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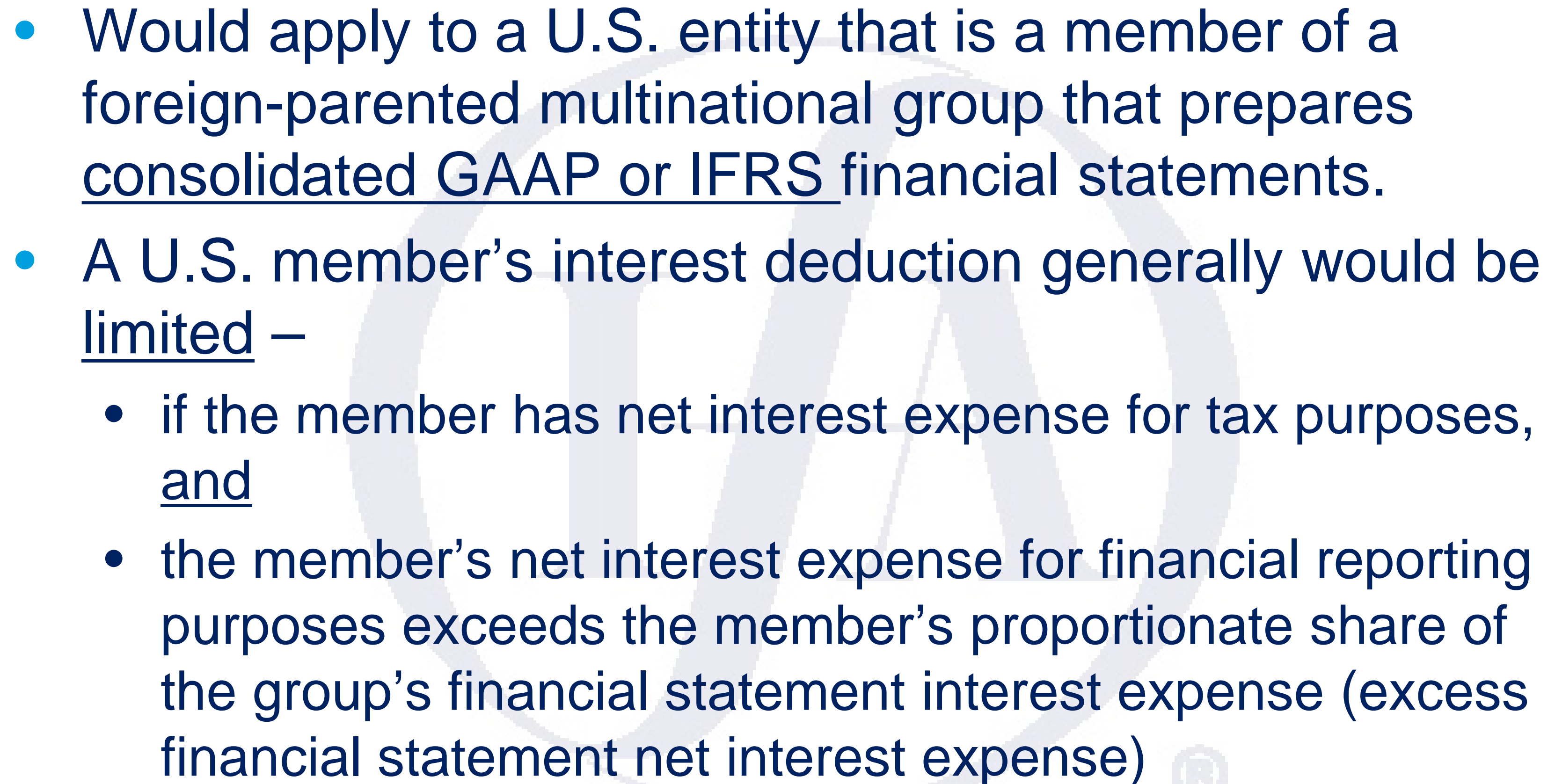
TELUS Convention Centre
Calgary, AB

