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Canadian Tax Perspective

How U.S. Tax Reform Affects Canada-U.S. Tax Factors

By Nathan Boidman, Esq.[*]

INTRODUCTION

Last December, the United States enacted the 2017 tax act ("the Act"),[1] its first major tax reform since 1986,[2] concluding years of effort to, *inter alia*, significantly lower a corporate tax rate that was virtually the highest among OECD countries and adopt a territorial tax system for U.S.-based multinationals. It succeeded on the first but, because of a radical new rule ("GILTI," explained and discussed below), largely failed on the second.[3]

This commentary examines how the 2017 tax act and in some cases recent controversial Canadian tax changes affect a number of comparative and cross-border Canada-U.S. tax factors.

CANADA- AND U.S.-BASED MULTINATIONAL ENTERPRISES

Corporate Tax Rates and Critical Tax Accounting

Leaving aside certain left-leaning voices, it is conventional (and maybe even actual) wisdom that the lower the corporate tax rate, the greater incentive to invest, which buoys the economy and creates jobs and economic growth. That fueled those who urged the United States to drastically reduce, as it did last December, its burdensome federal rate of 35%, which together with deductible state and city taxes could lead to overall rates as high as around 47%.

Those rates had long given Canada a large competitive edge. At the time of the U.S. 1986 tax reform the rates were high in both countries (around 45%–55% depending upon sub-national rates),[4] but Canada phased in and has now had for several years aggregate federal and provincial corporate tax rates for MNEs ranging mainly between 27% and 31%. All of Canada's largest provinces (including Ontario and Quebec) hover around 27%, made up of a net federal rate of 15% and a provincial rate (applied to the same income base as the federal rate) of around 12%.

But now with the new U.S. 21% rate, where is the comparative advantage?

If the focus is on the six tax-free states (which include Ohio and Texas), the advantage is clearly in the United States. But if the focus is on places like Philadelphia, where local/state taxes are 16.38% and the overall rate is 34.33%, or New York City where those rates are 15.35% and 32.33%, the advantage is still in Canada. In between, the comparisons vary and where the state taxes are around 8%, there is not much difference between the two countries.

The two key comparative points in tax accounting coming out of the 2017 tax act are with respect to interest deductibility and depreciation. With respect to interest, on the domestic front, MNEs in the two countries were, before the 2017 tax act, on equal footing — enjoying full deductibility. (Widely held MNEs in either country would not ordinarily be affected by thin capitalization/earnings stripping rules in respect of their own funding but of course, as discussed below, could be affected by such rules in financing cross-border subsidiaries.)

However that domestic equivalence terminated with the 2017 tax act's new 30% of EBITDA (EBIT after 2023) limitation on interest expense deductibility. Here the advantage is to Canada. But the full immediate expensing of many types of depreciable properties provided by the Act gives the advantage to the United States in this area.

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[*] Nathan Boidman is with Davies Ward Phillips & Vineberg LLP, Montreal, Canada.

[1] Pub. L. No. 115-97 (Dec. 22, 2017); during legislative proceedings, known as the Tax Cuts and Jobs Act (TCJA).

[2] The Tax Reform Act of 1986. *See* Nathan Boidman and Gary J. Gartner, *U.S. Tax Reform*, The Canadian Perspective CCH Canadian Limited, 1987.

[3] On the House and Senate bills before reconciliation into 2017 tax act, see Gregg Benson, Nathan Boidman, and Peter Glicklich, *U.S. Tax Reform in a Canadian Context*, 46 Tax. Mgmt. Int'l J. 767 (Dec. 8, 2017), and on the failure to achieve territoriality, see Nathan Boidman, *The US's Illusionary Turn to Territoriality*, 89(7) Tax Notes Int'l 619 (Feb. 12, 2018).

[4] *See* Boidman and Gartner, above n.2: 46% plus state and local taxes in the United States and 45–50% (combined federal and provincial) in Canada.

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Taxing Unremitted Active Business Profits of Foreign Subsidiaries in General and Cross-Border in Particular

Prior to the 2017 tax act both Canada and the United States followed the international norm of not taxing unremitted profits derived by foreign subsidiaries from the active conduct of business (and that were not deemed passive under CFC/subpart F type rules). On the other hand, as discussed in the next section, Canada, but not the United States, followed the related norm of generally not taxing the distribution of such profits.

The 2017 tax act abandoned the first norm by adopting the "global intangible low-taxed income" (GILTI) rule that taxes, upon realization (i.e., as an extension of immediate taxation under the U.S. CFC/subpart F rules), 50% of GILTI, which is the excess of a controlled foreign corporation's active business income over 10% of its basis in depreciable tangible assets.[5] The 50% goes up to 62.5% after 2025.

