Relief Tax Act

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of 2008, Congress enacted a broad mark-to-market "exit tax" -

which taxes covered expatriates as though their property

were sold for fair market value on the day before they -

five preceding years.

Section 877A continued…

- For the purposes of § 877A, a “long-term resident” is defined as: “any
  - For the purposes of § 877A, a “long-term resident” is defined as: “any
- Couple has 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 a relocation prior to 2014 and that the exit tax , therefore, does not apply.
- This exit tax can take people by surprise, though. Possible contexts: Foreign nationals who enter the US on EB-5 visas, obtain green cards with their investment and later wish to return to their home countries. One can envision other situations where a green card holder moves out of the United States and either formally gives up or effectively loses green card status. Section 877A always needs to be considered.

Application of Rules to Step 2

- Technically, this step 2 would also meet the requirements of a section 351 transfer – a 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 corporate stock, this transfer takes the contributed assets and their appreciation completely outside of the United States– therefore different policy considerations apply.

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

General rule of section 367(a) (1) -- a foreign corporation shall not be considered to be a corporation for purposes of determining gain to be recognized on the 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 ("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").

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 THESE TRANSACTIONS.

Exceptions to Section 367
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 or Business Exception to Hypothetical

The proposed transfer of USCo stock to CANCo is ineligible for this exception, as stock is intangible property.

Additionally, 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 will remain in the United States immediately after the transfer.

This exception is extremely difficult to satisfy.

Other Exceptions to Section 367 Certain Transfers of Stock by US Holders

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

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
- 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 - Exception for Certain Stock Transfers by US Holders continued…

Certain Transfers of **US Stock** by a US Shareholder to a Foreign Corporation ("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 four separate 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 has been actively engaged in business for at least three years, which 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.

The exception is very narrow.

Application of Stock Transfer Exceptions 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.

- Couple 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 the Couple'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 of the Couple is a taxable US person.* Then section 367 will not apply. This is by far the easiest way to avoid application of section 367.
- It is also important to guard against treatment of the transfers as one transaction occurring while the Couple are US residents under "step transaction" principles. Ideally, steps 1 and 2 should occur in different tax years with as much time in between Couple's relocation and step 2 as possible.

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 and can apply even if section 367(a) does not. It can require recognition of certain amounts of gain if the foreign corporation is currently, or has been, a controlled foreign corporation ("CFC") (e.g., more than 50% owned by 10% US shareholders) and any of the exchanging shareholders have been such a 10% US Holder of the CFC during the 5-year period leading up to the exchange. This will not applicable to the hypothetical which does not involve transfer of shares in a foreign corporation.

US Shareholders in Foreign Corporations

- Another consequence of having step 2 occur while Couple still resides in the US would be the application of special tax rules applicable to US persons owning shares in controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs"). Both Subpart F of the Code, applicable to CFCs, and the rules applicable to PFICS, operate to require that US shareholders in these entities pay US income tax on undistributed income. It is likely that these rules would apply to Couple 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 Couple has migrated to Canada.

- Because shareholders in a corporation are not generally taxable until they receive dividend distributions from the corporation, investment in foreign corporations by US persons can present an opportunity for tax deferral. Domestic corporations are subject to current US tax on their income, and therefore, the fact that income may not be distributed to shareholders currently does not pose the same concern.

- Potential implications under Subpart F and under the PFIC rules should be examined for any situation in which US persons own shares in a foreign corporation.

US Shareholders in Foreign Corporations cont. - CFC and PFIC

- 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. A foreign corporation is a CFC if 50% or more of the vote and value are owned by US shareholders holding 10% or more if the stock. Current inclusion is required for the following types of income: foreign personal holding income (passive income); foreign base company sales income; foreign base company services income; foreign base company oil related income and insurance income.

