INBOUND INVESTMENT:
USING NOVA SCOTIA UNLIMITED LIABILITY COMPANIES

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ABSTRACT[*]

An archaic vestige of U.K. corporate law, the Nova Scotia Unlimited Liability Company ("ULC") was resurrected from obscurity by U.S. tax practitioners sometime in the early 1990s. Since then, it has become one of the most powerful tools in the cross-border tax planner's kitbox. This paper will attempt to give a broad overview of some of the more common uses of the ULC, showing advantages and disadvantages by comparison to an ordinary Canadian corporation.[1]

The benefits of a ULC arise from its hybrid classification: a corporation for Canadian tax purposes but a flow-through entity for U.S. tax purposes. These benefits are considered from the perspective of a U.S. individual and C corporation investor, and include: the ability to flow through losses of the ULC, to claim a foreign tax credit for the Canadian corporate tax paid by the ULC, transfer pricing advantages, the avoidance of certain negative consequences associated with foreign corporations, the creation of a basis bump on acquisition of a Canadian corporation, and use as a vehicle for a cross-border estate freeze.

CLASSIFICATION OF ULC FOR TAX PURPOSES

A ULC is a company formed under the *Nova Scotia Companies Act* of which the shareholders have unlimited liability for corporate debts. This liability may be distinguished from the liability of members of a partnership, who have direct liability to partnership creditors, in that the liability of shareholders of a ULC only arises if the company has insufficient assets to meet its obligations on winding up.[2]

How is a ULC classified for income tax purposes? For Canadian tax purposes, a corporation is defined in a rather sweeping manner in subsection 248(1) of the Income Tax Act[3] as follows:

> **"corporation"** includes an incorporated company

As a ULC is incorporated under the *Nova Scotia Companies Act*, it is commonly accepted that it is a corporation for Canadian tax purposes. This view has been confirmed by the Canada Customs and Revenue Agency ("CCRA").[4]

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[*] This paper is based on material presented in a workshop at the 2001 Annual Conference by the author and John A. Fuerst, C.P.A. of KPMG LLP, Vancouver. The author would like to express his sincere appreciation to Mr. Fuerst for his role in developing this material and his assistance in the preparation of this paper. Any errors or omissions, however, are solely the author's.

[1] This paper will not address legal issues regarding formation of ULCs and conversion of existing corporations to ULCs, as these are amply covered in Paul W. Festeryga, "Nova Scotia Unlimited Liability Companies: What Are They and How Do They Work?" in *Report of Proceedings of the Fiftieth Tax Conference,* 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 17:1-28.

[2] Ibid., at 17:7.

[3] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "ITA").

Classification of a ULC for U.S. tax purposes would be determined pursuant to entity classification regulations issued under section 7701(a) of the Internal Revenue Code,[5] commonly referred to as the "check-the-box" regulations. These regulations first give a list of foreign entities that are *per se* corporations, or entities required to be treated as corporations, which includes Canadian corporations and companies generally.[6] The regulations then carve out from the category of *per se* corporations "a Nova Scotia Unlimited Liability Company (or any other Canadian company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law)."[7] Consequently, unless an election is made to be treated as a corporation,[8] the default classification of a ULC is as a flow-through entity. Such an entity would be disregarded as an entity separate from its owner if it has only one shareholder, and treated as a partnership if it has more than one shareholder.[9]

Thus, a ULC will generally be a "hybrid" entity – a corporation for Canadian tax purposes and a flow-through entity (disregarded entity or partnership) for U.S. tax purposes.

ISSUES PARTICULAR TO U.S. INDIVIDUAL INVESTOR

Structuring

A ULC offers particularly significant benefits where one or more U.S. individuals are investing in a Canadian business venture. In such a case, the common structure utilized is to interpose an S corporation ("SCO") between the individual investor ("Ms. X") and the ULC, as shown in Figure 1. For the sake of simplicity, the discussion below will assume one individual shareholder; however, the analysis can accommodate multiple shareholders and multiple S corporations.[10] Furthermore, if the ULC has a 50% Canadian shareholder that is not a public corporation, it should be able to qualify for the preferential Canadian tax treatment afforded Canadian-controlled private corporations.

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[4] Technical Interpretations 9408195 and 9510435.

[5] Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

[6] Reg. 301.7701-2(b)(8)(i).

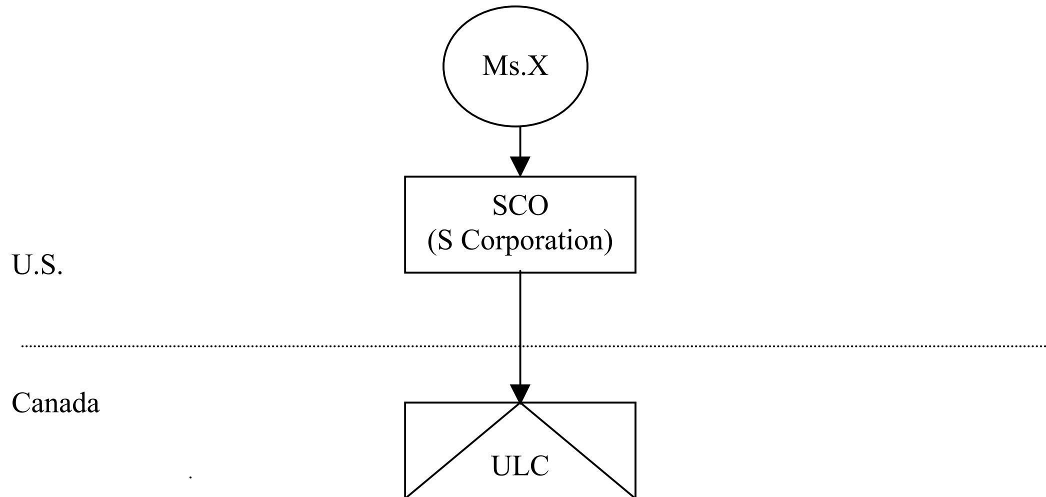
[7] Reg. 301.7701-2(b)(8)(ii)(A)(1). It appears that this specific carve-out for a ULC was made to thwart an argument that had been advanced under previous regulations that any company formed under the *Nova Scotia Companies Act* could receive flow-through treatment.

[8] Under Reg. 301.7701-3(c).

[9] Reg. 301.7701-2(c).

[10] If Ms. X already owns an S corporation that carries on a business, and it is desirable for that S corporation to own the ULC, then another S corporation should be interposed between it and the ULC (in order to insulate it from any liabilities of the ULC). Pursuant to IRC 1361(b)(3), an election would be made to treat the interposed entity as a "qualified subchapter S subsidiary," which would be disregarded as an entity separate from its owner.

Figure 1



In this case, SCO serves two purposes:

- Insulation of Ms. X from liabilities of the ULC.
- Reduction in the withholding tax rate on dividends from 15% to 5%.[11]

An S corporation is simply a U.S. corporation that elects to be an S corporation.[12] The result of this election is that all items of income, loss, etc. of the S corporation flow through to the shareholders. Thus, SCO accomplishes the above two purposes while preserving flow-through treatment from the ULC to Ms. X. Because the ULC would be wholly owned by SCO, for U.S. tax purposes it would be disregarded as an entity separate from SCO, as discussed above.

A number of restrictions are imposed on S corporations.[13] A limited liability company avoids these restrictions, while preserving limited liability and flow-through treatment, and is therefore generally favored by U.S. practitioners. However, CCRA does not consider a limited liability company to be a resident of the U.S. for Treaty purposes, as it is not liable for tax in the U.S.[14] Consequently, a limited liability company would not receive any Treaty benefits – such that, for example, dividends from a ULC to a limited

[11] Under Article X(2) of the Canada-U.S. Income Tax Convention (the "Treaty").

[12] This election, under IRC 1362(a), must be made with the consent of all shareholders.

[13] For example, an S corporation cannot have more than 75 shareholders, a nonresident alien or C corporation as shareholder, or more than 1 class of stock. See IRC 1361(b).

[14] Document 9416455. In contrast to a limited liability company, an S corporation is only exempt from tax by virtue of an election, which can be revoked or terminated; in addition, an S corporation can be subject to tax on "built-in gains" under IRC 1374. Consequently, CCRA considers an S corporation to be resident of the U.S. for Treaty purposes.

liability company would be subject to withholding tax at the 25% statutory rate.[15] Therefore, a limited liability company is not generally an appropriate entity to interpose between a U.S. individual shareholder and a ULC.

