The brave new (tax) world: What Canadians should know about U.S. tax reform

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Now that U.S. tax reform has been enacted into law, we are at the beginning of a major reset in how U.S.-Canadian cross-border tax planning will be done. The changes included in the final legislation (known as the “Tax Cuts & Jobs Act” [PDF] or TCJA) and signed into law on December 22, 2017, cut deep and decades-old norms have been turned on their heads. As with many landmark legislative enactments, there will be winners and losers and plenty of growing pains, but these changes will also present opportunities for fresh thinking about how cross-border businesses and investments should be structured, capitalized and operated. Because the new changes alter so many basic and long-standing tenets of U.S. tax law, it will be a while before the full impact of this reform becomes clear. However, because most of the major provisions were effective beginning January 1, 2018, taxpayers will not have time to dwell on hypotheticals and will instead need to analyze the new rules quickly in order to optimize their near-term decisions and lay the groundwork for longer-term planning.

This memo will provide a summary of the new U.S. tax landscape. This overview will not be a deep technical dive into the mechanics of the relevant rules, but rather a guided tour through the components of the legislation that we believe are most important to Canadian businesses and investors in the cross-border space. Clients and friends with more specific and/or technical questions should feel free to contact any member of our U.S. tax department at any time. Additionally, members of our U.S. tax group will be providing client conferences at the following locations/times:

- Osler Toronto: Tuesday, January 9, 2018 (Seminar only)
- Osler Calgary: Thursday, January 11, 2018 (Seminar and webinar)
- Osler Montréal: Thursday, January 18, 2018 (Seminar & webinar)

THIS ARTICLE INCLUDES:

- General thoughts on the final U.S. tax legislation
- Domestic U.S. tax changes affecting cross-border markets
- Key U.S.-inbound tax changes
- Other key international tax changes
- Taxing gains on foreign person’s sale of a partnership interest
GENERAL THOUGHTS ON THE FINAL U.S. TAX LEGISLATION

The “reform” effected by the new U.S. tax legislation is not a complete tear-down and reconstruction of U.S. tax rules, but rather a fundamental overhaul of the existing U.S. tax system. This means that, for the most part, the basic architecture of the “old” U.S. tax system remains intact but with drastic reformation in many areas. As a result, the new legislation offers little in terms of tangible “simplification” of U.S. tax rules and, to the contrary, in many areas (particularly in the area of cross-border tax rules) the uneasy co-habitation of both “old” and “new” tax rules makes for new levels of complexity. Broadly speaking, most of this additional cross-border complexity is applicable in the U.S.-outbound arena (i.e., U.S.-based multinationals with non-U.S. activities). However, there are several game-changing developments in the U.S.-inbound arena which are particularly impactful to Canadians with U.S. activities. Moreover, given the extreme interconnectedness between the Canadian and U.S. markets, both U.S.-inbound and U.S.-outbound rules can have important consequences for Canadian businesses (as discussed in more detail below).

In addition, because the tax bill was hustled through Congress on an accelerated track, the final legislative text has many gaps and leaves many important details underdeveloped. As a result, it is reasonable to expect that the Treasury Department will be under pressure to issue an extraordinary amount of supporting regulatory guidance. These trailing regulatory projects will in all likelihood have a major substantive impact and will create aftershocks that will reverberate over the next few years. Adding to this turbulence is the fact that several key provisions in the new legislation will phase in or phase out over time. These dynamics will make tax planning over the next several years a challenging endeavour and, we expect, will place a premium on preserving flexibility and optionality in order to adapt with this evolving landscape and manage the timing of important tax events.

DOMESTIC U.S. TAX CHANGES AFFECTING CROSS-BORDER MARKETS

Although the focus here is on cross-border tax changes, it is important to recognize that changes to U.S. domestic tax rules will dramatically lower the effective tax burden borne by many U.S. businesses. This should fundamentally reshape the competitive landscape within the U.S. market (by far the most significant international market for Canadians) and reduce important systemic advantages that foreign-based multinationals had over their U.S. competitors. In addition, Canadian companies that operate on both sides of the border through U.S. subsidiaries or U.S. branches will need to rethink how (if at all) these U.S. tax rules will affect their decisions on how to allocate business and capital expenditures, enterprise “opportunities,” the location of IP ownership, employee hiring, supply chain management and financing. From this point of view, the most important domestic U.S. tax changes are:

- **Lower corporate rates**: Permanent reduction of U.S. corporate tax rates from 35% to 21% as well as elimination of the corporate alternative minimum tax (AMT).
- **Immediate expensing**: Allowance of immediate, full expensing of expenditures on qualifying property (generally, tangible business property with a class life of 20 years or less). Importantly, these expensing rules apply to both new and “used” property, subject to certain exceptions. Immediate expensing begins to phase out, however, beginning in 2023 through 2026.
- **Limiting use of net operating losses (NOLs)**: NOLs generated in 2018 and beyond, when carried forward to a subsequent tax year, may not be used to offset more than 80% of the taxable income of
the taxpayer for that year. In addition, NOLs generated in 2018 and beyond (i) may no longer be carried back (previously, NOLs could be carried back two years) and (ii) may be carried forward indefinitely (previously they could be carried forward for 20 years). Moreover, unlike an earlier proposal in the House Bill, NOLs will not carry an interest factor to account for the time value of money, meaning that their “real” value will diminish over time. NOLs generated before 2018 are generally not subject to these new rules.

- **Restricting interest deductions**: The new legislation significantly tightens the Section 163(j) earnings stripping limitation. Most importantly, new Section 163(j) limits annual “business interest” deductions to 30% (down from 50%) of “adjusted taxable income” (ATI), without any debt-equity safe harbor. During 2018-2021, ATI will essentially be equivalent to EBITDA (similar to the “old” rules), but beginning in 2022, ATI will be adjusted so that it is roughly equivalent to EBIT, i.e., without adding back depreciation or amortization deductions. The “double-whammy” effect of a lower (30%) limit and a lower base (EBIT, not EBITDA) will dramatically limit the availability of interest deductions for many businesses.

- Unlike “old” Section 163(j), this new limitation applies to all business interest, regardless of whether the underlying debt is with (or guaranteed by) a related party.

- Interest not allowed as a deduction is carried forward indefinitely, but is subject to limitation following an ownership change of a corporate taxpayer.

- For partnership and other pass-through entities, new Section 163(j) applies at the partnership level. Any disallowed interest carryforward is allocated among the partners. A partner may only deduct its share of the carryforward in future years against taxable income attributed to the partner by the partnership’s activities which gave rise to the carryforward.

- There is no grandfathering of pre-2018 debt.

- **“Patent box lite”**: As explained in more detail below (see discussion below related to “foreign derived intangible income” or “FDII”), U.S. corporations earning income from (i) selling or licensing IP to non-U.S. persons, or (ii) providing services to non-U.S. persons, may be eligible for a special lower rate of U.S. corporate tax on a portion of such income. Beginning in 2018, U.S. corporations will be eligible for an effective rate of 13.125% on such income (increasing to an effective rate of 21.875% for tax years beginning on or after January 1, 2026).

- **Lower rates for pass-throughs**: Beginning in 2018 (and continuing through 2025), non-corporate owners of pass-through entities and sole proprietorships conducting certain kinds of businesses will be entitled to a 20% deduction on domestic “qualified business income.” The ability of taxpayers to claim this deduction is subject to limitations and caps and is generally not available for professional services businesses. Assuming an individual U.S. partner is subject to U.S. income tax at the new highest marginal rate of 37%, this 20% deduction would mean that the individual bears an effective rate of U.S. tax equal to 29.6% on qualified business income derived through the partnership.

**OSLER COMMENTARY**

1. **Financial statement impact**: The rate reduction may produce an immediate financial statement “hit” for U.S. companies. Specifically, U.S. companies may be required to take a charge to the extent that lower corporate tax rates mean that their booked tax assets (e.g., NOLs or credits) deliver lower tax benefits to the taxpayer. As a simplified example, if a U.S. corporation’s effective U.S. tax rate drops from 35% to 21%, a $1-
NOL may be expected to deliver only 21 cents of “value” (down from 35 cents), leaving aside time value considerations.

2. **Increasing the after-tax value of U.S. cash flows:** On the flip side, going forward, the present value of a U.S. company’s after-tax future stream of cash flows should increase and correspondingly lift the equity value of the U.S. company (to the extent not already priced in). This could increase the ability of U.S. companies to access debt or equity capital from third parties relative to non-U.S. competitors. In the near term, we anticipate that the appropriate valuation of these tax benefits may give rise to disputes among buyers and sellers in cross-border M&A transactions.

