

Turbulent economy increases U.S. investors' tax concerns

The global economic meltdown has heightened U.S. tax considerations for U.S. investors in Canadian companies.

Two sets of rules prevent U.S. investors from postponing federal income tax through the use of foreign corporations. Both employ concepts of ownership that are intended to ensure compliance.

For example, a U.S. citizen-beneficiary of a trust that owns stock in an Ontario corporation may be treated as an investor in the corporation in certain circumstances. Such an individual may now, unexpectedly, be required to pay tax at the highest U.S. ordinary income tax rate on dividends distributed through the trust, plus an interest charge if the value of the company has declined. And, if the corporation is publicly traded, the company may need to disclose U.S. tax issues to potential investors.

Controlled foreign corporations

A non-U.S. corporation is a controlled foreign corporation



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(CFC) if, on any day during its tax year, one or more U.S. shareholders directly, indirectly or constructively own more than 50 percent of the total combined voting power of all classes of the company's voting stock, or more than 50 percent of the total value of the corporation's stock.

For the purposes of this rule, a U.S. shareholder is a U.S. person who owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote. A U.S. shareholder of a CFC is taxed currently on the shareholder's pro rata share of certain types of income of the CFC even though it is not distributed. For individual shareholders, income is taxed at ordinary income tax rates (up to 35 percent) in con-

trast to the preferential rate (15 percent) for qualified dividends, and no foreign tax credit is available.

Passive foreign investment companies

Unlike the CFC rules, the passive foreign investment company (PFIC) rules do not require current taxation of undistributed income. However, any distribution of income or disposition of shares is potentially subject to tax at the highest ordinary income rate, plus a penalty interest charge for the benefit of deferring U.S. tax on profits of the corporation.

A passive foreign investment company is a non-U.S. corporation that meets one of two alternative tests: (1) 75 percent or more of the gross income of the corporation is passive income (interest, dividends, certain personal service income and so on); (2) 50 percent or more of its assets are assets that produce (or are held to produce) passive income.

The assets test is particularly
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problematic for many companies, even in less troubled times. IRS interpretations provide that cash and accounts receivables are passive assets, even if the cash is working capital. If a company, either as a start-up or on an ongoing basis, raises capital and does not immediately invest in operating assets, the company may be a PFIC simply as a result of the capital raised. Unfortunately, if a U.S.

investor is a shareholder in the company at any time at which it is a PFIC, the company will always be a PFIC with respect to that shareholder, even if it never again meets either one of the PFIC tests.

And now, in troubled times, the question of how to value a PFIC's assets becomes even more important. There is limited guidance on this point, but legislative history indicates that the market capitalization approach is generally the correct one for a public company. Under this approach, a company's

market value could have declined recently to the amount of its cash and other passive assets. In other words, there could be completely unanticipated results for investors in an operating company.

There may be strategies other than the use of market capitalization. Also, in situations where a corporation becomes a PFIC for the first time, certain elections may be possible for U.S. shareholders to alleviate the tax pain.

The potential for onerous U.S. tax results increases if shares of the

non-U.S. corporation are held through a non-U.S. trust, particularly a trust that may accumulate income. In such situations, a U.S. beneficiary may be taxed under the regimes described above, and also be subject to a penalty interest charge if income is accumulated in the trust prior to distribution. ■

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