Flow-Through of Losses

We will now turn our attention to the benefits of using a ULC in this case. An obvious benefit is that losses flow through to SCO and then, potentially, to Ms. X's U.S. tax returns.[16] In this regard it should be noted that her ability to deduct losses of SCO will generally be subject to three separate limitations: her tax basis in SCO stock and indebtedness to her,[17] her "at risk" amount,[18] and the passive activity loss rules.[19] Assuming these hurdles are overcome, the flow-through of losses constitutes both a timing benefit and a potential permanent benefit. If the ULC turns around and becomes profitable, Ms. X has realized a timing benefit from the loss flow-through. If the ULC does not turn around, and is eventually wound up at a loss, then the loss flow-through is a permanent benefit; that is because, if an ordinary Canadian corporation had been used instead of a ULC, the loss on liquidation would be a capital loss.[20]

Foreign Tax Credits

Avoidance of Double Taxation

The next benefit we will consider, which may well be the most significant, is that Ms. X can claim a foreign tax credit on her U.S. individual income tax return for the Canadian corporate tax paid by the ULC.[21] For an individual shareholder such as Ms. X, using a

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[15] Under ITA 212(2).

[16] This flow-through occurs in the following manner. First, the income and expenses of the ULC would be translated into U.S. dollars, and recharacterized under U.S. tax accounting principles, and reported on the S corporation income tax return (Form 1120S). This return would include a Schedule K-1 for each shareholder, showing his or her allocated share of the S corporation's business income or loss, foreign taxes, etc. The shareholder would then include each item from the K-1 on his or her U.S. income tax return.

[17] IRC 1366(d)(1).

[18] IRC 465(a).

[19] IRC 469.

[20] Capital losses offset capital gains. $3,000 of net capital losses are deductible against ordinary income ($1,500 if married filing separate), with the excess carried forward to offset capital gains or deduct against ordinary income ($3,000 or $1,500 per year, depending on filing status).

[21] This flow-through is accomplished technically as follows. Under IRC 1373(a), an S corporation is treated as a partnership for foreign tax credit purposes (i. .e., for purposes of Subchapter N, Part III, Subpart A of the IRC, containing sections 901-908). The flow-through of foreign-source income and taxes is provided in IRC 702(a)(6), under which each partner (i.e., shareholder of the S corporation) takes into account separately his/her distributive share of the partnership's (i.e., S corporation's) foreign income taxes. This provision, combined with IRC 901(b)(5), allows the individual S corporation shareholders to claim a foreign tax credit on their personal tax returns. It should also be noted that IRC 1363(c)(2)(B) provides that foreign tax credit elections under IRC 901 shall be made by the shareholders of the S corporation. Of

ULC is the only way to obtain such a credit and thereby avoid double taxation. The economic significance of this foreign tax credit in increasing Ms. X's after-tax cash is illustrated in Table 1.[22]

Table 1: After-tax income

	Earned in Canada		***Earned in U.S.***	
	Non-ULC	*ULC*	*C Corp*	*S Corp*
Pre-tax net income	100	100	100	100
Taxes payable by corporation	(40)	(40)	(38)	0
After-tax profit = dividend payable	60	60	62	100
Taxes payable by Ms. X:				
Canadian dividend withholding tax @5%	(3)	(3)	0	0
U.S. federal income tax @38.6%	(23)	(39)	(24)	(39)
Foreign tax credit	3	39	0	0
Net federal income tax	(20)	0	(24)	(39)
State income tax @4% (no FTC)	(2)	(4)	(2)	(4)
After-tax cash	35	53	36	57
Total tax rate	65%	47%	64%	43%

The two columns headed "Earned in Canada" compare an ordinary Canadian corporation with a ULC. In the "Non-ULC" column we see the consequence of using an ordinary corporation: Ms. X is subject to U.S. tax on dividends paid, but only receives a foreign tax credit for the dividend withholding tax. The resulting double taxation creates a total tax rate of 65%, leaving only $35 after-tax cash on $100 pre-tax income. In the "ULC" column, Ms. X includes the full $100 pre-tax net income on her U.S. tax returns, and claims a foreign tax credit for the Canadian corporate income tax of the ULC and the dividend withholding tax. As these taxes exceed the U.S. federal income tax liability on this income, $4 of foreign taxes are "left on the table" in this example. Nonetheless, the

course, these provisions are all federal; for state tax purposes, the mechanism (or lack thereof) for claiming a foreign tax credit varies from state to state.

[22] Simplified assumptions under which this table was made include: tax rates as shown (generally, these are projected 2002 tax rates), no difference in tax accounting between Canada and the U.S., and no foreign tax credit availability on Ms. X's state income tax return. For comparability in the withholding tax rate on dividends in the "Non-ULC" and "ULC" columns, ownership of the Canadian company by an S corporation is assumed in both cases.

increase in after-tax cash achieved by the ULC structure – from $35 to $53 – is compelling.[23]

As a point of comparison, the two columns headed "Earned in U.S." illustrate the impact of earning the same $100 in the U.S. through U.S. entities. The "C Corp" column shows the effect of earning the income through a C corporation.[24] Due to the lack of integration, income is subject to a total tax rate of 64%, yielding only $36 after-tax income. The "S Corp" column shows the effect of earning the income through an S corporation, with all taxes paid by Ms. X.[25] These columns show that earning income through a Canadian corporation does not compare that unfavorably with earning the same income in the U.S. The primary differences are due to higher Canadian corporate tax rates that, in the case of the non-ULC, exacerbate the lack of integration and, in the case of the ULC, create excess foreign taxes.

<u>Foreign Loss Recapture Rules</u>

If SCO incurs losses, or Ms. X has foreign losses from other sources, then her ability to claim foreign tax credits may be limited by the foreign loss recapture rules.[26] These rules are intended to curb the ability to use foreign losses to offset U.S. income and then, when foreign operations turn around, use foreign tax credits to reduce U.S. tax on foreign-source income. They operate by resourcing up to 50% of foreign income as domestic income, until all foreign losses have been recaptured. The effect of this regime is to defer or deny the use of a portion of a taxpayer's foreign taxes.

Where Ms. X owns one ULC that incurs losses for the first few years and then becomes profitable, the overall foreign loss regime should not cause a reduction of foreign tax credits as long as the income/loss of the ULC for Canadian tax purposes is the same as its income/loss for U.S. foreign tax credit purposes each year (i.e., there is no mismatching of income). In other words, if the ULC earns income that absorbs its loss carryovers and becomes taxable in Canada in the same year that it absorbs its overall foreign losses for U.S. foreign tax credit purposes, then there should be no foreign tax credit reduction under this regime.

However, if the ULC's loss for U.S. foreign tax credit purposes is greater than its loss for Canadian, then a reduction under the overall foreign loss regime would be likely. This could occur if the ULC has less debt than SCO, such that its foreign-source taxable loss

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[23] Foreign-source income and taxes would be reported on the Schedule K-1 that SCO issues to Ms. X, but the actual foreign tax credit claim would be made on Ms. X's 1040 Individual Income Tax Return. Thus, other elements of her personal tax situation may affect her foreign tax credit. For example, if she is subject to the alternative minimum tax, only 90% of this tax may be offset by foreign tax credit.

[24] A C corporation is defined in IRC 1361(a)(2) as a corporation which is not an S corporation. A limited liability company is not considered to be a corporation for U.S. tax purposes.

[25] The tax result would be the same if a limited liability company, partnership or proprietorship were used.

[26] IRC 904(f).

for U.S. purposes is greater than its loss for Canadian tax purposes.[27] In such a case, an improvement in the ULC's income will cause it to become taxable in Canada before it has absorbed its overall foreign losses for U.S. purposes.

Another scenario in which the overall foreign loss regime could be problematic is if Ms. X establishes a ULC that incurs operating losses for a few years and then starts another ULC that is immediately profitable. Ms. X's foreign tax credit for the Canadian taxes paid by the second ULC will likely be limited under the overall foreign loss regime. In such a case, it may be preferable for the second Canadian venture to be a branch of the first ULC or an ordinary corporation.