3. **Reversing the flow of planning?** For many years, the value of a $1 deduction in the U.S. was, all other things being equal, greater than a $1-deduction in Canada. This simple reality has directed the flow of billions of dollars of cross-border arrangements and payments across the Canada-U.S. border. Although state, provincial and local taxes all need to be factored in, the domestic U.S. tax changes described above unsettle that simple premise in ways that are not yet fully appreciated. As a result, Canadian businesses operating in the cross-border space should systematically rethink their cross-border arrangements from the ground up and realistically assess their continuing value to the enterprise. In some cases, no action will be merited but, in others, unwinds should be considered.

4. **Incorporate in the U.S.?** At certain stages of the lifecycle of a Canadian business, its owners may be confronted with the decision of whether to incorporate the business in a Canadian corporation or a U.S. corporation. At early stages of the business’s lifecycle, this decision may be relevant to attracting U.S. venture capital to fund the business. In later stages, this decision point may arise in the context of a cross-border M&A transaction or an IPO. While it is dangerous to over-generalize, in many of these cases, there were typically good tax reasons to prefer to incorporate the entity in Canada (if possible). The U.S. tax reforms outlined above will make that decision more difficult and may actually reverse the preference to U.S. incorporation in several cases. The significance of this shift to Canadian-U.S. cross-border tax planning is profound and illustrates how these U.S. tax changes demand fresh thinking about “established” tax planning and structuring norms.

5. **Now trending in cross-border tax planning – “Matching”:** The combination of immediate expensing and NOL limitations should create formidable pressure on U.S. corporate taxpayers to achieve a greater “matching” of current-year expenses with current-year income. In particular, to the extent that current-year expenses exceed current-year income, the “excess” expense is treated as an NOL. As a general matter, $1 of expense claimed as a current-year deduction (matched with current-year income) is more valuable to a taxpayer than $1 of NOL because of the fact that NOL carryforwards may not offset more than 80% of taxpayer income in the carryforward year. Accordingly, in the long run, U.S. corporate taxpayers (including U.S. branches of Canadian companies) that succeed in developing strategies to create better matching of income and expense should enjoy lower effective rates of U.S. tax than those that are not able to match effectively. Many of these strategies will focus on providing taxpayers with the flexibility to accelerate or decelerate items of expense or otherwise controlling the flow of deductions. Canadian and other non-U.S. based companies might have more levers for achieving better matching than purely domestic U.S.
6. E&P mismatches: We expect that immediate expensing will result in greater and more systemic mismatches between taxable income and earnings & profits (E&P) for U.S. companies. In particular, qualifying business expenditures may be deducted immediately for purposes of determining taxable income but, for purposes of determining E&P, these costs are generally depreciated on a straight-line basis over the asset’s class life. As a result, all other factors being neutral, a corporation may have significant current-year E&P (but very little taxable income) in the year a business asset is acquired. If not managed, this could complicate the ability of U.S. subsidiaries to tax-effectively distribute excess cash back to Canadian parent companies. Accordingly, Canadian companies with U.S. subsidiaries will need to model and plan for these mismatches in order to plan for tax-effective repatriation of U.S. earnings. We also anticipate that these sorts of complications will reinforce the continued relevance of cross-border debt as a tax-effective means of repatriating U.S. earnings to Canada (even if the interest deductions created by that debt may have less value to the taxpayer by reason of new Section 163(j) and lower U.S. corporate tax rates).

7. Investment funds - leveraged blockers feeling the squeeze: The application of new Section 163(j) at the partnership level may have a dramatically negative impact on the private equity, U.S. real estate, venture and other investment funds that offer “leveraged blocker” feeders for Canadian investors. More specifically, because the computational work of Section 163(j) is done at the partnership level, these blockers will typically enjoy separate interest deductibility at the blocker level only to the extent that the investment fund itself has “leftover” Section 163(j) capacity that is allocated out to them. This mechanic, coupled with the reduction in the overall Section 163(j) limit from 50% to 30% of adjusted taxable income will mean that many leveraged blockers will find it challenging to actually utilize interest deductions during the holding period of their investment. It is not yet clear whether the blocker may carry forward any disallowed interest expense to shelter potential blocker-level capital gains on an exit event.

8. Public utility companies: Utilities are excluded from (a) the new Section 163(j) interest limitations and (b) eligibility for immediate expensing benefits.

9. Implications for M&A: The changes described above are expected by many to make asset deals (or stock deals that are treated as asset deals for U.S. tax purposes by reason of a 338(h)(10) election) more attractive than they were previously. In general this is because buyers will be able to immediately expense the purchase price attributable to qualifying business assets, rather than waiting to harvest these benefits through depreciation deductions over several years. We also expect that taxpayers will look for alternatives to debt for acquisition financing which may well result in more acquisitions being done through partnerships or so-called “UP-C” structures financed with preferred partnership interest “financing” in lieu of debt.