There is a credit for 80% of the foreign tax paid on the GILTI. This means that without regard to state taxes, the effective rate is 21% of 50% or 10.5%, and that is eliminated if the applicable foreign tax is 13.25% which, at 80%, produces a foreign tax credit of 10.5%. Since a Canadian subsidiary of a U.S. MNE would pay at least double that 13.25%, GILTI should not raise any net U.S. federal tax in respect of a Canadian subsidiary.

However, query whether the rules of a U.S. state can reach GILTI.[6]

Therefore, state tax aside, in the Canada-U.S. cross-border subsidiary context, GILTI does not change the pre-existing equilibrium. However, compare (1) a Canadian hotel group owning and operating a project in a tax haven with net profit of $100 million and basis in depreciable tangible assets of $500 million and (2) a U.S. group across the street with a project with identical numbers. Under GILTI, the U.S. group will pay $5.25 million of U.S. tax: 21% of 50% of $100 million less 10% of $500 million (and pay it whether or not the profits are distributed), while the Canadian group will pay no tax on the undistributed profits. The result for distributed profits is discussed in the next section.[7]

[5] *See* new §951A of the Internal Revenue Code.

[6] *See* Isabel Gottlieb, *Global U.S. Tax Provision Creates Unexpected State Tax*, Tax Mgmt. Transfer Pricing Rep. (June 14, 2018).

[7] The numbers look more dramatic where one assumes, say, a software business with nominal tangible property. There the comparison is $10.5 million to $0.

Taxing Dividends From Foreign Subsidiaries

As noted above, the equivalency of tax treatment that prevailed prior to the 2017 tax act respecting undistributed business profits of foreign subsidiaries was not seen with respect to the distribution of active business profits to MNEs. Before 1976, Canada did not tax any such distributions and from then until 2007 taxed only profits of subsidiaries not based/operating in the few developed countries with which Canada did not have bilateral income tax treaty relations and since 2008 the few countries that don't have either such a treaty or a tax information exchange agreement.[8]

The United States, on the other hand, persisted in being since 2009 (when Japan and the United Kingdom adopted territorial regimes) the only industrialized country that taxed such distributions on a gross-up and credit basis.[9] But the 2017 tax act has adopted an exemption on foreign subsidiary dividends provided certain hybrid instrument requirements are met.[10]

However, given the new GILTI rules, isn't this exemption illusionary at least in part? In general it works fully in respect of Canadian subsidiaries because, as noted above, Canada's corporate tax rates trigger sufficient FTCs to eliminate net tax on GILTI. And therefore under the new exemption, the distribution in the above example will not attract any U.S. tax.

But in the offshore hotel subsidiary example above, the net U.S. tax on the GILTI reduces the benefits of the §245A exemption and puts the U.S. MNE in an inferior position compared to its Canadian competitor, assuming the latter is located in one of the several tax havens with which Canada has concluded a TIEA.[11]

Taxing Passive Income of Foreign Subsidiaries and Direct Foreign-Source Intangible Property Income

The 2017 tax act does not fundamentally diminish the similarity of the two countries' approaches to tax-

[8] See generally the "foreign affiliate" system provided for in §90–§95 and §113 of the *Income Tax Act* and part 5900 of the income tax regulations. Aside from the treaty country nexus the Canadian shareholder must be a corporation and own 10% or more of any class of shares of the foreign (technically non-resident) corporation or 1% with at least 9% owned by related parties.

[9] For example, if a Canadian subsidiary earned $100 and paid respectively $27 of Canadian corporate tax and 5% Canadian withholding tax on a $73 distribution ($3.50) the U.S. parent would gross that back up to $100, apply the old rate of 35%, take a credit of $30.50, and pay net $4.50.

[10] *See* §425A: The exemption does not apply if the dividend is deductible by the foreign subsidiary in its home country.

[11] Canada has TIEAs with most if not all major tax havens including Bermuda, Bahamas BVI, and Cayman Islands.

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ing passive income of foreign subsidiaries, but it does raise a substantial difference in the treatment of directly earned foreign-source income, under a label — foreign-derived intangible income (FDII) — that is as inaccurate and misleading as the expression GILTI.

In 1972, with effect in 1976, Canada adopted the principal features of the U.S.'s 1962-enacted CFC/subpart F system for taxing passive foreign subsidiary income. But Canada, in enacting rules to attribute foreign passive income to domestic shareholders, chose different terminology: for CFC, Canada chose "controlled foreign affiliate"[12] and for subpart F income, Canada chose "foreign accrual property income."[13]

Aside from some extension/expansion of the CFC concept, the 2017 tax act does not seem to substantially change the CFC passive income attribution rules. In fact, interestingly, it is Canada that is tightening its foreign passive income rules with the issue in July of draft legislation to counter tracking stock-based strategies to avoid FAPI attribution as well as narrowing exceptions from FAPI for certain debt instrument dealing and lending operations.[14]