ISSUES PARTICULAR TO U.S. C CORPORATION INVESTOR

Structuring

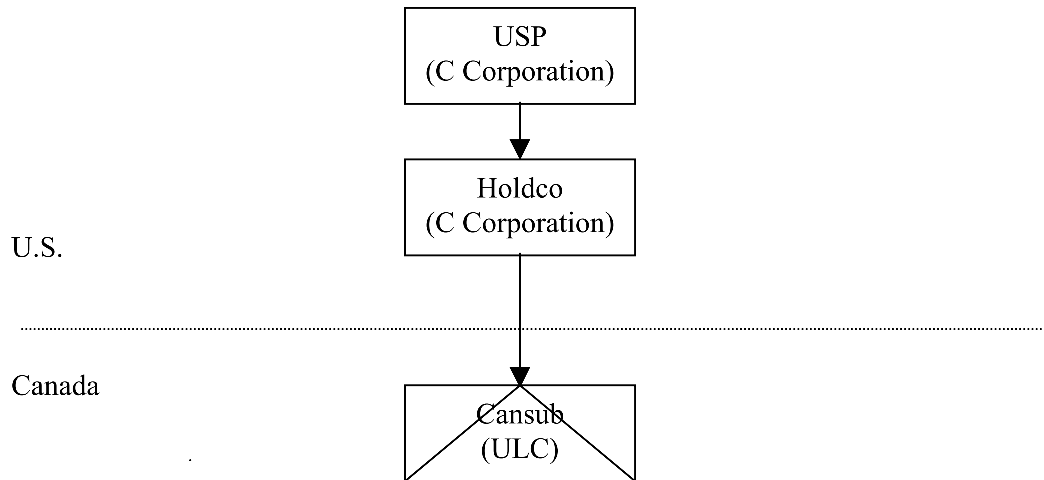
This section will consider the use of a ULC where the U.S. investor is a C corporation. As in the case where the U.S. investor is an individual, consideration should be given to interposing a sole-purpose U.S. corporation ("Holdco"), which in this case would be a C corporation, between the U.S. parent ("USP") and its Canadian ULC subsidiary ("Cansub"), as illustrated in Figure 2.[28] The sole purpose of Holdco would be to limit the exposure of USP to liabilities of Cansub. In that case, Cansub would be treated as a foreign branch of Holdco for U.S. tax purposes. USP and Holdco would elect to file a consolidated return, to enable the flow-through of Cansub income and expenses to USP.[29] It may be advantageous to incorporate Holdco in a state that either does not have a state income tax or that imposes income tax based on domicile rather than incorporation.

[27] I.e., the reverse of the scenario described below in "Utilizing Excess Canadian Taxes – Example 2: Decreasing Foreign-Source Deductions."

[28] If Cansub is expected to realize losses that would be deductible on USP's state returns, the benefit of those losses should be weighed against the liability insulation in deciding whether to interpose a Holdco.

[29] The election to file a consolidated return will cause Holdco and Cansub (its Canadian "branch") to be jointly and severally liable for the U.S. federal tax liability of USP and any other members of the consolidated group, per Reg. 1.1502-6.

Figure 2



Flow-Through of Losses

Benefit Is Only Timing

As with the U.S. individual investor as shown above, losses of Cansub will flow through to the USP consolidated return. Furthermore, since Cansub is 100%-owned and therefore treated as a branch for U.S. purposes, the deductibility of such losses will not be subject to limitations regarding tax basis, at-risk amount and passive activity losses as were shown to apply to the individual shareholder/S corporation scenario.

However, whereas the benefit of the loss flow-through to a U.S. individual investor was shown above to potentially provide both a timing benefit and a permanent tax reduction, the benefit of flowing through losses to a C corporation shareholder will generally only be a timing benefit. This will be apparent if we consider the tax result if Cansub were an ordinary Canadian corporation that, after incurring losses, is eventually wound up into Holdco at a loss (i.e., the fair market value of Cansub's net assets received on liquidation is less than Holdco's tax basis in Cansub stock). In that case, Holdco may claim an ordinary deduction for worthless stock on liquidation of Cansub,[30] provided the following conditions are met:

1. Cansub must be insolvent at the time of liquidation.[31]

2. Holdco must own at least 80% of the stock of Cansub (by votes and value).[32]

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[30] Under IRC 165(g)(3).

[31] If Cansub is insolvent at the time of liquidation, it would not be considered to have made a payment to Holdco in exchange for its stock, and therefore IRC 332 would not prevent Holdco from claiming a loss on the liquidation. See Reg. 1.332-2(b), which directs one to IRC 165(g) in such a case.

[32] IRC 165(g)(3)(A).

3. Cansub must meet an active business test, which generally requires that more than 90% of its aggregate receipts for all years are from sources other than dividends, interest, etc.[33]

4. Cansub stock must not have become worthless in a previous year.[34]

5. The liquidation must be an event fixing the stock's worthlessness. The courts have generally held that this test is met where the subsidiary is insolvent at the time of liquidation.[35]

Thus, if Cansub is an ordinary corporation that carries on an active business and is insolvent at the time of liquidation, its C corporation parent company would generally be able to claim an ordinary deduction for its loss on liquidation. The amount of this loss would be its basis in Cansub stock.[36] As this should be approximately the same as the total losses that would be realized on a flow-through basis if Cansub were a ULC, it follows that the advantage of the ULC flow-through would only be a timing benefit. Furthermore, because the worthless stock deduction would likely be U.S.-source,[37] whereas losses flowed through from a ULC would be foreign-source, the deduction for worthless stock would likely offer foreign tax credit advantages over ULC losses.

Limitations Under Dual Consolidated Loss Regime

Even though the benefit of flowing through ULC losses will generally only be a timing benefit to a C corporation shareholder, it may be significant nonetheless. However, in this case the deduction of those losses will be subject to the dual consolidated loss rules. These rules were introduced to prevent losses of "dual resident corporations" from being used twice: once to offset income of the U.S. consolidated group, and again to offset income earned by other members of a foreign affiliated group. They operate to disallow the deduction of a dual consolidated loss of a dual resident corporation against the income

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[33] IRC 165(g)(3)(B). Rev. Rul. 75-186 provides that this test is made on an aggregate basis for the subsidiary's entire period of existence, rather than for each particular year.

[34] The courts have established a stringent test for determining worthlessness, expressed as follows: "stock may not be considered as worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time" (*Morton v. Comr.,*33 BTA 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940)).

[35] See *Iron Fireman Manufacturing Co. v. Comr.,* 5 TC 452 (1945)); *Martin M. Dittmar v. Comr.*, 23 TC 789 (1955); Rev. Rul. 70-489; and PLR 9610030.

[36] While IRC 165(g)(3) provides the rules under which a loss on worthless securities may be an ordinary loss, the deduction itself would be claimed under IRC 165(a), as provided in Reg. 1.165-5(d)(1). IRC 165(b) provides that the basis for determining a loss under IRC 165(a) is the adjusted basis under IRC 1011. Reg. 1.165-1(c)(1) then provides that the amount of loss allowed under IRC 165(a) shall not exceed the adjusted basis of the property, as calculated under Reg. 1.1011-1.

[37] Reg. 1.865-2(a)(1).

of a U.S. corporation, regardless of whether the loss actually offsets income of another entity under the tax laws of the foreign country.[38]

In order for the dual consolidated loss rules to apply, two elements must be present:

- A loss must be incurred by a dual resident corporation, which is generally defined as a U.S. domestic corporation that is also subject to tax by a foreign country on worldwide income or on a residency basis.[39] Under this definition, a separate unit of a domestic corporation is treated as a dual resident corporation; a separate unit in turn is defined to include a foreign branch, an interest in a foreign partnership or trust, and a "hybrid entity separate unit" – which is an entity that is treated as a corporation under foreign tax law but not under U.S. tax law.[40] Thus it is clear that a ULC would be a separate unit that is treated as a dual resident corporation for these purposes.

- The loss must be a dual consolidated loss, which is generally defined as the net operating loss of a dual resident corporation, unless an exception applies. None of the exceptions provided in the regulations would appear to apply to a ULC.[41]

However, if an election is made to forego utilization of the dual consolidated loss against the income of any other foreign entity, then the dual consolidated loss restrictions will not apply.[42] Making this election will generally be the only way for the USP consolidated group to deduct losses of the ULC.[43] Although this election may at first glance appear innocuous, it could limit future Canadian tax planning. For example, it would preclude amalgamation of the ULC with another Canadian corporation to utilize the ULC's losses, even if that corporation were a third party purchasing shares of the ULC.

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[38] IRC 1503(d)(1) and Reg. 1.1503-2(b)(1).

[39] Reg. 1.1503-2(c)(2); see also IRC 1503(d)(2)(A).

[40] Reg. 1.1503-2(c)(3) and (4).

[41] The primary exception is for a loss incurred in a foreign country whose tax laws do not permit losses to be recognized by another entity, either in the same year or another year (Reg. 1.1503-2(c)(5)(ii)(A)). This exception would not be available for a ULC, because Canadian law allows loss carryovers to be utilized against the income of another entity following an amalgamation (ITA 87(2.1) and (2.11)).

[42] Reg. 1.1503-2(g)(2)(i). The election would include an agreement by the USP consolidated group and the ULC certifying that (i) no portion of the dual consolidated loss will ever be used to offset the income of any other person under the tax laws of a foreign country, and (ii) arrangements have been made to ensure that such usage this will not occur.

[43] Even if there is no consolidated group, but merely a C corporation owning a ULC, the election will be necessary to avoid the dual consolidated loss rules. See Reg. 1.1503-2(b)(1).