KEY U.S.-INBOUND TAX CHANGES

We believe that the following changes to U.S. international tax rules will be most relevant for Canadian
businesses operating in the U.S. through subsidiaries or branches and for Canadian investors holding U.S.-based assets.

RELATED-PARTY ANTI-HYBRID PROVISIONS: CRACKING DOWN ON DOUBLE DIPS

New Section 267A denies a deduction for any interest or royalty payments paid or accrued if such payment or accrual (1) gives rise to a “disqualified related-party amount,” and (2) is made pursuant to a hybrid transaction or by, or to, a hybrid entity.

In general, a “disqualified related-party amount” is any interest or royalty amount paid or accrued to a related party if (i) such amount is not included by the related party under the tax law of its country of residence or where it is subject to tax, or (ii) the related party is allowed a deduction with respect to such amount (i.e., the interest or royalty) under the tax law of its country.

A “hybrid transaction” is any transaction, series of transactions, agreement or instrument one or more payments on which are treated as interest or royalties for U.S. tax purposes but are not so treated under the tax law applicable to the recipient. A “hybrid entity” is an entity which is treated as fiscally transparent for U.S. tax purposes, but not so treated under the tax law applicable to the recipient, or vice versa. Two parties are generally considered related for these purposes if either party “controls” the other (meaning, for this purpose, a party owns directly or indirectly more than 50%, by vote or value, of the equity of the other), or both parties are under common control by a third person. Section 267A does not apply to interest or royalties that are treated as “Subpart F income” to a U.S. shareholder.

This section is expected to deny deductions for interest paid under certain common cross-border financing structures, including interest paid by a U.S. payor to a related Canadian-party pursuant to a repurchase (i.e., “repo”) arrangement. Importantly, the provision also grants the U.S. Treasury extremely broad regulatory authority to extend the reach of the provision, including by (i) disallowing interest deductions for interest that is exempt in the hands of the interest recipient by reason of a participation exemption system, (ii) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity, (iii) applying the provision to foreign branches, and (iv) applying the provision to certain structured transactions.

New Section 267A is effective for taxable years beginning after December 31, 2017, and does not include any rule for “grandfathering” existing arrangements.

OSLER COMMENTARY

1. While it is clear that Congress intended to give the Treasury Department a broad grant of power to combat the use of hybrid instruments and entities in financing arrangements, the scope of the currently operative components of Section 267A in advance of such regulatory action is unclear. In making this determination, taxpayers will need to interpret key language, such as (a) what constitutes a “series of transactions” (for purposes of the definition of a “hybrid transaction”), and (b) what it means for a related-party holder of U.S. debt to be “allowed a deduction with respect to the payment” of interest on such debt.

2. If 267A applies, the provision denies a deduction for the relevant interest or royalty amount but does not recharacterize the offending amount for U.S. tax purposes. Accordingly, as noted
above, cross-border debt or intercompany arrangements may still be relevant from the perspective of planning for tax-effective repatriation of U.S. earnings.

BASE EROSION AND ANTI-ABUSE TAX (BEAT) APPLICABLE TO LARGE CORPORATIONS

New Section 59A effectively operates as an alternative minimum tax for those corporate taxpayers to which it applies and is designed to curb the use of base-stripping payments by U.S. taxpayers. The BEAT generally applies a minimum tax rate (5% for 2018 taxable years, 10% for 2019 through 2025 taxable years, and 12.5% thereafter) on the taxpayer’s “modified taxable income.” The BEAT payable by a corporate taxpayer in a given year may be expressed as:

BEAT = 10% of “modified taxable income” – “regular tax liability” (less certain tax credits)

“Modified taxable income” is generally the taxpayer’s taxable income recomputed to exclude the tax benefits arising from “base erosion payments.” For this purpose, base erosion payments are generally deductible payments paid or accrued to 25%-related foreign persons, deductions arising from depreciable or amortizable assets acquired from such related persons, and tax benefits arising from certain reinsurance payments to such related persons. Modified taxable income also excludes the “base erosion percentage” (defined below) of NOL carryforwards. “Base erosion payments” do not include (x) U.S.-source payments subject to gross-basis withholding and with respect to which the full amount of tax (i.e., 30%) has been withheld pursuant to Sections 1441 and 1442 of the Code (with a proration rule to the extent that the withholding tax rate is reduced pursuant to a treaty), (y) service payments charged at cost with no markup and eligible for the use of services cost method under U.S. transfer-pricing rules, or (z) payments with respect to certain marked-to-market derivatives.