It is in the direct foreign business area — that is, without using foreign subsidiaries — that the 2017 tax act substantially changes the preexisting equilibrium between U.S. and Canadian taxation and provides an interesting counterweight to GILTI by adopting (in part) a tax incentive that has been developed in recent years by several EU countries and is termed "patent boxes." That is a shorthand way to refer to legislation that exempts in whole or in part local tax on income derived from developing and exploiting, internationally, intangible property. This type of legislation is considered, by the BEPS project (action 5 of the October 2015 BEPS recommendations to the G20 by the OECD (coordinator of the project)) to be offensive where the intangible has not been developed in the relevant country. Historically, subject to any treaty-based tax sparing rules, Canada and the United States fully tax directly earned foreign-source income and seek to avoid double tax through foreign tax credit rules. But now the 2017 tax act has provided a tax reduction for U.S. taxpayers on profits earned from selling products to or providing services to or licensing property to foreign persons. This, under the FDII label referred to above, and provided for in §250, takes the form of reducing income otherwise subject to tax by 37.5% (21.875% after 2025) of the excess of the relevant foreign source income over 10% of the basis in tangible property used in carrying on the relevant business.

The effect (before 2026) at the U.S. federal level (and ignoring state/local taxes) is to reduce the effective tax rate on the relevant profit, if one assumes nominal tangible property, from 21% by 7.875% to 13.125%. That, for a U.S. corporation operating in a no-tax state such as Ohio and leaving aside foreign taxes, is about half the roughly 27% rate an Ontario-based MNE would pay on the same foreign-source income. Of course, as the assumed level of tangible property increases and/or state and local taxes are brought into the mix, the advantage to the United States decreases. For example, if one assumes nominal tangible assets but location in Philadelphia, the effective tax rate would be 34.33% of 62.5%, or 21.45%.

Finally, in the Canada-U.S. cross-border context, a U.S. MNE with direct relevant Canadian-source income would benefit most from the FDII if it has neither a permanent establishment in Canada within the meaning of the Canada-U.S. tax treaty (the "Treaty") nor items of income, particularly royalties that the treaty permits Canada to tax.[15]

Taxing Outbound (Earnings Stripping) Payments

Since at least 1972 (the time of Canada's last complete tax reform), both countries have relied upon transfer pricing and thin capitalization rules or concepts to prevent undue reduction of the taxable income base of local subsidiaries of foreign-based MNEs. In 1997, the United States added a tool to its arsenal by enacting the world's first anti-hybrid rule — a rule (§894(c)) specifically aimed at Canadian MNEs taking over or financing expansion of U.S. businesses.

In the transfer pricing area, in 1968 the United States formalized pre-existing arm's-length notions by adopting (non-legislative mandated) regulations under §482. In Canada, the Canada Revenue Agency effectively adopted in 1987, as a basis for applying long-standing briefly worded statutory arm's-length-based rules (now found in §247 of the *Income Tax Act* since 1998), the U.S. regulations by issuing a non-binding information circular (IC 87-2) that was a restatement of the 1977 OECD transfer pricing guidelines that

[12] *See ITA* §95(1).

[13] *See ITA* §95(1).

[14] See, respectively, proposed additions of *ITA* §95(8) to (12) and amendments of *ITA* §95(2)(l) and §95(2.11). For a discussion, see Nathan Boidman, *Canada Targets Conduits and Tracking Stock*, Tax Notes Int'l (Sept. 17, 2018), at p. 1223.

[15] While *ITA* §212(1)(d) would impose tax of 25% on most forms of royalties and similar payments derived from Canada without use of a domestically defined permanent establishment, article XII of the treaty would exempt most such payments to a U.S. treaty resident and reduce the rate to 10% on the balance.

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themselves were basically a knock-off of the 1968 U.S. regs.[16]

In the thin capitalization area, the United States has long had the statutory notion (§385) that in order for interest paid to shareholder loans to be deductible, the loans cannot be disguised equity — that is, they would have been made by third parties in the same circumstances without undue shareholder guarantees. That is a rule of general application but was supplemented in the case of loans from foreign shareholders by the enactment in 1989 of §163(j) that could further limit (up to 50% of EBITDA) deductible interest on such loans. In Canada mechanical thin capitalization rules (under §18(4) *et seq.*) were adopted in 1972 that deny the deduction of interest payments on the portion of loans from 25% or greater nonresident shareholders that exceed 150% of the aggregate of the paid-up capital of the shares owned by such lenders and the retained earnings of the corporation.[17]