Foreign Tax Credit Issues

A C corporation owning an ordinary Canadian corporation is allowed a "deemed paid" foreign tax credit for the underlying foreign tax of the subsidiary.[44] The deemed paid credit arises in the year in which dividends are paid, whereas the direct credit for ULC taxes arises in the year the Canadian taxes are paid or accrued. Apart from timing differences, the amount of the two credits will be similar in many cases. Thus, for a C corporation shareholder, the potential foreign tax credit benefits of a ULC are generally much more modest than for an individual shareholder. Certain foreign tax credit benefits of a ULC that are common to both C corporation and individual shareholders are discussed in the next section ("Utilizing Excess Canadian Taxes"). Additional foreign tax credit benefits of a ULC that are relevant to C corporation shareholders are:

1. A ULC avoids anomalous results on dividends. Distributions from a ULC are non-events from a U.S. perspective. Distributions from an ordinary Canadian corporation are taxed as dividends, to the extent of current or accumulated earnings and profits, which can produce inappropriate results. For example, if an ordinary Canadian corporation with accumulated losses makes a distribution in a profitable year, that distribution would be taxable to the U.S. parent as a dividend; however, because Canadian taxes have not been paid (due to loss carryovers), no deemed paid foreign tax credit would arise.

2. A ULC avoids the separate foreign tax credit basket for foreign subsidiaries where the percentage of voting stock owned is between 10 and 50%.[45] A ULC engaged in business operations would normally create foreign taxes in the general limitation basket, available against a wide range of foreign-source income.

3. Deemed paid foreign tax credits stop at 6th tier controlled foreign corporations and 3rd tier non-controlled foreign corporations.[46] A ULC avoids this limitation.

UTILIZING EXCESS CANADIAN TAXES

A number of methods may be available to utilize excess foreign taxes created by a ULC, and thereby increase the after-tax yield on the Canadian income. First, it should be noted that U.S. law allows excess foreign taxes to be carried back two years and forward five years.[47] Furthermore, as the U.S. foreign tax credit is not subject to a per country limitation, excess taxes from high-tax countries such as Canada may generate a credit

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[44] IRC 902(a). This credit is only available to a C corporation that owns at least 10% of the foreign subsidiary's voting stock. The credit allowed under IRC 902(a) must be included in income under IRC 78.

[45] IRC 904(d)(2)(E). As a result of the 1997 Taxpayer Relief Act, this separate basket will not apply to earnings and profits accumulated after 2002 unless the foreign corporation is a passive foreign investment company.

[46] IRC 902(b).

[47] IRC 904(c).

against foreign-source income from low-tax countries as long as the income is in the same category or "basket."[48]

Depending on the particular facts and circumstances, a ULC may offer opportunities to utilize excess Canadian taxes that are not available where an ordinary Canadian corporation is used, by taking advantage of the rules for sourcing income and deductions in calculating the U.S. foreign tax credit. The basic formula that limits the foreign tax credit is:[49]

$$\frac{\text{foreign-source taxable income}}{\text{total taxable income}} \times \text{U.S. tax liability}$$

Where the foreign tax rate exceeds the U.S. tax rate, the foreign tax credit will be greater if the ratio of foreign-source taxable income to total taxable income is increased. This can be accomplished by either increasing foreign-source income or decreasing foreign-source deductions. We will consider an example of each possibility, in each case assuming a simplified scenario in which the U.S. parent company ("USP") carries on other business activities in the U.S. and owns 100% of ULC. These examples are equally applicable if USP is a C corporation or an S corporation.

Example 1: Increasing Foreign-Source Income

This example is based on the following assumed facts:

- USP is in the business of creating custom computer software, which is characterized as income from services.
- ULC provides computer programming services to USP, which are incorporated in the services USP provides to its client. ULC charges an arm's length fee to USP for these services.
- ULC programmers are paid less (when translated into US$) than USP employees for similar work.

The first step in the foreign tax credit calculation is the computation of foreign-source gross income. Under general principles, income from services is sourced to the location where the services are provided, without reference to the jurisdiction of the customer.[50] Where services are performed partly within and partly without the U.S., as is the case here, the gross income from those services must be apportioned between U.S. and foreign

[48] Under IRC 904(d) there are nine categories of income (commonly referred to as "baskets"), on which the foreign tax credit must be calculated separately.

[49] IRC 904(a).

[50] IRC 862(a)(3).

sources.[51] In making this apportionment, Reg. 1.861-4(b)(1)(i) provides that an apportionment based on time may be acceptable, depending on the facts and circumstances.[52] In this case, because ULC's Canadian personnel contribute to the work product equally with USP's U.S. personnel, an apportionment based on time would appear to be the most appropriate, notwithstanding that labor costs are lower in Canada.

The next step in calculating the foreign tax credit is computing foreign-source deductions, which would be done on a factual basis.[53] Thus all ULC expenses, such as salaries, would be foreign-source deductions. Consequently, foreign-source gross income will be disproportionately high when compared to foreign-source deductions. The resulting higher foreign-source taxable income will enable more of the ULC's Canadian tax to be recovered as a foreign tax credit. This can shave a few percentage points off the total tax rate, and may bring the total tax rate under the ULC scenario to the rate that would prevail if the income were earned totally in the U.S.

Example 2: Decreasing Foreign-Source Deductions

This example is based on the following assumed facts:

- USP is a profitable business entity, has significant assets and no debt.
- ULC is purchasing assets which will be financed by borrowing from a Canadian bank. This debt will be guaranteed by USP.

In calculating USP's foreign-source taxable income, interest expense would be apportioned under the concept of fungibility, based on the relative proportion of assets used to earn U.S. versus foreign-source income.[54] Consequently, the amount of interest expense apportioned to Canada would be less than the interest expense actually paid by ULC. As a result, USP's foreign-source taxable income would be greater than ULC's income for Canadian tax purposes, thereby enabling more of the Canadian tax to be recovered as a foreign tax credit and increasing the after-tax cash accordingly. In addition to this foreign tax credit benefit, USP will receive an immediate deduction for the interest expense of ULC.

In this example, the potential impact of Canadian thin capitalization rules should be considered.[55] The February 2000 Budget had proposed to expand the definition of debt

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[51] IRC 863(b)(1) provides the statutory basis for such apportionment. In implementing this statute, Reg. 1.863-1(c) refers one to Reg. 1.861-8 through 1.861-14T.

[52] Court cases in this area of note are *Tipton & Kalmbach, Inc. v. U.S.* 480 F2d 1118 (CA-10, 1973) and *Le Beau Tours Inter-America, Inc. v. U.S.*, 547 F2d 9 (CA-2, 1976).

[53] Reg. 1.861-8T(c)(1).

[54] Reg. 1.861-9T(f)(2). Assets may be determined based on U.S. tax book value or fair market value (Reg. 1.861-9T(g)(1)(ii)).

[55] ITA 18(4).

under these rules to include third party debt that is guaranteed by a specified non-resident;[56] however, on May 9, 2000 the Minister of Finance announced the deferral of this proposal, pending further consultation. If this proposal is implemented, the above planning would obviously be impacted.

An alternative method of achieving a similar result would be for USP to loan funds to ULC, up to the amount allowable under Canadian thin capitalization rules. As long as the interest charged does not exceed an arm's length interest rate, the interest should be deductible by ULC for Canadian purposes. However, the interest would not constitute income to USP, as this would be considered an inter-branch transaction for U.S. purposes.[57] Thus, the interest would be deductible at high Canadian corporate rates, at a cost of only 10% withholding tax.[58] This strategy has been termed "the poor man's double dip," as it achieves some of the benefits of double dip structures without the associated planning and implementation costs.[59]

TRANSFER PRICING BENEFITS OF A ULC

Advantages Over Ordinary Canadian Corporation

Where Cansub is a ULC that is owned 100% by USP, a number of transfer pricing benefits arise. As Canadian corporate income tax rates are higher than those in the U.S., there will be an incentive in setting transfer prices for goods and services between USP and Cansub so as to minimize Cansub's income. If Cansub is an ordinary corporation, any amounts USP charges it for goods and services would create income to USP; accordingly, if CCRA lowers the amount of those charges under Canadian transfer pricing rules,[60] double taxation would result unless USP is able to convince the Internal Revenue Service ("IRS") to lower its income inclusion for U.S. purposes.[61]

If Cansub is a ULC, any payments between it and USP would be disregarded for U.S. purposes, thereby avoiding the above risk of double taxation due to transfer pricing adjustments. Furthermore, USP would only have to concern itself with one set of transfer pricing rules (Canadian), thereby avoiding the need to determine appropriate transfer pricing under IRC 482 and prepare related documentation under IRC 6662(e)(3)(B), as well as the risk of potential adjustments and penalties under those provisions.

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[56] By amendments to ITA 18(6).

[57] For U.S. foreign tax credit purposes, some of USP's interest expense would be apportioned to ULC's income, based on the relative value of assets deployed as discussed above. This would reduce the effectiveness of this strategy.