The new provision generally applies to corporate taxpayers that have (x) an average annual gross receipts of at least $500 million for the preceding three tax years and (y) a “base erosion percentage” of 3% or higher. Corporations within the same 50%-controlled group are generally aggregated for these purposes. In determining the gross receipts amount taken into account with respect to foreign corporations, only gross receipts effectively connected with a U.S. trade or business are taken into account. Broadly speaking, the “base erosion percentage” for a taxpayer in any given tax year is the percentage determined by dividing the total amount of base erosion tax benefits realized by the taxpayer over the total deductions (including deductions for the base erosion tax benefits and excluding NOL carryforwards, participation exemption deductions and certain other deductions) for the taxpayer.

For U.S. corporations and their affiliates that “inverted” after November 9, 2017, but whose “surrogate foreign parent” did not trip the 80%-acquisition trigger for deemed U.S. corporate treatment (i.e., so-called 60% inversions), base erosion payments also include payments resulting in a reduction of gross receipts (e.g., acquisition of property that are taken into account in the cost of goods sold by the U.S. corporation) if paid or accrued to a 25%-related foreign person.

Different thresholds and rates apply to banks and registered securities dealers and their affiliates. For such taxpayers, the “base erosion percentage” triggering application of the BEAT is 2% instead of 3%, and the base erosion minimum tax amount is calculated at a rate 1% higher than the rate applicable to other taxpayers.

The BEAT is effective for “base erosion payments” paid or accrued in taxable years after December 31,
OSLER COMMENTARY

1. The BEAT is an innovative (but poorly executed) rearguard effort to protect the U.S. tax base against excessive erosion. In many ways, this provision essentially prevents base eroding payments made to related parties from reducing a U.S. taxpayer’s taxable income (determined without regard to such base eroding payments) by more than 50%.

2. The mechanics of the BEAT rule are particularly harsh to non-U.S. banks. First, because base eroding payments are measured on a “gross” (not net) basis, U.S.-outbound related party payments of interest are “counted” as base eroding payments but large amounts of correlative U.S. inbound payments are not netted against the outbound payments. For banks, the movement of large amounts of cash (and other financial assets) across borders via intercompany loans and other arrangements is vital to the execution of their business model and compliance with their regulatory requirements. The current mechanics of the BEAT do not adequately take these business realities of this sector into account. Second, Canadian banks frequently operate in the U.S. through both U.S. corporate subsidiaries and U.S. branches. Under the BEAT rules, it appears that deductible payments made by a U.S. subsidiary to the U.S. branch are treated as being made directly to the owner of the branch (the Canadian bank). In such case, such payments could be treated as base eroding payments and subject to the BEAT excise tax despite the fact that there would be no “erosion” per se because the U.S. branch would be required to include that payment in its U.S. taxable income. As noted by many observers, this would amount to double U.S. taxation of the same income item. The Institute of International Bankers (IIB) highlighted these complaints in a comment letter sent to Tax Conference Chair Kevin Brady on December 7, 2017. The concerns raised by the IIB were not meaningfully addressed in the final legislation but may be the subject of regulatory guidance to be issued by Treasury.

SECTION 163(J)

As described under Domestic U.S. tax changes affecting cross-border markets, Section 163(j) is amended to impose a stricter limitation on deductibility of net interest expense by U.S. taxpayers. This provision, in conjunction with the BEAT, could materially limit the effectiveness of cross-border financing arrangements and planning.

OSLER COMMENTARY

Pressure on cross-border lending? The combined effect of new 163(j) and the BEAT could have surprising and potentially anti-growth implications for cross-border lending markets. In
particular, the dramatic limitation of interest deductibility under 163(j) will have the effect of increasing the cost of capital to U.S. borrowers, which may restrain borrowing. Compounding this problem, is the fact that BEAT taxation could dramatically increase the cost to Canadian banks of making loans to U.S. borrowers, which may discourage cross-border lending by virtue of either squeezing the bank’s margins or increasing the cost of capital to borrowers. It is not yet clear whether the reduction in U.S. corporate and flow-through business tax rates will be enough of a counterbalance to offset the economic impact of these pressures.