U.S. Developments and Implications for Canadian Tax Planning

Interest Deductibility—Current sec. 163(j)

- Applies to interest paid by the taxpayer to a related person and interest paid on debt guaranteed by a related person.
- Limitation applies if:
  - The corporation has a debt to equity ratio exceeding <u>1.5 to 1</u>, and
  - The corporation has "excess interest expense"—generally net interest expense over <u>50%</u> of adjusted taxable income.
- Excess interest expense amounts can be carried over.
- Notice 2014-32 (anti-inversion notice) did <u>not</u> make changes to sec. 163(j).

Interest Deductibility—Obama Budget



- Would apply to a U.S. entity that is a member of a foreign-parented multinational group that prepares consolidated GAAP or IFRS financial statements.
- A U.S. member's interest deduction generally would be limited –
  - if the member has net interest expense for tax purposes, and
  - the member's net interest expense for financial reporting purposes exceeds the member's proportionate share of the group's financial statement interest expense (excess financial statement net interest expense)

Interest Deductibility—Obama Budget

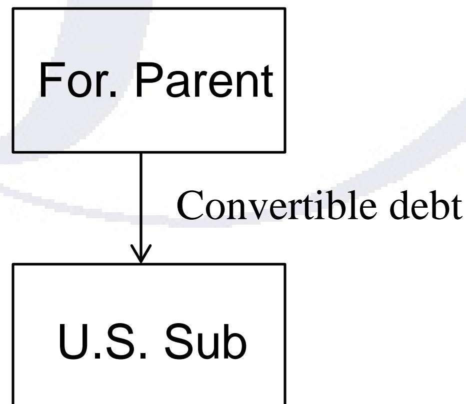
- Member's tax deduction is disallowed in the same proportion as its financial statement net interest expense is "excess."
- The reverse situation (net interest expense for financial reporting purposes is less than member's share of group's net interest expense would create excess limitation.

Interest Deductibility—Obama Budget

- If a member fails to substantiate its share of the group's net interest expense, or a member elects, the member's interest expense will be limited to the member's interest income plus 10% of the member's adjusted taxable income.
- Section 163(j) would not apply to a member subject to the proposed rule.

Interest Deductibility—PLR 201517003

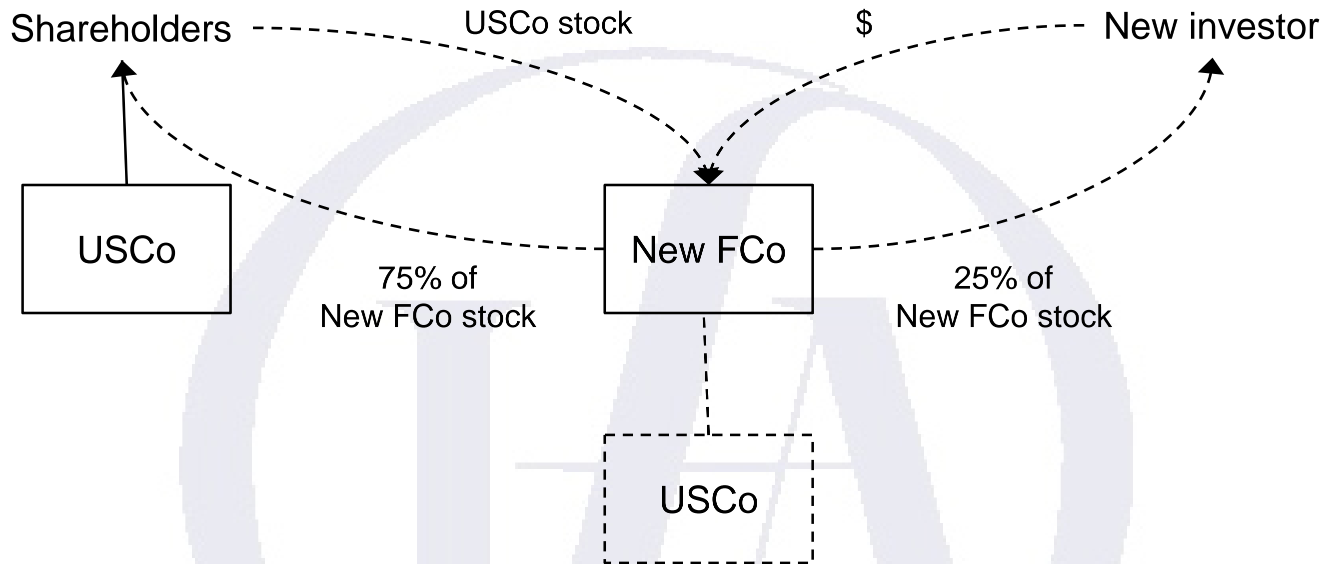
- Interest on convertible note issued to foreign parent by its wholly owned U.S. sub was ruled to be deductible.
- Section 163(l) disallows interest deductibility on debt instruments payable in equity if there is a substantial certainty that the holder will elect to convert the debt to equity.
- Here, the conversion formula caused convertibility not to be economical on issuance.