[58] Treaty Article XI(2).

[59] One could of course attempt to obtain a similar benefit if the Canadian company is an ordinary corporation and USP borrows funds and on-lends them to it. However, in that case Reg. 1.861-10 serves to limit or deny such a benefit.

[60] ITA 247(2).

[61] If the IRS refuses such a request, recourse can be had to the competent authority provisions of Treaty Article IX, however, this is a very time-consuming and potentially frustrating process.

Advantages Over Canadian Branch

Another relevant comparison, from a transfer pricing perspective, is between the use of a ULC and a branch. Branch income for Canadian tax purposes would be determined under Treaty Article VII. In this determination, paragraph 2 provides that business profits shall be attributed to the branch as if it "were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident." Thus, in theory the income attributable to a branch should be similar to that which a Canadian subsidiary would earn, since in both cases the transfer price for transactions with the parent should be determined under the arm's length principle.

However, there are severe practical difficulties in determining branch profits under the arm's length principle, as illustrated by the *Cudd Pressure* decision.[62] That decision concerned a U.S. corporation that used specialized equipment in its Canadian branch, and sought to deduct rent that it asserted would have been payable under the arm's length principle (under the 1942 Canada-U.S. Tax Treaty) to the parent company for use of the equipment. The Tax Court of Canada held that paragraph 4(b) of the Income Tax Conventions Interpretation Act prohibits a deduction for notional expenses of a branch under a tax treaty.[63]

It is submitted that the *Cudd Pressure* decision and CCRA's position regarding notional expenses[64] may be based on a misunderstanding of paragraph 4(b) of the Income Tax Conventions Interpretation Act. This paragraph provides that, in determining business profits attributable to a permanent establishment in Canada under a tax treaty, deductions shall not be allowed that would not be deductible by a person resident in Canada. It would appear that the purpose of this paragraph is to disallow deductions that *by their nature* are non-deductible under Canadian law – for example, expenses described in ITA 18(1), such as payments to earn exempt income and contingent reserves. If this paragraph disallows all notional expenses between a Canadian branch and its head office, then it renders the arm's length principle of Treaty Article VII(2) meaningless.

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[62] *Cudd Pressure Control v. the Queen,* 98 DTC 6630 (FCA). This decision is discussed in David A. Ward, "Attribution of Income to Permanent Establishments" (2000), Vol. 48, no. 3 *Canadian Tax Journal* 559-576 at 568-570.

[63] The majority decision of the Federal Court of Appeal found the expenses in question to be non-deductible under the facts, and did not find it necessary to deal with the broader issue of the deductibility of notional expenses as a matter of law. In a concurring decision of the Court of Appeal, McDonald JA stated that notional expenses could potentially be deductible under the Treaty, but agreed that the facts of this case prohibited such a deduction.

[64] See Michael Hiltz's comments in *Recent Cases: The View from Revenue Canada, Report of Proceedings of the Fiftieth Tax Conference,* 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 47:16-19.

Notwithstanding that the *Cudd Pressure* decision may not represent good law, until it is overturned the ability of a Canadian branch to claim deductions for inter-branch charges under the arm's length principle will be severely restricted. The use of a ULC avoids this problem.

AVOIDING NEGATIVE CONSEQUENCES OF FOREIGN CORPORATIONS

In addition to positive benefits of flow-through treatment as described above, a ULC avoids a number of potentially negative U.S. tax consequences associated with ownership of a foreign corporation by a U.S. person.

Transfer of Intangibles

Where a U.S. person transfers intangible property to a foreign corporation in what would otherwise be a rollover transaction for U.S. purposes, the "super-royalty" rules of IRC 367(d) will be triggered. These rules cause the transferor to include in income annually a deemed royalty commensurate with the income earned by the intangible in the hands of the foreign corporation. The definition of intangible property for these purposes is very broad.[65] Where the foreign transferee is a Canadian corporation, the result of these super-royalty provisions is double taxation, because the Canadian corporation would receive no corresponding deduction for Canadian tax purposes.

Under current law, the super-royalty provisions do not come into play if intangible property is transferred to a ULC.[66] This use of a ULC to effect a transfer of intangible property to Canada is equally applicable where the transferor is a U.S. individual, S corporation or C corporation. In addition, it is particularly suited to a Canadian joint venture where the U.S. joint venturer is contributing intangible property.

Controlled Foreign Corporation

A Controlled Foreign Corporation ("CFC") is defined as a foreign corporation of which shares comprising more than 50% of the votes or value are owned by U.S. shareholders.[67] Negative consequence of CFC status include the following:

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[65] As defined in IRC 936(h)(3)(B), it includes patents, inventions, formulas, processes, know-how, copyrights, literary, musical or artistic compositions, trademarks, trade names or brand names, franchises, licenses, contracts, methods, and similar items.

[66] Where intangibles are transferred to a wholly-owned ULC, the transfer would be ignored for U.S. tax purposes. If the ULC has more than one shareholder, the transfer would be treated as a tax-free contribution of property to a partnership under current law (IRC 721(a)); in this regard IRC 367(d)(3) grants authority to the IRS to write regulations subjecting transfers of intangibles to foreign partnerships to super-royalty treatment but, to date, no such regulations have been written.

[67] IRC 957(a). A U.S. shareholder is defined in IRC 951(b) as a U.S. person owning at least 10% of voting stock, after considering attribution rules.

- Subpart F income of a CFC must be included in the income of a U.S. shareholder.[68] Subpart F income generally includes passive income such as dividends, interest, rents and royalties, and certain related party sales and services income.[69]

- Earnings of a CFC which are invested in U.S. property must be included in the income of a U.S. shareholder.[70] U.S. property includes stock and debt of U.S. persons, such as loans to a U.S. shareholder.

- Gain on the sale of a CFC is recharacterized as a dividend, to the extent of the CFC's accumulated earnings and profits.[71] On the other hand, sale of a ULC which is a disregarded entity would be treated as a sale of the underlying assets,[72] most of which would normally qualify for capital gain treatment.[73] To C corporation shareholders, this may be insignificant, as they are not subject to a rate differential between dividends and capital gains. However, for an individual the rate differential is dramatic: a maximum of 39.1% for dividends (which are simply taxed as ordinary income) versus 20% for capital gains.

Passive Foreign Investment Company

A Passive Foreign Investment Company ("PFIC") is a foreign corporation that meets one of the following tests:

1. at least 75% of its gross income for the year is passive income, or

2. on average for the year, at least 50% of its assets are passive assets.[74]

Passive income generally includes dividends, interest, rents and royalties, as discussed above with respect to CFCs. Passive assets are generally defined as assets which produce passive income. However, the IRS position is that cash and cash-like assets are passive

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[68] IRC 951(a)(1)(A)(i). Where the U.S. shareholder is a C corporation, a foreign tax credit is available for the foreign taxes paid by the CFC under IRC 960, thereby mitigating the effect of the income inclusion.

[69] A number of exceptions exist, such as those for certain income from related CFCs incorporated and/or operating in the same country, active business rents and royalties, and income that is de minimus or subject to high foreign tax.

[70] IRC 956.

[71] IRC 1248(a).

[72] If the ULC has multiple shareholders, a sale of ULC shares would be treated as a sale of a partnership interest. A gain on the sale of a partnership interest is generally capital, except to the extent attributable to unrealized receivables or inventory of the partnership (see IRC 751(a)). However, such gain would generally be sourced to the residence of the seller for U.S. foreign tax credit purposes under IRC 865(a).

[73] Capital gain assets would generally include business assets (other than inventory) as well as investments.

[74] IRC 1297(a).

assets, regardless of a corporation's working capital requirements;[75] consequently, active business entities can meet the PFIC asset test if they temporarily have large amounts of cash.

The consequences of PFIC status are onerous, and include the following:

- "Excess distributions" are subject to tax at the highest marginal rate plus an interest charge.[76]
- Gain on sale of stock is treated entirely as an excess distribution.[77]
- Tax-free reorganizations are generally not available.[78]
- Shares of a PFIC acquired by inheritance from a U.S. decedent do not generally receive a step-up in U.S. tax basis.[79]
- Under proposed regulations, a deemed disposition of the PFIC stock at fair market value occurs if the U.S. shareholder becomes a nonresident alien (i.e., renounces citizenship or terminates residency).[80] The deemed gain would then be subject to the above treatment as an excess distribution.

For a CFC acquired after 1997, the PFIC rules do not generally apply.[81] Therefore, PFIC issues will more likely be relevant if the U.S. shareholder is a minority shareholder. It should be noted that some negative effects of PFIC status can be ameliorated by a "Qualified Electing Fund" election, which generally causes accrued income of PFIC to be included in the shareholder's income annually.[82]

Foreign Personal Holding Company

A Foreign Personal Holding Company ("FPHC") is defined[83] as a foreign corporation meeting two tests:

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[75] Notice 88-22.