OTHER KEY INTERNATIONAL TAX CHANGES

KEY U.S.-OUTBOUND RULE CHANGES

Some of the most significant international changes in the U.S. tax reform occurred in the rules governing U.S.-outbound investments. These changes are particularly relevant to Canadian businesses with U.S. investors and Canadian businesses with U.S. subsidiaries that themselves have foreign activities, assets or subsidiaries. In addition, these changes could also have surprising application to Canadian companies with U.S. subsidiaries, as further described below.

CFC definitional changes: There will be more CFCs

Effective for the last taxable year beginning before 2018, the constructive ownership rules in the CFC regime have been amended to remove a rule that previously prevented the downward attribution of stock owned by a foreign person to a U.S. person. The application of the downward attribution rules can result in surprising results. For example, it could cause non-U.S. subsidiaries of a non-U.S. multinational group to be treated as CFCs as a result of the presence of U.S. subsidiaries within the group, even if the non-U.S. subsidiaries are not controlled by the U.S. affiliates and even if the U.S. affiliates do not own any direct interest in the non-U.S. subsidiaries. If the U.S. subsidiaries own a direct interest in the non-U.S. subsidiaries (even a minority or insignificant interest), then such U.S. subsidiaries could be subject to phantom income inclusions under the GILTI regime and the one-time repatriation tax noted above, as well as the existing subpart F regime. Additionally, these changes may result in structuring concerns for tiered CFCs and additional reporting requirements for U.S. subsidiaries within multinational groups.

Separately, the definition of “United States shareholder” has been amended to include U.S. shareholders that own 10% of a foreign corporation by vote or value (unlike prior law, which only included 10% by vote). This, together with the attribution rule change noted above, could have material impact on U.S. investors of Canadian businesses and multinational groups.

Shift to a “semi”-territorial system of tax

In a much-vaunted move toward a territorial system, new Section 245A of the Code generally provides a domestic corporation which owns at least 10%, by vote or value, of a qualifying foreign corporation with a 100% dividends received deduction on eligible dividends paid by that foreign corporation. This so-called “participation exemption” system has limitations - it is restricted to the foreign-source portion of dividends, applies only to domestic corporate shareholders, and requires a holding period of at least 365 days over the 731 days straddling the ex-dividend date. Hybrid dividends, for which the foreign corporation receives a deduction in a foreign jurisdiction, are not eligible. When calculating loss (but not
gain) on a subsequent sale of foreign subsidiary stock, the U.S. parent’s basis in that stock is reduced by the amount of any dividends qualifying for the participation exemption. Finally, unlike many European participation exemption regimes, Section 245A does not generally provide for any exemption for proceeds from the direct or indirect sale of a foreign subsidiary (except to the extent that such gain is otherwise recharacterized as a dividend under Section 1248 of the Code).

One-time repatriation tax

To transition to the “semi”-territorial tax system described above, which allows for tax-free repatriations of distributed future foreign profits, a one-time repatriation tax is imposed on U.S. taxpayers’ previously deferred offshore earnings.

Under new Section 965, 10% U.S. shareholders, including non-corporate shareholders, of “specified foreign corporations” are required to include in income for its taxable year that includes the last taxable year of such foreign corporations beginning before 2018 (i.e., for calendar year U.S. shareholders and foreign corporations, the inclusion occurs in 2017) the accumulated deferred earnings of such foreign corporations as of November 2, 2017, or December 31, 2017, whichever is greater. “Specified foreign corporations” are CFCs and any foreign corporations with at least one 10% corporate U.S. shareholder.

For corporate 10% U.S. shareholders, this one-time deemed repatriation tax is imposed at a 15.5% rate on earnings held in cash and an 8% rate on earnings held otherwise. Various aggregation rules apply to affiliated U.S. shareholders and shareholders that are U.S. shareholders with respect to multiple foreign corporations, including rules permitting earnings deficits to offset accumulated earnings. The tax due from this provision may be paid in instalments over eight years, with instalments increasing towards the eighth year. Certain triggers, such as a sale of all of the assets of the taxpayer, can accelerate these instalment payments.

