U.S. tax changes loom large over cross-border deals

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While the rollercoaster effort to repeal and replace Obamacare has claimed most of the attention in Washington over the past several weeks, there have been less publicized U.S. tax developments that may profoundly affect cross-border transactions and which Canadian businesses and investors need to be aware of. We provide a short summary of these developments below. Readers that are interested in learning more about these should contact any member of our New York Tax Group.

385 REGULATIONS ON THE CHOPPING BLOCK?

In April, U.S. President Donald Trump signed an Executive Order requiring the Treasury Department (the Treasury) to review all U.S. tax regulations issued since January 1, 2016. The purpose of this review was to identify regulations that exceeded statutory authority or that placed undue financial burden or undue complexity on taxpayers within 60 days (the Interim Report). The Treasury Department was also ordered to issue a final report recommending specific actions (i.e., repeal or modification) within 150 days (the Final Report).

On July 7, the Treasury issued Notice 2017-38 (which appears to effectively serve as the Interim Report) identifying eight regulations that are believed to place an undue burden on taxpayers. By far the most relevant of these to Canadian businesses is the Section 385 Regulations. Readers will recall from prior updates that the Section 385 regulations have a profound and far-ranging effect on cross-border financing arrangements and, in many cases, can cause cross-border debt instruments between Canadian and U.S. affiliates to be reclassified as equity for U.S. tax purposes. After much fanfare, these regulations were finalized in October, 2016, and many Canadian companies are still grappling with their effect on intercompany financings and transactions.

Notice 2017-38 does not indicate whether Treasury is contemplating a repeal, partial repeal or modification of the Section 385 regulations. A more detailed recommendation regarding the fate of these regulations is, however, to be included in the Final Report, which is due on September 18, 2017. Many have speculated that the controversial “per se” rule component of these rules should be repealed but that the documentation requirements component could be retained in some modified form. A repeal of the per se rule component of these regulations would be a welcome development for Canadian businesses looking to fund U.S. business operations and, we expect, increase the flow of foreign capital.
into U.S. business and simplify cross-border financings and restructurings.

Notice 2017-38 also identified seven other regulations that, generally speaking, will not be as directly relevant to most Canadian businesses, including: (1) regulations addressing the manner in which partnership liabilities will be allocated to partners and the effect of so-called “bottom-dollar” guarantees (which may impact certain so-called “leveraged partnership” structures), (2) regulations under Section 987 dealing with foreign currency gains and losses of certain branch operations, and (3) regulations under Section 367(d) addressing the transfer of certain intangible property by U.S. persons to non-U.S. corporations. Interestingly, the Notice did not identify 2016 or 2017 inversion regulations as being targeted for modification or repeal.

Notice 2017-38 also announces that the Treasury is looking for comments on whether and how the identified regulations should be rescinded or modified. Taxpayers’ comments are due by August 7, 2017.

**U.S. TAX COURT DECISION PAVES THE WAY FOR NEW CROSS-BORDER STRUCTURING POSSIBILITIES**

Since 1991, when it released Revenue Ruling 91-32, the Internal Revenue Service (IRS) has taken the position that gain recognized by a non-U.S. person on the sale of a partnership interest is taxable in the U.S. as “effectively connected income” to the extent that the proceeds are attributable to partnership assets that are part of a U.S. trade or business. While taxpayers have questioned the validity of this result, the IRS has adhered to this position for the intervening 26 years. On July 13, however, the U.S. Tax Court released a decision [Grecian Magnesite Mining (148 T.C. No. 3 (2017))] that has up-ended this approach and non-U.S. Investors should be assessing the potential impact of this case. In the meantime, many expect that the IRS will appeal this decision or perhaps push for administrative or legislative action to overturn it.

In Grecian, the taxpayer (a Greek corporation, “Grecian”) was a member of a Delaware LLC that was classified as a partnership for U.S. Federal income tax purposes (Partnership). Partnership was engaged in the mining business inside the United States. As a result, income earned by Partnership was “effectively connected income” (ECI) for U.S. tax purposes and Grecian was subject to U.S. Federal income tax on (and filed a U.S. tax return to report) its allocable share of such income. In 2008, Grecian’s partnership interest in Partnership was redeemed in exchange for two distributions of cash and Grecian recognized a gain on this redemption (i.e., the cash received was greater than Grecian’s tax basis in the redeemed Partnership interest). Under relevant U.S. tax rules, the cash distributions were treated as proceeds from the sale of Grecian’s redeemed interest in Partnership. Grecian conceded that a portion of the redemption gain was subject to tax under Section 897(g) of the **U.S. Internal Revenue Code** and the so-called “FIRPTA” rules (i.e., to the extent that Partnership’s underlying assets were U.S. real property assets). The IRS asserted, however, that the remaining portion of Grecian’s gain was also subject to tax as ECI under the principles of Rev. Rul. 91-32.

In a technically rigorous decision, the Tax Court concluded that Rev. Rul. 91-32 did not have “the power to persuade” and that it was not appropriate to treat the sale of a partnership interest as if it was a sale of a portion of the partnership’s underlying assets (except in the case of U.S. real property assets because the FIRPTA rules explicitly prescribed such look-through treatment statutorily). Accordingly, the Tax Court decided that Grecian was treated as disposing of a capital asset (i.e., its partnership interest) and, accordingly, was not subject to U.S. tax under the ECI rules on the disputed portion of the gain recognized. We emphasize, and all parties recognized, that Grecian was subject to tax under the FIRPTA
rules on the portion of the gain allocable to Partnership’s U.S. real property.

This decision is a dramatic rebuke to the IRS’s position for the past 26 years and opens up new structuring considerations for Canadian businesses investing in U.S. operating investments. Many Canadian investors structuring investments into U.S. Operating businesses set up as flow-through entities choose to “block” those investments by holding them through a blocker corporation. By interposing a corporation between the investor and the ECI generating investment (typically an operating entity established as a U.S. Partnership or LLC), Canadian investors are able to avoid having to file a U.S. Income Tax return and reporting their allocable share of ECI from that investment. In many cases, investors adopting this blocking strategy elect to use a U.S. Corporation as the “blocker” in order to more effectively leverage the blocker with debt and also to avoid U.S. Branch profits tax (which would otherwise apply if the blocker was a non-U.S. Corporation).

It’s still too early to say whether the Grecian case will amount to a “game-changer” for Canadian investors and it may well be short-lived if, as many expect, the IRS challenges this decision in some fashion. For now, we do not anticipate that the Grecian case will affect the baseline decision of Canadian investors to block their exposure to ECI investments. In particular, we expect these investors will still wish to avoid incurring the U.S. tax return filing obligations that come with ECI income and, in many cases, governmental investors will still wish to avoid commercial activity exposure for purposes of Section 892 of the Code. We do, however, expect this case to prompt Canadian investors to reconsider the use of non-U.S. Blocker entities due to the fact that Grecian should allow these blockers to exit via a sale of partnership interests without ECI tax being applicable to that gain (by contrast, a similar exit by a U.S. blocker would be fully taxable at the blocker level). There are, of course, pros and cons to be weighed when making this assessment but, for present purposes, it is enough to note that this case may broaden the range of structuring choices available (at least for now). In the right circumstances, this change could have a material impact on after-tax returns from cross-border investments in flow-through U.S. Entities.

We will continue to monitor this area, including any potential IRS or legislative response, and update readers as appropriate.
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