[76] IRC 1291(a)(1). An excess distribution is defined in IRC 1291(b) as the amount by which the distribution exceeds 125% of the average distributions for the 3 preceding years, and generally applies to "lumpy" dividends.

[77] IRC 1291(a)(2).

[78] IRC 1291(f).

[79] Under IRC 1291(e), which generally operates to deny the basis step-up unless the decedent was a nonresident alien at all times in which he or she owned the PFIC stock.

[80] Prop. Reg. 1.1291-3(b)(2). This regulation is proposed to be retroactive to April 11, 1992, under Prop. Reg. 1.1291-1(j)(1).

[81] IRC 1297(e).

[82] IRC 1295.

[83] IRC 552(a).

1. More than 50% of the votes or value of the outstanding stock is owned, directly or indirectly, by 5 or fewer U.S. citizens or resident aliens,[84] and

2. At least 60% of the income is passive income.

Consequences of FPHC status include the following:

- A U.S. shareholder must include in income his/her entire share of the undistributed income of the FPHC.[85]

- Shares of an FPHC acquired by inheritance do not receive a step-up in U.S. tax basis.[86]

In closely-held Canadian companies where one or more family members are U.S. taxpayers, an FPHC can easily be created inadvertently if the corporate structure has been designed without considering U.S. tax ramifications. For example, in a typical Holdco-Opco structure where the Holdco builds up an investment portfolio from the dividends received from the Opco, if its investment income exceeds 60% of its gross income it will meet the income test for FPHC status noted above.[87] Another example is a cross-border estate freeze as discussed below.

BASIS BUMP IN ACQUISITION OF CANADIAN CORPORATION

Converting Target to ULC Prior to Acquisition

Method of Structuring

Using ULCs in the acquisition of a Canadian corporation may, with appropriate planning, enable a step-up in the tax basis of the target company's assets for U.S. tax purposes. One way is to cause the target to be converted to a ULC prior to its acquisition, as shown in the following example.

Assumed facts: A Canadian corporation ("Mr. Y") owns a Canadian corporation ("Target") that a U.S. individual ("Ms. X") wants to acquire.

Step 1: Target becomes a ULC, in a three-step process. First, unless Target is already a Nova Scotia company, it continues into Nova Scotia. Then, Target forms a subsidiary

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[84] After considering related party attribution rules, under which stock owned by related parties who are not U.S. taxpayers can be attributed to U.S. persons who are shareholders.

[85] IRC 551.

[86] IRC 1014(b)(5). Instead, such shares would have the same basis as they had in the hands of the decedent.

[87] Dividends from Opco would generally not be passive income for these purposes if Opco is an active business entity, due to look-through rules in IRC 552(c).

that is a ULC. Finally, Target and its subsidiary amalgamate, with the amalgamated entity ("New Target") electing to be a ULC.

Step 2: Ms. X forms a single purpose S corporation ("SCO").

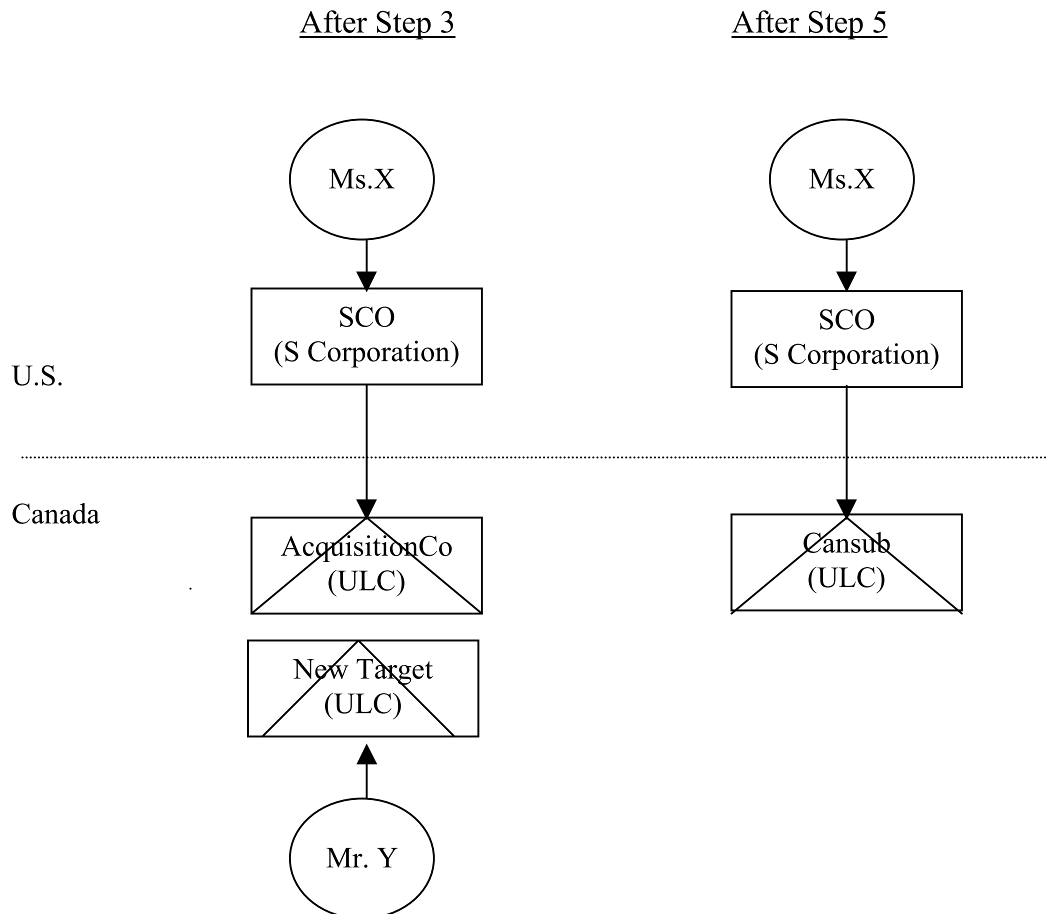
Step 3: SCO incorporates a ULC (AcquisitionCo) to acquire New Target. SCO funds AcquisitionCo with a mix of debt and equity as desired.[88]

Step 4: AcquisitionCo purchases all the shares of New Target.

Step 5: AcquisitionCo and New Target amalgamate, with the amalgamated entity ("Cansub") remaining a ULC.

The corporate structure is illustrated below:

Figure 3



[88] Equity may be provided as high paid-up capital shares, to enable a return of capital free of Canadian withholding tax.

As New Target would be considered a disregarded entity for U.S. tax purposes, the purchase of its shares by AcquisitionCo in Step 4 would be treated as the purchase of assets of Mr. Y by SCO. Accordingly, the amount paid for the shares would be allocated among the assets of New Target.[89] The amalgamation of AcquisitionCo and New Target would be ignored for U.S. tax purposes, as the merger of two disregarded entities. It should be noted that, if Target has more than one shareholder, such that New Target would be considered a partnership for U.S. tax purposes, a similar but not identical result would be achieved.[90]

To limit his liability for the period in which he owns New Target, Mr. Y may wish to interpose an ordinary Canadian corporation. This would create some additional issues from a Canadian tax perspective, but would not affect the basis bump for U.S. purposes.

Is there a risk that the IRS could disallow the basis bump arising from this transaction under the sham transaction doctrine? The definition of sham for U.S. tax purposes extends beyond the classical definition under Canadian law[91] to include transactions which lack economic substance *and* have no business purpose other than tax savings.[92] In this case, the basis bump arises directly from the treatment of the purchase as an asset acquisition, which treatment is mandated by the entity classification regulations (under which New Target would be a disregarded entity); therefore it would appear that the transaction should not need to run the gauntlet of the sham doctrine. Nonetheless, there

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[89] It should also be noted that the amalgamation of Target and its ULC subsidiary to form New Target would be treated as a liquidation of Target for U.S. tax purposes (See PLRs 9404021, 9409014, 9409016 and 200035031, regarding the merger of a U.S. corporation into its wholly-owned limited liability company) In this case, since the shareholder of Target was an individual, this liquidation would be a taxable event for U.S. tax purposes, thereby triggering any gain to Mr. Y and a step-up in tax basis of New Target assets for U.S. tax purposes (IRC 331(a) and 334(a)). However, as long as Mr. Y is not a U.S. taxpayer, this should not be problematic for him. Furthermore, since AcquisitionCo would be considered to purchase assets Mr. Y for U.S. tax purposes, the basis of those assets in the hands of Mr. Y would be irrelevant.