GILTI – A new type of “phantom income”

The “global intangible low-taxed income” (GILTI) provisions are among the most interesting and disruptive provisions enacted by the new tax legislation. More specifically, new Section 951A of the Code essentially ring-fences income earned by a “controlled foreign corporation” (a “CFC” within the meaning of Section 957 of the Code) that exceeds an “ordinary” 10% return on tangible assets and deems this “extraordinary” income to be attributable to intangible assets (whether or not that is actually the case). This excess income, referred to as “global intangible low-taxed income” is essentially treated as if it were a new class of Subpart F income and is deemed to be distributed to 10% U.S. shareholders on a current basis. While the mechanics underlying these provisions are complex, a 10% U.S. shareholder’s annual GILTI inclusion may be determined under the following basic formula:

\[
\text{GILTI} = \text{“Net-Tested Income” – “Net-Deemed Tangible Income Return”}
\]

Where

- “Net-Tested Income” is the 10% U.S. shareholder’s share of the aggregate net income of all of its CFCs, excluding (i) Subpart F income, (ii) income that is effectively connected with a U.S. trade or business, (iii) income that would have been subpart F income but for the so-called “high tax kick-out” which exempts from subpart F income that was subject to high foreign effective tax rates (at least 90% of the U.S. rate), (iv) dividends received from related persons and (v) certain foreign oil and gas income.
“Net-Deemed Tangible Income Return” for the 10% U.S. shareholders is effectively equal to 10% of the tax basis of certain tangible business assets held by each relevant CFC minus any net interest that was taken into account in determining Net-Tested Income. For purposes of this computation, CFCs are deemed to have U.S. tax basis in relevant assets equal to cost depreciated on a straight-line basis over the class life of the asset.

A U.S. corporation with GILTI is entitled to take a deduction (under Section 250 of the Code) which has the effect of lowering the corporation’s effective rate of U.S. tax on GILTI. During 2018-2025, the deduction is 50% of GILTI which equates to an effective rate of U.S. tax of 10.5%. Beginning in 2026, the GILTI deduction drops to 37.5% (equating to an effective rate of U.S. tax of 13.125%). Note that this GILTI deduction is only available to corporations.

U.S. corporations with GILTI are also entitled to claim foreign tax credits in respect of GILTI income, albeit with a 20% haircut. As a practical matter, this will in many cases mean that so long as the underlying GILTI income has borne a level of foreign tax at least equal to 13.125%, there will not be residual U.S. tax to pay on the GILTI. Accordingly, GILTI income earned by Canadian corporations that are CFCs would not typically be presumed to give rise to GILTI tax liability for their U.S. owners. However, because the aggregation mechanics for computing GILTI can blend high-taxed and low-taxed income streams, this simple presumption will in many cases not bear out.

**Foreign Derived Intangible Income (a patent box “Lite”)**

Foreign Derived Intangible Income (or FDII) is conceptually related to GILTI but instead applies to foreign source “intangible” income earned by domestic U.S. corporations. In particular, a U.S. corporation’s annual FDII may be determined through the following basic equation:

\[
FDII = DEI \times [\text{Foreign DEI/DEI}]
\]

Where

- **DEI** is essentially
  - the gross income of the U.S. corporation (excluding certain types of income such as subpart F income and GILTI) less any deductions (including taxes) related to such gross income, *minus*
  - an amount equal to 10% of the corporation’s U.S. tax basis in its tangible business assets.
- **Foreign DEI** is DEI that is derived from (i) property sold or licensed to non-U.S. persons for “foreign use” or (ii) services provided to any non-U.S. person or with respect to property not located in the U.S.

During 2018 to 2025, applicable U.S. corporations are entitled to a deduction on FDII equal to 37.5% of the FDII, resulting in an effective rate of U.S. tax of 13.125%. After 2025, the deduction ratchets down to 21.875%, which produces an effective rate of U.S. tax of 16.406%.

**OSLER COMMENTARY**

1. The changes to the CFC attribution rules and “United States shareholder” definition increase the likelihood that a Canadian company (or its non-U.S. subsidiaries) could be treated
as CFCs (and in certain circumstances, as PFICs). As such, Canadian businesses with material U.S. owners or investors should revisit their CFC and PFIC determinations and consider the potential impact of these rules in light of any undertakings they may have previously provided to their U.S. investors or shareholders. Canadian businesses looking for capital infusions from U.S. investors will also have to carefully consider the potential impact of these rules in negotiating any tax covenants or “tax distribution” provisions with potential U.S. investors. These changes will particularly be relevant to Canadian businesses within the following sectors:

- emerging markets
- investment funds

2. Canadian multinational groups with U.S. and non-U.S. subsidiaries should consider the potential impact of the CFC attribution changes on their structure, including potential additional reporting requirements for its U.S. subsidiaries. If any of its U.S. subsidiaries own interest in the non-U.S. affiliates, careful consideration should be given to whether such U.S. subsidiaries are subject to any phantom income inclusion (including the repatriation tax for its 2017 taxable year), and the unwinding of such structure.