In the hybrid area, the 1997 enactment of §894(c) denied a treaty rate of tax on outbound interest payments to an entity that was transparent under the laws of the United States (like an LLC that has not elected to be treated as a corporation for U.S. income tax purposes) but not under the laws of its owner (like Canada where an LLC is treated as a corporation). That put an end to arrangements where a Canadian acquirer of a U.S. target established a U.S. C corporation, funded it in part with an appropriate amount of capital stock (having regard to the U.S. thin cap rules referred to above), and as to the balance funded the C corp through a sister transparent LLC that the Canadian acquirer funded with capital so that the LLC could make an interest-bearing loan to the C corp. Before the enactment the interest payment by the C corp to the transparent LLC benefited from the then-reduced treaty rate of 10% applicable to a Canadian recipient of U.S.-source interest even though under Canadian law the interest was treated as earned by a separate person (the LLC), which under Canada's foreign affiliate system would not attract Canadian tax either when received by the LLC or when distributed by the LLC to a Canadian corporate owner.[18] The effect of the 1997 rule in this illustration was to deny the treaty rate on the interest payment to the LLC. Canadian MNEs reacted by developing a complex (so-called Tower) structure to finance U.S. acquisitions and expansions. This involved not only a transparent LLC but a transparent Nova Scotia unlimited liability company and a U.S. partnership that elected to be treated as a U.S. corporation. The Treasury responded to this in 2001 by issuing regulations under §894(c) that denied as a deduction for U.S. tax purposes the portion of interest payments that did not go on a back-to-back basis to third-party lenders.

Against that background, what are the effects of the 2017 tax act?

There appear to be none respecting transfer pricing, but some important changes respecting thin cap-related interest payments and hybrids. And, as well, there is a new minimum tax (the base erosion and anti-abuse tax (BEAT)) with which Canadian MNEs with U.S. subsidiaries may have to contend.

With respect to interest it was noted above that all U.S. taxpayers will be subject to a limitation: 30% of EBITDA (EBIT after 2025). That replaces, but may extend the effects of, the §163(j) limitations. This change, inspired by the BEPS project, may well provide Canadian-owned U.S. subsidiaries with less interest deductions, whether involving related or unrelated party debt, than available to U.S.-owned Canadian subsidiaries.

As far as anti-hybrid initiatives are concerned, the 2017 tax act effectively extends the denial of deduction rules seen in the 2001 regs under §894(c). A deduction of interest or royalties paid by a U.S. subsidiary to a foreign-owned group will be denied where the payment is not treated as such in the hands of the foreign party or where the latter is allowed a deduction against the payment or if regulations are adopted to counter other arrangements. But even without such regulations it seems clear that these rules will obstruct those foreign-based MNEs, including Canadian MNEs that used repos in funding U.S. acquisitions and expansions.[19]

Canada has no such anti-hybrid rules to obstruct U.S. MNEs operating in Canada although article

[16] The Canadian Supreme Court confirmed in its decision in *GlaxoSmithKline Inc. v. the Queen*, 2012 SCC 52, that, while the OECD guidelines are of assistance, in Canada they do not have the binding effect of a statute because they are not specifically incorporated into the *ITA*.

[17] The limitation originally was 300% and then it was reduced to 200% and then to the current 150%. So a CN$1 billion acquisition by a U.S. MNE of a Canadian target could see, when the rules were first enacted, the acquirer establish a Canadian acquisition corporation, fund it with capital stock of $250 million and interest-bearing debt of $750 million, and then acquire the target. When the limitation was reduced to 200%, the acquisition corporation could be funded with $333 million of stock and $666 million of interest-bearing debt. Under the current rules the numbers are $400 million and $600 million. Therefore assuming a 10% interest rate the deductible interest per year has over time been reduced in the above example from $75 million to $60 million.

[18] *See* discussion above.

[19] A repo sees a foreign group purchase, from one U.S. subsidiary, dividend-paying preferred shares issued by another U.S. subsidiary with an agreement that the shares will be repurchased at a fixed future point. The United States typically sees this as a loan (secured by the preferred shares) made by the foreign group to the U.S. subsidiary, producing deductible interest while the other country may respect the form and see the receipt of dividends that may not be taxable under territoriality rules discussed above.

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IV(7) of the Treaty may deny treaty reduction or exemption of Canadian withholding tax on hybrid-related payments from Canada to the United States.

As far as the new BEAT rule under new §59A (also not seen in Canada) the government's objective seems to be to not rely on transfer pricing rules to pre-empt inappropriate levels of earnings stripping by effectuating a minimum tax on foreign-owned U.S. subsidiaries. The new rule imposes a tax of 10% (5% for 2018 and 12.5% after 2025) on income that would be subject to the regular 21% corporate tax but has been sheltered from that tax by an outbound intercompany payment (typically interest or royalties or management fees, but not the cost of goods that have been purchased for resale unless an inverted corporation is involved). Stated simply, the tax is the excess of (1) 10% of the aggregate of the taxable income and the BEAT payment over (2) the tax otherwise payable for the year. So if a U.S. subsidiary has $100 of taxable income before a $100 royalty payment to a Canadian parent, the tax is the excess of (1) 10% of $0 + $100 over (2) $0 or $10.

As noted Canada has no such tax but the BEAT applies only where the U.S. subsidiary has gross annual revenue of at least $500 million and the BEAT payments exceed 3% of all deductible expenses.

An open question is whether either the new anti-hybrid rules or the BEAT rules could be challenged, where a Canadian MNE owns a U.S. subsidiary, under treaty nondiscrimination rules.