Anti-Inversion Rules—Sec. 1.7874-4T

- Section 7874 applies to “inversions”—transactions where a U.S. parent is replaced by a foreign parent.
- Under Section 7874, the new foreign parent will be treated as a domestic corporation if three conditions are met:
  - It acquires (directly or indirectly) substantially all of the assets of a domestic corporation or the U.S. business of a domestic partnership.
  - After the acquisition at least 80% of its stock is held by former owners of the domestic entity by reason of their former ownership.
  - After the acquisition the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign corporation’s country of incorporation when compared to the group’s worldwide business activities.
- Certain less severe consequences apply if former owners of the domestic entity hold at least 60% (but less than 80%) of the stock.
- In Notice 2009-78, the IRS ruled that in applying the 60% or 80% tests, certain stock acquired for cash is not taken into account.

Anti-Inversion Rules—Sec. 1.7874-4T



- Under Notice 2009-78, the 25% of New FCo stock issued to the investor would be ignored in applying the 80% test.
- The former USCo shareholders would thus be viewed as holding 100% of the New FCo stock by reason of having owned their USCo stock.
- If the other conditions of Section 7874 were met, New FCo would be treated as a U.S. corporation for U.S. tax purposes.

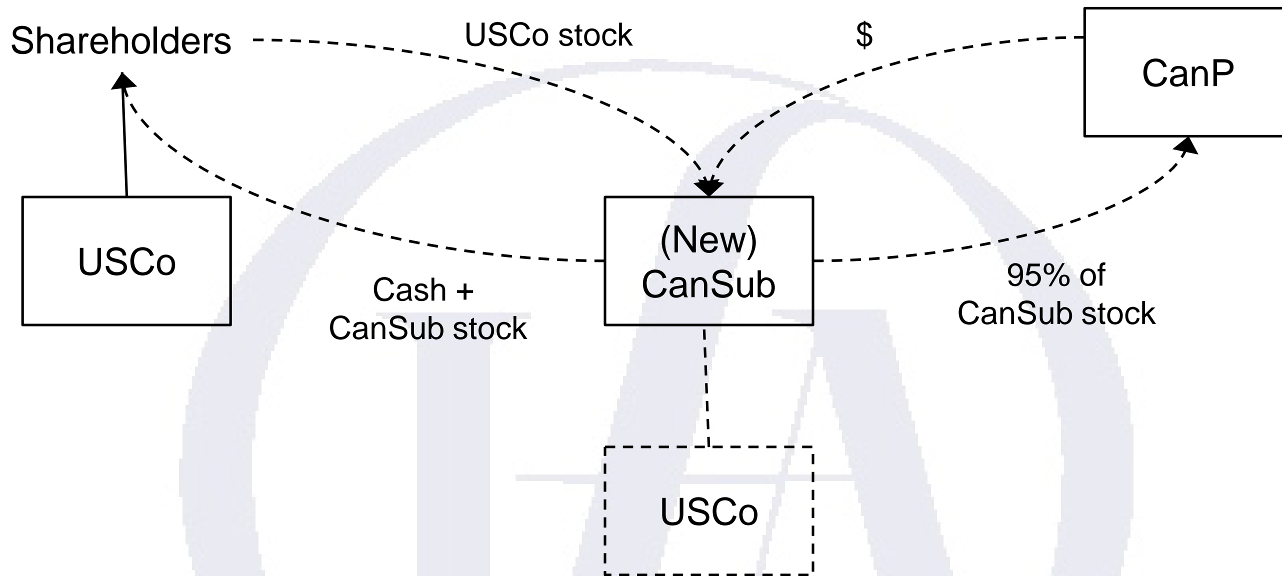
Anti-Inversion Rules—Sec. 1.7874-4T

- New temporary regulations, Temp. Treas. Reg. sec. 1.7874-4T (Jan. 2014) codify the rules in IRS Notice 2009-78, with certain changes.
- The new temporary regulations disregard certain "disqualified" stock of the new foreign parent corporation for purposes of applying the 80% and 60% stock ownership tests.
- "Disqualified stock" generally means stock of the foreign acquiring corporation that is transferred for "nonqualified property"—generally, cash, marketable securities, or debt obligations of any member of the group or related person.

Anti-Inversion Rules—Sec. 1.7874-4T

- Exceptions:
- Transfers that do not increase the value of the new foreign parent, for example, sales of stock by existing shareholders.
- Disqualified stock will not be disregarded if former owners of the acquired domestic entity would otherwise hold less than 5% of the stock of the new foreign parent or any member of the group.

Anti-Inversion Rules—Sec. 1.7874-4T



- CanP wants to acquire USCo through a new Canadian subsidiary (CanSub), and wants management shareholders of USCo to roll their shares over into CanSub shares.
- The anti-inversion rules could apply, and CanSub could be treated as a U.S. corporation, if USCo shareholders in the aggregate acquire 5% or more of CanSub stock.
- Same result if management shareholders received CanP stock instead.

