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CANADIAN TAX *Highlights*

US Inversion Concerns

In a number of transactions in the late 1990s and early 2000s, UScos (or their assets) became subsidiaries of (or the businesses were taken over by) foreign shell corporations (forcos). These inversions may yield US tax benefits by removing the foreign operations from the US taxing jurisdiction when the forco assumes ownership of the foreign business or USco from the former US parent. The potential for abuse may not be present when the forco acquiror is in a high-tax jurisdiction such as Canada, but the transaction is often captured by the breadth of the inversion rules, especially if the forco is a Canadian shell company.

In a typical shell corporation transaction, a Canco acquires a US business operation. The Canco raises funds from its founders and the public for use in the acquisition. The USco shareholders usually exchange their shares for Canco shares, an exchange squarely within the US inversion rules' framework. In recent months, there has been an increase in Canadian shell companies interested in acquiring US businesses; apparently the participants are often unaware of the impact of the US inversion rules.

An inversion has occurred if the forco acquiror meets the following conditions: (1) the forco acquires "substantially all" the properties of the US business (either ownership interests or assets); (2) after the acquisition, the "expanded affiliated group," including the forco, does not have substantial business activities in the foreign country where the forco was organized; and (3) after the acquisition, at least 60 percent of the forco's shares (determined by vote or value, and subject to special rules) are held by former owners of the US business. Although an inversion occurs at a 60 percent threshold, ownership of 80 percent or more of the forco's shares triggers more extreme tax consequences.

The first condition is usually met if all of the target is acquired. In the case of an acquisition of a USco by a Canadian shell company, the second condition is generally met because the shell company does not have substantial business activities in Canada. The third condition is more difficult to ascertain: one must determine how much of the forco's stock, determined by vote or value, is held by the former USco shareholders after the acquisition. This condition is not as straightforward as it may seem, because any stock sold in a public offering related to the US business's acquisition is generally disregarded in testing for the 60 percent ownership threshold that triggers an inversion. For example, the IRS may take the position that there has in fact been a 100 percent inversion if a Canco acquires all of a USco's stock and thereafter the former shareholders are acquiring Canco's only shareholders (other than shareholders via a public offering). The situation is less clear if the USco was a public company and issued shares to founders or in a private placement before or around the same time as the acquisition. The inversion rules also include a two-year lookback and lookforward provision under which certain transactions in that period are treated as undertaken pursuant to a plan or related series of transactions; a transaction outside the four-year period may still result in an inversion because the four-year period is not exhaustive.

Even if the former USco shareholders receive only exchangeable shares in a newly formed US subsidiary of the Canco acquiror and not shares in itself, they will likely be treated as having exercised the rights under the exchangeable shares and thus will be considered owners of the Canco shares for the purposes of inversion testing.

If the inversion rules deem the former USco shareholders to acquire between 60 and 80 percent (exclusive) of the acquiror, it continues to be treated as a forco for US tax purposes, but any applicable corporate-level "toll charges" (such as recognition of a gain in appreciated assets) for establishing the inverted structure cannot be offset by tax attributes such as net operating losses or foreign tax credits. If the inversion involves the acquisition of USco shares (not assets), there may not be any immediate tax consequences, because there is no corporate-level asset transaction against which those tax attributes could be used. The IRS has not issued any guidance on this point.

In an inversion in which the former USco shareholders acquire at least an 80 percent interest in the forco, the forco is treated as a USco for all US tax purposes. The forco is thus fully taxable in the United States on its worldwide income; presumably any foreign tax is not creditable against US tax if some of the forco's income is deemed to be US-source. Moreover, dividends from the forco to its non-US shareholders are treated as dividends paid by a USco to non-resident shareholders and thus are likely subject to US withholding tax. For example, a Canco acquiror must withhold US withholding tax on dividends paid to non-US shareholders. Presumably Canada would view the dividends as Canadian-source and thus would not allow a foreign tax credit to the non-US shareholders for the US withholding tax. Similarly, the US shareholders are subject to Canadian withholding tax on dividends, which the IRS would likely consider to be US-source because they are paid by a USco; thus, it is likely that the IRS would not allow the US shareholders any foreign tax credit for US tax purposes.

At the corporate level, the inverted entity may also face double taxation due to a mismatch of foreign tax credits, and at the very least must juggle disparate rules in the United States and the foreign jurisdiction where it resides. Moreover, non-US shareholders may also face US estate tax on death, because the stock of the forco is a US-situs asset for US estate tax purposes. Therefore, upon the death of a Canadian shareholder of an inverted company, his or her estate is exposed to US estate tax that is based on the value at that time of the Canadian-deemed-US shares.

A US business owner may contemplate becoming a public company listed on a Canadian or other foreign stock exchange in a transaction that involves being acquired by a forco, swapping its ownership interests in a USco tax-free for a similar interest in the forco, and achieving access to a public marketplace. Although US tax rules such as Code section 367 generally impose current US tax on a US shareholder who exchanges USco shares for forco shares, a swap that amounts to an inversion does not trigger gain recognition. That result is initially beneficial for the former USco shareholders, but in the long run it may result in double taxation on dividends and on the sale of the business. Moreover, non-US owners of the forco may suffer similar results under the US inversion rules.

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