CANADA- AND U.S.-BASED PRIVATELY OWNED BUSINESS

Effect on Choice of Vehicle

How does the 2017 tax act affect the pre-existing comparison between tax burdens in the two countries on domestic-focused privately owned business and choice of vehicle to carry on such business?

In Canada, an individual carrying on business directly or through a flow-through (transparent) partnership[20] may pay up to 53% combined federal and provincial tax in Canada's two largest provinces: Ontario and Quebec.[21]

But much lower rates are available if a Canadian individual uses a Canadian corporation to carry on an active business[22] and does not distribute, by way of dividends, the business's profits. The roughly 27% combined federal and provincial corporate tax rates discussed above would not apply if the corporation qualifies for special low rates (hereinafter "Small Business Rates") of 10%–18%[23] on up to the first CN$500,000 of active business profits.[24] Unlike in the United States, the retention of profit — whether actively or passively reinvested — does not, per se, directly give rise to a penalty or special tax as might arise in the United States under the accumulated earnings tax rules.

On the U.S. side, before the 2017 tax act, corporate tax rates and distribution taxes generally drove individuals to carry on business in non-corporate form (e.g., as sole proprietors or through non-check-the-box partnerships or LLCs or trusts) so as to attract one-time personal tax rates that at the top margin would range from a low of 39.6% in states such as Florida that do not impose personal income tax to a high of around 47.6% in California, where the top rate is 13.3%, which was deductible for federal purposes prior to the 2017 tax act, or 47.2% in New York City, which has a top city and state rate of 12.69%. Additionally, the Obamacare tax could increase those rates.

Obviously those rates compared unfavourably to the Canadian rates on retained business profit but generally compared favourably to the overall Canadian rates on distributed business profits, which in Ontario and Quebec are, at the top, in the area of 55%.[25]

The 2017 tax act improves the U.S. side of the comparison in at least three ways but hurts it in at least one way. First the top individual rate is reduced to 37%. But that is relatively immaterial.

Second and more interesting is the 20% of profits deduction (under new §199A), available in controlled circumstances, where business is carried on by an individual without a corporation — that is, directly or on a flow-through basis. But at the top and without regard to state taxes, that provides a net 29.6% rate,

[20] In Canada, unlike the United States, domestic formed partnerships are always considered transparent and there is no notion of electing to treat them as corporations.

[21] The lowest combined rate is in 47% in the province of Saskatchewan, and the highest combined rate is 54% in the province of Nova Scotia.

[22] Certain types of active businesses involving investment assets do not qualify for the rates discussed here.

[23] The higher end had applied in Quebec but as a result of recent changes is being reduced over time to 13%, taking into account a forthcoming reduction of the federal component to 9%.

[24] This reduction, commonly referred to as the "small business deduction" (SBD) requires, *inter alia*, that the corporation be a "Canadian controlled private corporation," which is a corporation formed under corporate law in Canada that is not controlled by non-residents or Canadian corporations that are publicly traded. *See ITA* §89(1) and §125(7).

[25] As noted, on $100 of profit the corporate tax paid by a CCPC in Ontario would be about a maximum of $27 (lower if the SBD applied). The personal tax on a distribution of the residual $73 paid to a top-rate Ontario individual would be about $28, resulting in the overall 55% tax rate.

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which is still greater than the 27% corporate rate available in a Canada. On September 28, the House passed a bill (H.R. 6760) as part of its "Tax Cut 2.0" legislative package that would make permanent this 20% deduction and the above-referenced reduced 37% tax rate, which are due to expire on December 31, 2025. It is not yet not clear if and when the Senate will follow suit.[26]

Third and potentially most interesting is the new reduced general corporate tax rate of 21%. That may well provide results that are not only better than using non-corporate vehicles but are also superior to those available in Canada. The comparative results will vary with the effect of ancillary rules and factual assumptions made. At one extreme assume there are no state taxes and profits are reinvested in the corporation's business: here the resulting 21% rate is at least 6 percentage points less than the lowest in Canada (leaving aside the small business rates resulting from the SBD). At the other extreme assume the corporation is taxable in Philadelphia and is reinvesting in passive marketable securities: here the rate is just under 34% as noted above *and* there is a risk the 20% accumulated earning tax (AET) may apply.

But if the latter is taken one step further, to a point of distribution, the United States may compare favourably. For example, if the Philadelphia-based corporation is owned by a Florida individual, the tax on a dividend on its residual $66 per $100 at a rate of 23.8% (20% + 3.8% Obamacare tax) would be around $16, resulting in overall tax of 50%, which is less than the overall rate (around 55%) on distributed profit of an Ontario-based corporation to an Ontario owner. On the other hand if the Philadelphia-based corporation is owned by a California resident so that the overall tax on the dividend is 37.1% (23.8% + 13.3%), the tax on the $66 dividend would be $24 and total tax would be 58%, which is higher than the Ontario or Quebec rate of 55%, although not by much. Obviously, the less the corporate-level tax, the better the chances that the overall results for a high-taxed U.S. individual will be superior to those of the Canadian counterpart.