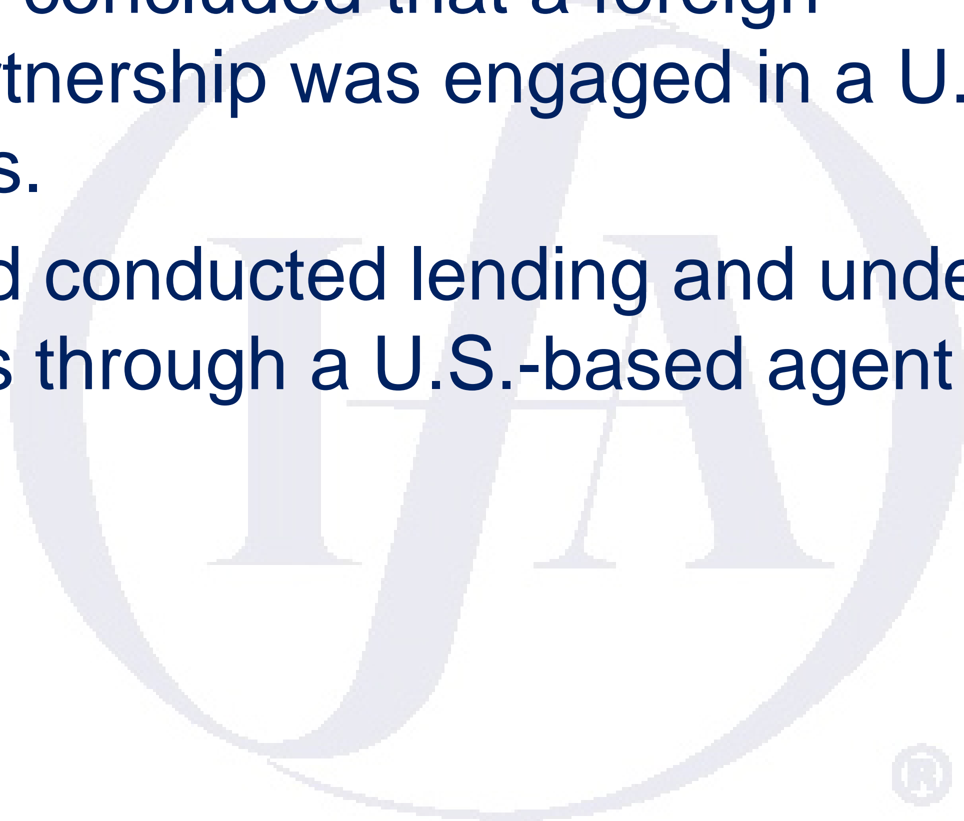
Anti-Inversion Rules—Notice 2014-52

- IRS Notice 2014-52 is the government's well-publicized (and legally questionable) effort to curtail inversion transactions.
- Two of the less well-publicized rules apply to all acquisitions (not just inversions) and can present traps for the unwary.
- In applying the "substantiality" test of Treas. Reg. sec. 1.367(a)-3(c), the Notice disregards all "non-ordinary course distributions" (i.e., distributions exceeding 110% of the preceding 3 years' average) of the domestic target corporation within the 36 months preceding the acquisition.
- In applying the 50% taxability test of Section 304(b)(5)(B) (discussed below), the Notice provides that only dividends from the foreign acquiring corporation are considered. Dividends from the issuing corporation are disregarded.
  - Since Section 304(b)(5)(B) is statutory, it's unclear how Treasury and/or the IRS have legal authority to change it.

Rev. Proc. 91-32

- Applies if a partnership has a U.S. trade or business
- IRS takes position non-U.S. partner's sale of its partnership interest is taxable to the extent attributable to partnership's U.S. property
- Contrast the IRS's position with section 741, providing for capital gains treatment on the sale of a partnership interest.
- Codification of the revenue ruling has been part of President Obama's budget proposals.