[90] In that case, New Target would be considered a partnership for U.S. tax purposes, causing the transaction to be treated as a purchase of partnership interests followed by the termination of the partnership. On the deemed distribution of assets on termination of the partnership, AcquisitionCo's cost of New Target shares (i.e., the tax basis of its partnership interest) would be "pushed down" to the New Target assets under IRC 732. However, IRC 732(c) has specific rules for allocating basis to partnership assets, which would produce a different result than if New Target were owned by a single Canadian shareholder.

[91] As set forth in *Snook v. London and West Riding Investments Ltd.*, [1967] 1 All E.R. 518, a sham is defined generally as a transaction whose form is designed to give the appearance of creating legal arrangements different from those actually created.

[92] The seminal case in this area is *Gregory v. Helvering* 293 US 465 (1935), which considered whether a transfer of assets from one wholly-owned corporation to another followed shortly thereafter by the liquidation of the latter constituted a tax-free reorganization. The Supreme Court held that, while "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted," the transfer in question did not fall within the rollover rules but was rather "an elaborate and devious form of conveyance masquerading as a corporate reorganization..." On the other hand, transactions entered into solely for tax benefits have generally been allowed where they had economic substance and were effected between arm's length parties (see *Cottage Savings Association v. Comr.*, 499 US 554 (1991); *Saba Partnership v. Comr.,* T.C. Memo. 1999-359.).

may be circumstances under which one should take precautions to ensure that either the economic substance or business purpose test is met. [93]

Risk Under Proposed Regulations

On December 13, 1999, a dark cloud appeared on the horizon of basis bump transactions such as the one outlined above. On that date, the IRS issued Prop. Reg. 301.7701-3(h), which applies *inter alia* to a change in classification of a foreign entity from an association taxable as a corporation to a disregarded entity, where a 10% or greater interest in the entity is sold within 12 months after the change in classification. The general result of the proposed regulation is to invalidate the change in status and continue to treat the entity as a corporation.[94]

This regulation is part of a broader IRS effort to prevent what it perceives as inappropriate benefits from the check-the-box regulations. For example, assume a U.S. parent company owns a Canadian subsidiary FC1 which in turn owns Canadian subsidiary FC2, which is engaged in an active business. FC1 desires to sell FC2 to a third party, but wants to avoid the Subpart F income that would be created by such a sale. To enable the sale of FC2 to be treated as a sale of active business assets, which would not generate Subpart F income, it either liquidates FC2 or converts it to a ULC prior to sale. On June 28, 1999 the IRS released CCA 199937038 dealing with a similar scenario, and held that such a transaction but would not qualify for the exception from Subpart F for active business assets, on the grounds that FC1 did not acquire the assets for use in its business operations but rather to sell them.[95]

Prop. Reg. 301.7701-3(h) extends CCA 199937038 to other scenarios in which a foreign entity changes its classification from an association taxable as a corporation to a disregarded entity within 12 months prior to a sale. While it is designed to attack the same problem, the way it accomplishes its result is different, in that it invalidates the change in classification and continues to treat the entity as a corporation. Thus, while it is

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[93] Some economic substance would be provided by the conversion of Target into a ULC, as operating without the protection of limited liability is economically different than operating with that protection; however, if the amalgamation of Target with its subsidiary occurs immediately prior to the purchase of New Target shares, one could argue that the unlimited liability of Mr. Y is insignificant from a practical perspective. Accordingly, it may be prudent to imbue the transaction with a business purpose, such as a preference on the part of the purchaser to acquire a Nova Scotia company. For example, the purchaser may prefer to acquire a company incorporated under the Nova Scotia Companies Act for reasons such as the lack of any requirement for Canadian directors and a very flexible corporate statute. See Paul W. Festeryga, supra note 1, at 17:3-4. Such reasons should of course be documented.

[94] These proposed regulations are discussed in Lowell D. Yoder, Esq. and Sheri L. Everson, Esq., “Proposed CTB Regulations Void Branch Elections: Subpart F and Other Consequences” in *Tax Management International Journal*, Vol. 29, No. 5, May 12, 2000.

[95] The specific transaction considered in CCA 199937038 was a conversion of FC2 to a branch by either electing to classify FC2 as a disregarded entity or liquidating FC2 into FC1. The IRS held that, in either case, the transaction would be treated as a sale of FC2 assets but would not qualify for the exception from Subpart F for active business assets, even if the branch conversion occurred three months prior to the sale.

of no concern whether CCA 199937038 applies to a basis bump transaction such as the one outlined above (because whether Mr. Y is selling active business assets is irrelevant to Ms. X in our case), it is of concern whether Prop. Reg. 301.7701-3(h) applies, because it could serve to treat New Target as a corporation rather than a disregarded entity and thereby nullify the basis bump.[96]

In this case, it appears that the conversion of Target to a ULC should fall outside the scope of Prop. Reg. 301.7701-3(h), because the proposed regulations only apply to an entity that was previously classified as "an association taxable as a corporation."[97] Such a classification can only apply to an entity eligible to check the box, which elects to be classified as a corporation.[98] In our case, Target was a *per se* corporation, unable to check the box and therefore not an association taxable as a corporation. However, it is understood that the IRS may consider Prop. Reg. 301.7701-3(h) to apply to any change in status from a corporation to a disregarded entity, and may expand the language to encompass any such change when it issues final regulations.

Prop. Reg. 301.7701-3(h) is effective on or after the date final regulations are published. Therefore, taxpayers planning basis bump transactions such as the one outlined above should closely monitor the progress of this regulation.

Election Under IRC 338

Another way to achieve a basis bump, which does not require the seller to convert Target to a ULC prior to the acquisition, is through an election under IRC 338(g). This election can only be made where the purchaser is a C corporation acquiring at least 80% of Target (by votes and value).[99] The election under IRC 338(g) would cause the Target to be treated (i) as having sold all its assets at fair market value at the close of the acquisition date, and (ii) as a new corporation which acquired those assets at fair market value on the beginning of the next day. Thus, the IRC 338(g) election wipes out all tax attributes of Target and gives it a fair market value tax basis in all its assets. As the effect of the IRC 338(g) election is to trigger any latent gain to both Target and its shareholders, this election is generally negative in a U.S. domestic context (i.e., where the Target and/or its

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[96] If Prop. Reg. 301.7701-3(h) were to apply, another result would be that the amalgamation of New Target and AcquisitionCo would be a deemed liquidation of New Target. Such a liquidation should fall within the nonrecognition rules of IRC 332 as long as SCO owns at least 80% of AcquisitionCo (as the rules of Subchapter C of the IRC apply to S corporations, per IRC 1371(a)), but would trigger gain if SCO owns less than 80%.

[97] One could also argue that the transaction should qualify for an exception in Prop. Reg. 301.7701-3(h)(3) for transactions in which the change in classification does not materially alter the Federal tax consequences of the sale, on the grounds that the conversion of Target to a ULC does not alter the U.S. tax consequences of the sale (because Mr. Y is not a U.S. taxpayer) but rather the U.S. tax consequences subsequent to the sale (in lowering the taxable income of Ms. X).

[98] Reg. 301.7701-3(a). This is also confirmed by the Preamble to Prop. Reg. 301.7701-3(h), which states that it applies to "foreign eligible entities," thereby excluding *per se* corporations.

[99] Under IRC 338(d), which provides a number of rules for a "qualified stock purchase."

shareholders are U.S. persons). However, where neither Target nor any of its shareholders (direct or indirect) are U.S. persons, the election can provide benefits to the purchaser without any tax cost to the seller.

The election under IRC 338(g) must be made in a timely fashion,[100] and entails considerable reporting. However, because it relies on a statutory election this method avoids any possibility of attack from the IRS as a sham or otherwise abusive transaction, and avoids any risk under Prop. Reg. 301.7701-3(h).

The basic steps in making an acquisition utilizing an IRC 338(g) election would be as follows:

Assumed facts: A Canadian corporation ("Parent") owns a Canadian subsidiary ("Target") that a U.S. C corporation ("USP") wants to acquire.

Step 1: USP forms a single purpose company that is a U.S. C corporation ("Holdco").

Step 2: Holdco incorporates a ULC ("AcquisitionCo") to acquire Target. Holdco funds AcquisitionCo with a mix of debt and equity as desired.