The adverse change in the 2017 tax act is the new deductibility limitation, to no more than $10,000, in respect of state income taxes. Under prior law the highest combined effective rate for a California resident was 47.63% (13.3% + 39.6% of 86.7%). Now the rate is 50.3% (13.3% + 37%). That certainly will increase interest in the use of corporations. As indicated above, Canada has no such issue because corporate and federal tax rates have always been applied to the same income base and in the larger provinces the rates are of a similar size.

Tax on Passive Investment of Business Profits

In which country is the tax burden less on income derived from the use/deployment of business profits and how does the 2017 tax act affect the question? That question also brings into focus controversial and radical Canadian proposals first aired in July 2017 but ultimately toned down respecting the taxation of CCPCs. The starting point is to note a few basic factors that govern the question.

First, the question is really addressing only the passive investment of profits not needed in the basic business being carried on and generally entailing the acquisition and holding of marketable securities or income-producing real estate or perhaps interests in private equity or start-up funds.

Second, in the United States the basic direct or flow through approach to carrying on private business meant that all income — whether from active businesses or passive investments — was taxed the same (leaving aside passive activity losses). But it is the possible turn to C corporations to carry on basic business that may complicate the results.

Third, in Canada the generally lower corporate than personal tax rates (seen above) together with a shareholder-corporation integration tax system for Canadian individuals and CCPCs[27] make it necessary to apply a special tax regime to the passive income of a CCPC. In particular, the long-standing rule is that the passive income of a CCPC is taxed (federally and provincially) at around 50% (not the general rate of 27%) and, to avoid double tax, when the passive income is distributed, a portion of the upfront corporate-level tax — about equal to the tax the shareholder will pay on the dividend — is refunded to the CCPC. The objective is to eliminate any tax advantage to earning passive income in a CCPC but to not impose overall tax greater than that which would be payable if the investment income were earned personally.

In July 2017, the government decided it was unfair that privately owned corporations could earn business profit, pay only 27% tax (or lower on the first $500,000 of profit), and then have at least 73% left to make private investments while employees had to immediately pay up to over 50% tax and thus might have less than 50% left to invest. To correct this imbalance, the government said it was considering increasing the overall tax on investment income earned by CCPCs from about 50% to 75% by eliminating the refund when the passive income is distributed. The backlash from all corners of the business and professional communities saw the government retreat, in its

[26] Laura Davison, *House Advances Tax Cut 2.0 Bill, but Senate Has No Plans to Act*, 190 Daily Tax Rep. 7 (Oct. 1, 2018).

[27] That sees income earned directly and distributed CCPC business profits taxed overall at about the same rates.

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2018 spring budget, to a proposal to reduce the amount of business profit (which as noted above is up to CN$500,000) of a CCPC that is eligible for the small business rates if the corporation earns more than CN$50,000 of passive income in a year and totally eliminate the eligibility where the passive income reaches $150,000 in a year. In other words, for every $1 of passive income over $50,000, $5 of the SBD is lost.

Fourth, the United States has long had two punitive tax rules potentially applicable to privately owned C corps that do passive investment. One is the AET already noted. That involves subjective motive tests, which renders its applicability uncertain. The other is a "personal holding company" (PHC) tax, which is essentially mechanical. Like the AET, it is a tax of 20% and is applied to passive income where it exceeds 60% of all income of the corporation. Since, as already noted, privately owned business has generally not been carried out through C corps, these two anti-avoidance rules have generally not been encountered. But, as also noted, the 2017 tax act may well see increased use of C corps by U.S. individuals that could lead to focus on these anti-avoidance rules.

In the foregoing context, the following factors and comparatives may be seen. First, a privately owned C corp that pays no state tax and avoids the AET and PHC and therefore under the 2017 tax act pays 21% on both business profit and passive investment thereof is far better off than its Canadian counterpart that is paying 27% on business profit and 50% on passive investment income. Second, that arrangement for the U.S. party is far superior than if it carried on the activities without a C corp even if it qualified fully for the 20% of profit reduction and were paying 29.6% tax on their business profit and 37% on investment income (and the Obamacare tax as well). Third, even if state taxes bring a C corp rate up to 27% (bearing in mind that they remain deductible for corporations) the U.S. party is far better off than the Canadian counterpart provided AET and PHC do not apply and leaving aside the effects that the Canadian SBD might have in the comparison. Fourth, whether a Canadian party with a CCPC is better off than a U.S. party that does not use a C corp will depend upon a number of factors, already noted, and cannot be generalized. There are obviously other comparisons that can be made but one thing is clear: both the 2017 tax act and the controversial Canadian changes can have a profound impact on the transaction of passive investment of business profit and on the two country comparatives.