- The budget proposals would also require the transferee to withhold 10% of the amount realized.
- Foreign partners should also be mindful of sec. 1446 in a non-sale context.

CCA 201501013--ECI



- The IRS concluded that a foreign fund/partnership was engaged in a U.S. trade or business.
- The fund conducted lending and underwriting activities through a U.S.-based agent

CCA 201501013--ECI

- Fund had no employees.
- The management of Fund was vested exclusively in Fund Manager, which acted as Fund's agent.
- Fund Manager conducted, according to the National Office, an "extensive" lending and stock distribution business on behalf of Fund from the U.S.
- Fund Manager generated deals for Fund.
- Fund Manager negotiated directly with borrowers concerning all key terms of the loans.
- Fund Manager also committed extensive time and resources to conducting Fund's stock distribution, or underwriting, activities.

CCA 201501013--ECI

- National Office concluded that the Fund's lending and underwriting activities was U.S. trade or business.
  - Fund’s lending and underwriting activities were profit-oriented activities.
  - Fund conducted them on a considerable, continuous, and regular basis in the U.S.
  - Lending and underwriting went beyond the “effecting of transactions in stock and securities.”
- National Office concluded that even if Fund was trading stocks and securities, safe harbors did not apply because Manager had discretionary authority and because Fund was a dealer.