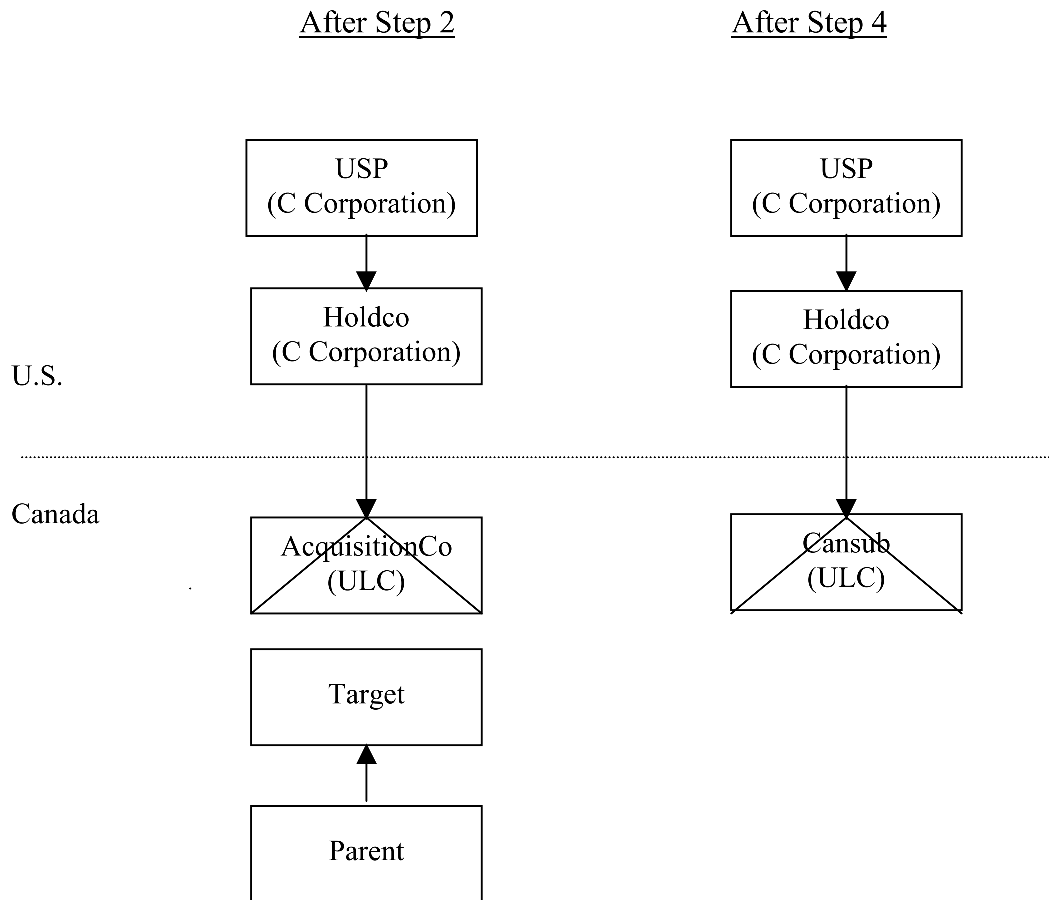
Step 3: AcquisitionCo purchases all the shares of Target.

Step 4: AcquisitionCo and Target amalgamate, with the amalgamated entity ("Cansub") electing to be a ULC.

The corporate structure in this example is illustrated below:

[100] IRC 338(g)(1) provides that the election must be made by the 15th day of the 9th month, beginning after the month in which the acquisition occurs. The election is irrevocable.

Figure 4



Benefits of Basis Bump

In considering a basis bump transaction, it should be kept in mind that it is not axiomatic that the bump will actually provide a tax benefit to the purchaser. Two potential benefits, which may or may not be relevant to a particular scenario, are:

- The basis bump will serve to reduce the taxable income of the ULC that is included in the income of its U.S. shareholder. However, because Canadian tax rates are higher than U.S. rates, this reduction in income will not likely produce a benefit unless the shareholder has foreign-source income from other sources that is subject to a low rate of foreign tax and can absorb the excess Canadian taxes, and such income is in the same basket as the income of the ULC.

- The gain on a future sale of the shares of the ULC, which would be treated as a sale of assets for U.S. tax purposes, would be reduced (to the extent assets which were subject to the basis bump are still owned).

CROSS-BORDER ESTATE PLANNING

The Problem

Another important use of ULCs is in cross-border estate planning. We will consider a simple scenario, in which a Canadian parent ("Dad") owns a portfolio of publicly traded securities and wishes to effect an estate freeze in favor of his two sons ("Son1" and "Son2"). Son1 resides in Canada and Son2 resides in the U.S. Dad has gone to a tax advisor who, without considering U.S. tax ramifications of Son2's residency, has suggested a garden variety Canadian estate freeze in which Son1 and Son2 would establish a Canadian corporation ("InvestCo"), subscribing for nominal value common shares, into which Dad would then roll his investment assets in return for high-low preferred shares.

The unfortunate result of this structure is that, because Son2 is a U.S. resident, Investco will be an FPHC.[101] This will then cause the following negative consequences as noted above:

- Son2 will have to include in income his share of the income of InvestCo annually, with no foreign tax credit for InvestCo's underlying Canadian tax.

- When Dad dies, his InvestCo shares inherited by Son2 will not receive a step-up in tax basis for U.S. purposes, even though those shares will be subject to a deemed disposition for Canadian tax purposes.

A ULC Alternative

A possible solution to this problem is for InvestCo to be a ULC, in which case it will not be an FPHC. Son2 should own his shares through an S corporation, to obtain the reduction in withholding tax on dividends to 5% as discussed above. It should be noted that, on Dad's transfer of investment assets into InvestCo, a basis step-up would not generally arise for U.S. tax purposes.[102]

If InvestCo has significant U.S. investments, two additional issues arise. First one must consider the risk that, as a partnership owning U.S.-situs assets, InvestCo may be

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[101] Stock owned by Son2's father and brother will be attributed to Son2, for purposes of determining whether InvestCo is an FPHC, under IRC 554(a)(2). It should be noted that, if Son2 does not own any shares, no such attribution would result, due to IRC 554(c)(1).

[102] The transfer would be a contribution of property to a partnership, tax-free under the general rules of IRC 721(a). It might be possible to cause this transfer to be taxable for U.S. purposes under IRC 721(b), and thereby cause a basis step-up, if InvestCo meets the criteria for an investment company; generally this would require two or more persons to transfer investments to InvestCo in such a way as to bring about a sufficient diversification of their portfolios. Also, if prior to the estate freeze Dad already owned InvestCo, which was an ordinary corporation, the conversion of that corporation to a ULC may create a basis step-up.

considered a U.S.-situs assets for U.S. estate tax purposes. Where a foreign partnership owns U.S.-situs assets, determining the situs of the partnership interest is an uncertain area of U.S. law.[103] It appears that in a case such as this, where a foreign partnership's only U.S. activity is the ownership of U.S. marketable securities, the partnership is not engaged in a trade or business in the U.S., and the partnership does not terminate on the death of a partner, the partnership interest would not be a U.S.-situs asset. On the other hand, due to the dearth of authority on point, it may be difficult to provide a definite answer. To minimize exposure to U.S. estate tax, Dad and Son1 may wish to own their shares of InvestCo through an ordinary Canadian corporation ("Holdco");[104] as long as Son2 owns no shares of Holdco, it should not be an FPHC.

The second issue created by InvestCo's U.S. investments is that this will exacerbate U.S. foreign tax credit problems for Son2. These problems would exist under this structure in any event, in that Son2's share of capital gains will be U.S.-source income for U.S. foreign tax credit purposes, regardless of whether the underlying investments are U.S. or not.[105] Consequently, such gains would not give rise to a foreign tax credit for Son2, even though Canadian tax will be paid on such gains by InvestCo. This problem will be exacerbated by InvestCo's U.S. investments, as whatever interest and dividend income these generate will also create U.S.-source income ineligible for a foreign tax credit to Son2. One way of dealing with this may be to put in place a partnership agreement under which such income (capital gains and U.S. interest and dividend income) will be allocated to Son1 and/or Dad.[106]

This alternative is illustrated below.

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[103] See Rev. Rul. 55-701; *Sanchez v. Bowers,* 70 F.2d 715 (2d Cir. 1934; *Vandenhoeck Est. v. Comr.,* 4 TC 125 (1944), *acq.,* 1944 CB 29; *Blodgett v. Silberman,* 277 US 1 (1927); GCM 16164 XV-1CB 363 (1936); GCM 18718; Rev. Rul. 70-59; Rev. Rul. 91-32. A useful discussion of this issue is found in Robert F. Hudson, Jr., "Alternative Inbound Structures" in *1993 Corporate Management Tax Conference* (Toronto: Canadian Tax Foundation, 1994), 17:14-17.

[104] On Dad's death, it will be desirable to push down the tax basis of inherited shares to the underlying assets of Investco, for U.S. (Son2) and Canadian (Son1) tax purposes. The issues involved in doing so, which will be complicated by the presence of Holdco, are not considered in this paper.

[105] Under IRC 865(i)(5), the sourcing of capital gains of a partnership is determined at the partner level. For a U.S. partner such as Son2, capital gains would generally be U.S.-source under IRC 865(a)(1).

[106] The partnership agreement must have "substantial economic effect" under IRC 704(b)(2) and the regulations thereunder. Drafting such an agreement in a way that is not economically disadvantageous to Son2 may be a daunting task.

Figure 5