The Effect on Cross-Border Business

Overview

It is interesting if not curious that the 2017 tax act has made southbound business undertakings more attractive from the tax standpoint for private Canadian interests than before and has made northbound undertakings less attractive in certain circumstances for private American interests.

Southbound Business in the U.S. by Private Canadian Interests

It was noted above that Canada-based MNEs operating in the United States through local subsidiaries are not taxable in Canada, under the foreign affiliate system, on active business profits either when earned or when repatriated and therefore the 2017 tax act corporate rate tax cut could only benefit such MNEs.

Since private Canadian interests in U.S. businesses that are carried on through tandem Canada-U.S. subsidiaries qualify for the exact same foreign affiliate rules, they similarly can only benefit from the U.S. corporate tax rate reduction. And unlike large Canadian MNEs, the size of private Canadian business undertakings in the United States should qualify the U.S. subsidiaries (used) for the carve-out from the BEAT rules described above and would likely not see financing structures that engage the new hybrid rules discussed above.

Northbound Business in Canada by Private U.S. Interests

In recent years and at present private U.S. interests could choose from among at least the following eight structures (alternatives) from the Canadian tax standpoint to carry on business in Canada:

(1) sole proprietorship or partnership, entailing up to 53% combined federal and provincial taxes where the business is carried on in one of the two largest provinces in Canada: Ontario or Quebec.[28]

(2) U.S. corporation, entailing roughly 27% federal and provincial tax on profits reinvested in the business or roughly 31% on profits not so reinvested.[29]

(3) U.S. corp that qualifies to elect and does elect S corp treatment, entailing the exact same Canadian treatment (27% and 31%) as a straight U.S. C corp in alternative 2.[30]

(4) U.S. limited liability company (LLC) that does not check the box to be treated as a corporation

[28] Unlike the seven alternatives that follow, this entails a single, immediate, and one-time tax.

[29] The additional 4% arises under Canada's branch tax rules, under Part XIV of the *ITA* which imposes a 25% tax (subject to reduction to 5% under the Canada-U.S. treaty) on the profits of non-resident corporations (net of mainstream tax) that are not reinvested in the Canadian business.

[30] There have always been cogent arguments/reasons why, notwithstanding, the flow through treatment for most if not all income/gains of an S corp, it should be treated as a U.S. resident corporation by/for the Canada-U.S. treaty. The Canada Revenue

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for U.S. tax purposes, entailing the same tax on reinvested profits (roughly 27%) as in alternatives 2 and 3, but roughly 45% on profits that are not reinvested because here the branch profit tax rate would be 25% because the LLC would not be considered a U.S. treaty resident since it is not a U.S. taxpayer under the code.[31]

(5) Canadian per se corporation, owned by a U.S. C corp owned by U.S. private investors, entailing tax of, say, 27% on undistributed profits with a 5% tax on a distribution of the residual 73% for a total of some 31%.[32]

(6) Canadian per se corporation, owned by U.S. private parties, entailing tax of, say, 27% on undistributed profits with a 15% tax on distributions if the shareholder is a U.S. individual or total of some 38%.[33]

(7) Same as alternative 5, except the entity is a Canadian "unlimited liability company" (ULC)[34] that elects to be transparent for U.S. tax purposes, entailing the same Canadian tax results as in 5 provided certain cumbersome mechanics are employed for dividend distributions to avoid treaty benefit denial rules in article IV(7).

(8) Same as alternative 6, except the entity is a ULC that elects to be transparent for U.S. tax purposes, entailing the same Canadian tax results as in 6.

To summarize (with ranking)

ALTERNATIVE	RANKING
Alternative 1 (direct)	53% (worst)
Alternative 2 (U.S. C corp)	27%/31% (best)
Alternative 3 (U.S. S corp)	27%/31% (best)
Alternative 4 (LLC)	27%/45% (third best)
Alternative 5 (Can C corp under U.S. C corp)	27%/31% (best)
Alternative 6 (Can C corp under U.S. individuals)	27%/38% (second best)
Alternative 7 (ULC under U.S. C corp)	27%/31% (best)
Alternative 8 (ULC under U.S. individuals)	27%/38% (second best)

The foregoing eight alternatives with associated Canadian tax results give rise to at least the following questions in considering the preferred approaches from the overall U.S. and Canadian tax perspectives.

The foregoing eight alternatives with associated Canadian tax results give rise to at least the following questions in considering the preferred approaches from the overall U.S. and Canadian tax perspectives.

Which approaches provide the best overall tax results where profits are reinvested in the Canadian business? From the Canadian perspective, all approaches but the first raise only 27% tax.

Which of those seven did not raise any net additional U.S. federal tax under pre-Act law? That would seem to be the two alternatives (5 and 6) involving Canadian C corps.