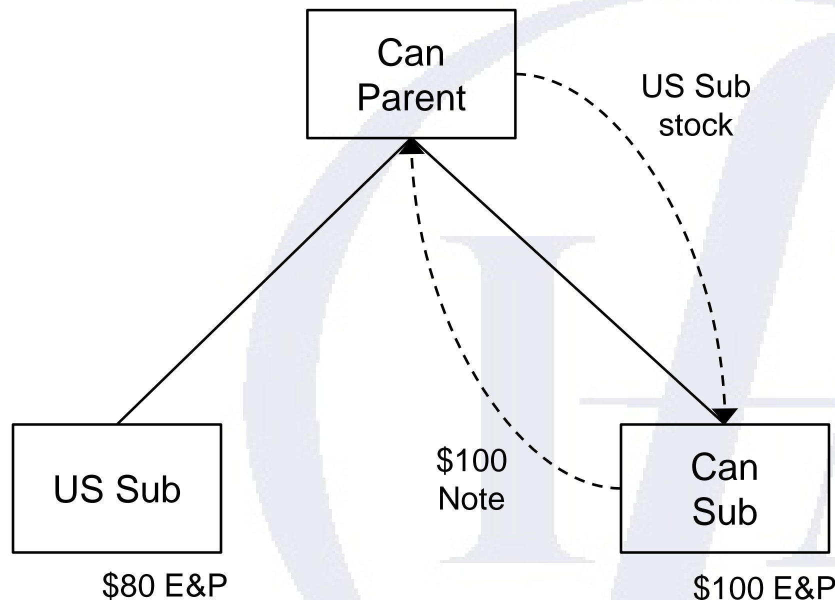
Section 304 Update

- Section 304(a)(1) applies when any person (or persons) are in control of each of two corporations, and one corporation acquires stock of the other corporation from that person in exchange for property.
  - “Control” means ownership of at least 50% of the stock by voting power or value. Certain attribution rules apply.
  - “Property” means cash, a note, or any other form of property, except stock of the acquiring corporation.
- The stock sale is recharacterized as (i) a transfer of the issuing corporation’s stock to the acquiring corporation in exchange for deemed stock of the acquiring corporation, followed by (ii) a deemed redemption of the deemed stock.
- The deemed redemption is treated as a dividend, first from the acquiring corporation’s E&P, and then from the issuing corporation’s E&P. Basis recovery after E&P is exhausted.

Section 304 Update

- Section 304(b)(5)(B) (2010 Tax Act) provides that the E&P of a foreign corporation will not be taken into account if more than 50% of the dividends would otherwise not be subject to U.S. tax or taken into account in E&P of a CFC.
- Treas. Reg. sec. 1.304-4 (Dec. 2012) permits the IRS to treat a corporation in control of the acquiring corporation as the "deemed acquiring corporation" if a principal purpose for creating, organizing, or funding the acquiring corporation is to avoid the application of Section 304 to the deemed acquiring corporation.
- Similarly, the IRS may treat a corporation controlled by the issuing corporation as the "deemed issuing corporation" if the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of Section 304 to the deemed issuing corporation.