- The PFIC rules are contained in sections 1291-1298 of the Code and apply to US holders in foreign corporations with a certain threshold of passive income and/or passive assets (75% or more of gross income and 50% quarterly average of asset value in passive assets). Passive income generally includes dividends, interest, gain from the sale of stock or securities, rents and royalty income, and passive assets, assets which generate passive income. These rules can result in penalties in the nature of interest for amounts not paid out currently as well as tax liability on such amounts, unless certain elections are available and made to avoid the penalty (e.g., the mark to market election or the qualified electing fund ("QEF") election.

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 for 7874 to Apply

"Pursuant to a plan, (or series of related transactions)" there is:

1. *An Acquisition.* 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 corporation's underlying assets.

2. *At least 60% Continuity.* 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** 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.

3. *No Substantial Business Activities in Foreign Country.* 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. Regulations list factors considered relevant in determining whether substantial business activities exist but do not indicate relative weighting. A safe harbor in prior regulations was eliminated.

Factors Indicating Substantial Business Activity 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.

Hypothetical -- No Substantial Business Activity in Canada

- The Canadian corporation is being formed for purposes of the acquisition, and, therefore, cannot be said to have substantial business activity in Canada currently.

- Therefore, if section 7874 is to be avoided on this basis, assets and effort would have to be directed towards developing Canadian based business activities and operations through CanCo or Couple would have to acquire one or more Canadian based businesses into which USCo could be absorbed at some future point in time.

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 Couple retains less than 80% ownership, CANCo would be taxable for all purposes of the US Code 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 two years after Couple receives stock in the 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, but it would be advisable for Couple to wait at least two years after acquiring their CanCo stock before transferring their USCo stock pursuant to step 2.
- As soon as Couple moves to Canada, they should either start developing an active business with active business assets in Canada to acquire USCo or acquire an existing Canadian business which will be used effect the acquisition of USCo.
- Alternatively, Couple could have over 40% of CanCo owned by others in order 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 Couple (e.g., son-in laws, daughters-in law, or other non lineal descendants.

Special Considerations for Real Estate

- In 1980, the Foreign Investment Real Property Tax Act ("FIRPTA") amended the Code to 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.

FIRPTA Rules applicable to Real estate 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 value of assets consists of USRPIs.
- 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 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. Under certain circumstances, certificates allowing for reduced withholding may be obtained from the IRS for delivery to the transferee.
- The burden of showing that shares in a domestic corporation are not USRPIs falls on the taxpayer. Therefore, for any transfer of corporate shares 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.

FIRPTA Tax cont.

- If a U.S. real property holding corporation disposes of all of its property in a taxable transaction in which the full amount of gain is recognized, the stock in the corporation ceases immediately to be a USRPI and the gain realized by foreign shareholders in the stock will not be subject to FIRPTA.
- Such a "cleansing" sale essentially serves as an exception to the Five Year Look-Back Rule.
- Thus, foreign shareholders receiving distributions in liquidation of a U.S. corporation under these circumstances generally can avoid being subject to FIRPTA.