But the 2017 tax act changes the result. Because of the reduced U.S. federal corporate tax rate, alternative 2 (involving a U.S. C corp) and alternative 7 (involving a transparent ULC under a U.S. C corp) join alternative 5 (a Can C corp under a U.S. C corp — which as noted earlier should be shielded from net GILTI tax) as being the structures that now would not raise any U.S. tax on reinvested Canadian profits. However, because of GILTI, alternative 6 (Can C corp under individuals) may raise state income taxes. This is because even though at the federal level a §962 election should offset the notional 21% tax on the full amount of GILTI by a credit for 80% of the Canadian 27% tax, it seems to be an open question as to whether state tax law would produce any net GILTI-related tax.[35] Furthermore, where the U.S. individual is a U.S. citizen resident in Canada so that the Canadian C corp is a CCPC under Canadian law that may be eligible for the small business rates discussed above, the 80% FTC under a §962 election will not fully offset the notional 21% U.S. corporate tax arising from the election.[36]

Another question is which approaches provide the best overall tax results where profits are not reinvested in the Canadian business and are to be used by the private interests for future investment outside Canada? Alternatives 2, 3, 5, and 7 all produce the lowest overall Canadian tax — roughly 31%.

Agency (CRA) has expressed agreement with that view. *See, e.g.*, CRA Technical Interpretation 2010 — 0376751E5, May 24, 2011.

[31] Given the look through rules of article IV(6) of the Treaty some have argued that the rate should be reduced as it would be (because of article IV(6) of the Treaty) if the LLC were owned only by U.S. C corporations. *See* Carl Irving and Todd Miller, *Canadian Branch Tax — Challenging the Denial of Treaty-Benefits for US LLCs*, Newsletter — Terra LEX Connections (Dec. 26, 2013).

[32] The tax is 25% under Part XIII of the ACT but reduced to 5% under article X(2)(a) of the Treaty.

[33] *See* art. X(2)(b) of the Treaty.

[34] A ULC can be formed under the laws of Alberta, British Columbia, and Nova Scotia, and is similar to a regular corporation except if it becomes insolvent, which triggers the personal liability of its shareholders. A ULC is taxed in Canada as a regular corporation and can be elected to be transparent (a flow-through) for U.S. tax purposes (which can bring into play certain anti-hybrid rules in article IV(7) of the Treaty).

[35] *See* n.6, above.

[36] This issue would be substantially or totally dissolved if the NYSBA recommendation (in a May 4, 2018, submission on GILTI) that individuals under a §962 election be allowed the same 50% of GILTI deduction (under §250(a)(1)(B)) to which U.S. C corps are entitled, were adopted.

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Which of those four did not raise any net additional U.S. federal tax under pre-Act law? They all raised additional U.S. tax, but the new 21% corporate tax rate in the 2017 tax act now changes that. Subject to AET and PHC considerations, alternatives 2, 5, and 7 do not seem to attract additional U.S. taxes.

The last fundamental question is which approaches provide the best overall tax results where profits are not to be reinvested but are to be used by the private reinterests for personal purposes. Here the strategy should be to approximate the amount of U.S. federal and state tax that would be paid if the Canadian profits were earned directly and then choose a structure that gives rise to aggregate Canadian and U.S. taxes (after FTCs) that do not exceed that base U.S. amount. The appropriate structure may well turn on the state tax element.

Before the 2017 tax act, with a top federal rate of 39.6% (aside from the Obamacare tax) and state tax being deductible, the lowest rate was 39.6% where the U.S. individual lived in a state like Florida and the highest rate was 47.66% when the party lived in California. For the Floridian, alternatives 3 and 8, which see no corporations from a U.S. perspective, would have kept overall Canadian taxes under 39.6% and fully creditable. For the Californian, at least alternatives 3, 4, and 8 would see overall taxes that do not exceed the U.S. rate.

With the 2017 tax act reducing the top overall U.S. rate for the Floridian to 37% but retaining the same rates on qualifying dividends, it appears the effective approaches remain the same (alternatives 3 and 8). Similarly for the Californian — who can no longer deduct state taxes exceeding $10,000, therefore making the highest overall rate 50.3% — the preferred approaches appear to remain 3, 4, and 8; although if the Obamacare tax of 3.8% is also applicable and can be offset by FTCs (which appears questionable), most of the other approaches may meet the objective stated above.

CONCLUDING COMMENTS

The foregoing discussion does not canvass all aspects of the impact of the 2017 tax act on the Canada-U.S. tax comparative or cross-border business.[37] But it clearly shows the impact is considerable in several ways for both MNEs and private interests.

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[37] For example, the 2017 tax act also affects, *inter alia*, taxes at death, sale of partnership interests, the definition and scope of the CFC rules (*see* Gregg Benson, Rhonda Rudick, and Peter Glicklich, *Elimination of 30-Day Requirement and Impact on Cross-Border Estate Planning for Canadian Families*, 47 Tax Mgmt. Int'l J. 398 (June 8, 2018)), and carried interests and, controversially, imposes tax (under §965) on deemed repatriation of CFC undistributed profits earned between 1986 and 2018.

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