Section 304 Update



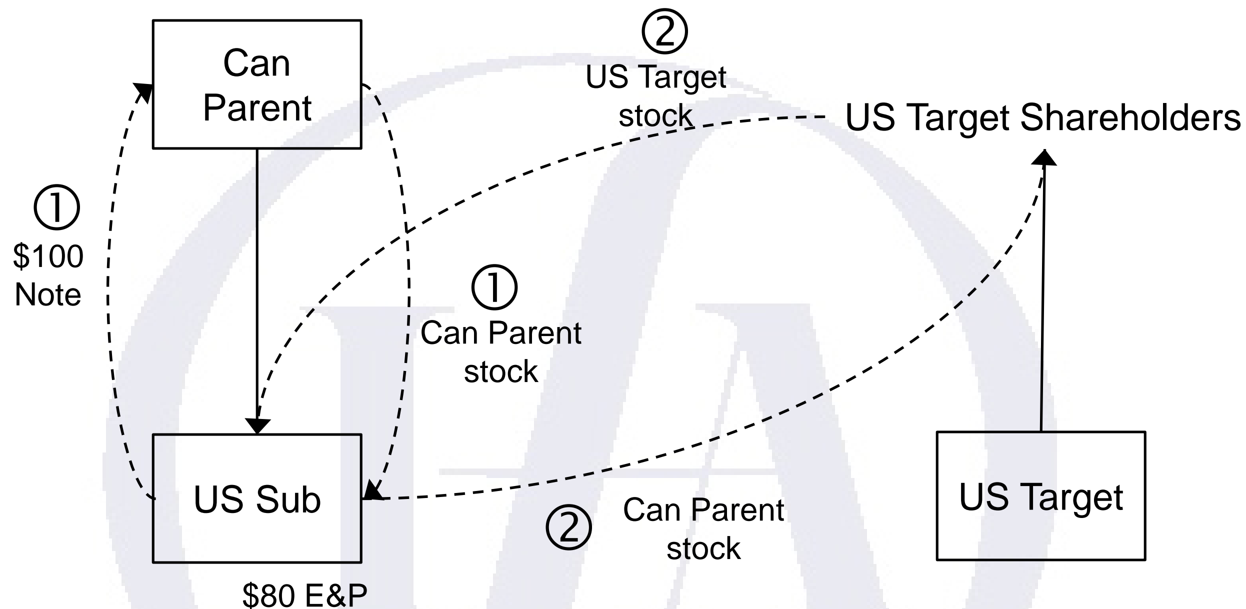
- Can Parent is treated as transferring US Sub to Can Sub in exchange for Can Sub shares, which are then redeemed.
- Can Sub's E&P cannot be taken into account, because more than 50% of the dividends would not be taxable and would not increase CFC E&P.

- In this case, only US Sub's E&P is taken into account in the redemption. The transaction generates $80 of dividend income from US Sub. U.S. withholding tax applies.
- Same result if Can Parent first transfers all of its US Sub stock to New US Sub and sells the New US Sub stock to Can Sub.
- Section 304 does not apply if CanSub uses its own stock to buy US Sub.

Notice 2014-32—“Killer B”

- IRS Notice 2014-32 announced that Treasury and the IRS will modify the so-called “Killer B” regulations involving certain triangular reorganizations in which S, a subsidiary of P, uses P stock to acquire T. See Treas. Reg. sec. 1.367(b)-10.
- The regulations will—
  - Remove the deemed contribution rule, such that, a Killer B transaction will result in a deemed distribution but no corresponding deemed contribution. P’s basis in its S stock will be adjusted in accordance with Treas. Reg. sec. 1.358-6, as if P had provided the P stock pursuant to the plan of reorganization.
  - Modify the Section 367(a) priority rule and the no-U.S. tax exception so as to eliminate opportunities to avoid recognizing gain.
  - “Clarify” the anti-abuse rule, Treas. Reg. sec. 1.367(b)-10(d), to provide that S’s acquisition of P stock in exchange for a note may invoke the rule, and that E&P of T, or of a subsidiary of S or T, may be taken into account for purposes of determining the amount of the deemed dividend. The scope of these changes is unclear, and potentially extremely broad.

Notice 2014-32—“Killer B”



- US Sub is deemed to make a $100 distribution to Can Parent. The distribution is a dividend to the extent of US Sub’s $80 E&P. Possibly, the remaining $20 is also a dividend out of US Target’s E&P under the “clarified” anti-abuse rule.
- Can Parent receives a basis step-up under Treas. Reg. sec. 1.358-6.
- Note: Killer B rules can be avoided by causing the transaction to fail to qualify as a tax-free reorganization.

U.S. Positions on BEPS

- U.S. has policy concerns about “special measures” regarding transfers of certain intangibles.
- U.S. is concerned about the Risk, Recharacterization Report’s use of the term “moral hazard,” the trade off between risk and return.
- U.S. is opposed to a “main purpose” clause being added to the OECD Model Treaty
- U.S. skeptical about a multilateral treaty.
- U.S. not in favor of broadening the PE concept.
- U.S. wants conditions on information sharing, *e.g.*, no use for formulary apportionment.