Application of FIRPTA to hypothetical

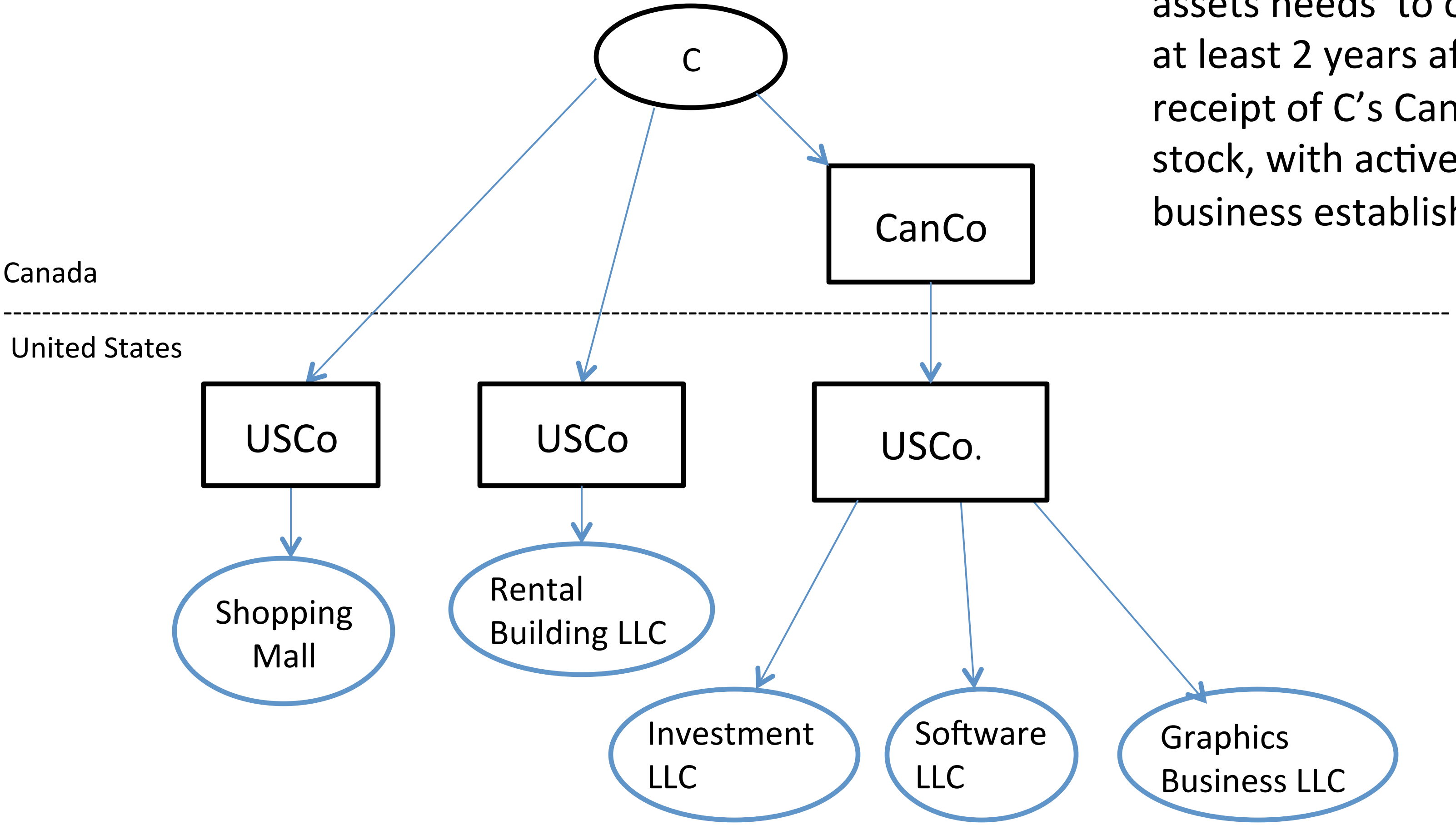
- For business and tax reasons, Couple's real estate assets will likely be placed in one or more corporations separate from the other LLC assets. Therefore, we will have U.S. corporations which qualify as USRPHCs after step 1.

- Therefore, if, as recommended, step 2 takes place after Couple has given up US residency and acquired Canadian residency, 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 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 is essentially cleansed of its status as a USRHC .
- If the sales proceeds are distributed to Couple in liquidation of the respective USRPHCs after a sale of the underlying real estate, such 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 Couple's shares in a corporate liquidation, and therefore not subject to US tax.
- While this approach leaves Couple subject to increased US estate tax risk, the avoidance of section 7874 and FIRPTA arguably make the risk worth it.

Recommended Holding Structure


C
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USCo.
Shopping Mall
Rental Building LLC
Investment LLC
Software LLC
Graphics Business LLC

* CANCo's acquisition of the non-real estate assets needs to occur at least 2 years after receipt of C's Canco stock, with active business established.