3. Participation exemption: The scope of foreign earnings that will actually be eligible for this new participation exemption deduction is smaller than it first appears. This is because, “Subpart F” income, Section 956 inclusions and GILTI earned by an offshore subsidiary are not eligible for the participation exemption. In particular, (a) “Subpart F” income earned by a foreign subsidiary that is a CFC is subject to current taxation in the hands of the U.S. shareholder at ordinary tax rates, regardless of whether these earnings are actually distributed to the U.S. shareholder during the same taxable year, and (b) so-called GILTI income (see discussion below) is subject to current U.S. taxation under “Subpart F-like” mechanics, albeit at a lower effective rate of taxation.

Based on the above (and on the broad definition of GILTI), it appears that the benefit of the participation exemption is limited primarily to the annual return earned by the foreign company equal to 10% of the foreign company’s tax basis in its tangible business assets.

4. "Semi"-territorial tax regime: In many ways, a more appropriate summary of the impact of these U.S.-outbound rules is to that the U.S. is moving to a system of full current income inclusion for worldwide income of foreign subsidiaries (with limited foreign tax crediting, albeit generally with a lower tax rate on GILTI inclusions), subject to a limited exception for annual income equal to 10% of the foreign subsidiary’s U.S. tax basis in its tangible business assets. This is not the way this change has been marketed.

5. Canadian companies within cross-border structures such as exchangeable share structures should consider the potential impact of these rules on the anticipated tax cost of the structure.

6. Continuing applicability of Section 956: Departing from the legislative path taken by both the House and Senate Bills, Section 956, the rule requiring current inclusions for CFC earnings invested in United States property by U.S. shareholders, was not repealed. As a result, limitations on CFC guarantees and pledges of CFC stock pursuant to debt financing that are designed to avoid deemed dividend inclusions are likely to remain.
TAXING GAINS ON FOREIGN PERSON’S SALE OF A PARTNERSHIP INTEREST

The IRS has long taken the position that gain from the sale by a foreign person of a partnership interest is treated as income effectively connected to a U.S. trade or business to the extent that gain is attributable to assets of the partnership used in the U.S. trade or business. The U.S. Tax Court had rejected this position in 2017 in Grecian Magnesite Mining Indus. & Shipping Co. v. Commissioner, 149 T.C. No. 3 (2017). The IRS on December 15, 2017 filed a notice seeking to appeal the Grecian decision to the applicable U.S. Court of Appeals.

New Subsection 864(c)(8) reverses the Grecian decision, effectively codifying the historic IRS position for dispositions of partnership interests on or after November 27, 2017. Any such effectively connected gain or loss is limited to the extent that the selling partner would have realized effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the tested disposition. A co-ordinating rule reduces the amount of such effectively connected gain or loss to the extent that it would be double-counted in conjunction with the FIRPTA rules (related to dispositions of U.S. real property).

Importantly, the new rules are supplemented with a new withholding scheme that requires the transferee of a partnership interest to withhold 10% of the amount realized on the disposition if any of the gain would be treated as effectively connected to a U.S. trade or business under the new rule. If the transferee fails to withhold, then the partnership itself must withhold the required amount from any future distributions to the new transferee partner. An exception to this withholding rule applies if the transferor certifies that it is not a foreign person. There also is no mechanism for the partnership to certify that a sale of its assets would not result in effectively connected income. The lack of this exception may result in cautious withholding and corresponding refund applications while regulations are developed. However, IRS Notice 2018-8, released shortly after the TCJA was enacted, temporarily suspended the withholding requirement (but not the deemed effectively connected income treatment) on dispositions of interests in publicly traded partnerships.

OSLER COMMENTARY

As a backstopping withholding agent, in order to properly apply these rules, a partnership must be privy to the details of any sale of its interests – it will require knowledge of the purchase price, the amount withheld, and whether a non-foreign person certification was provided. As a practical matter, in the near term we expect confusion over withholding logistics may create deal “friction” between buyers, sellers and partnerships in transactions involving partnership interests. In the medium term, we expect that investment fund agreements and JV operating agreements will be drafted to include more robust information-sharing requirements in order to promote compliance with withholding tax obligations as well as provisions entitling partnerships to claw back any distributions that were made without properly withholding.
The new legislation significantly tightens the Section 163(j) earnings restriction. Beginning in 2018 (and continuing through 2025), non-corporate entities will be subject to new restrictions on their deductibles.

The combination of the new Section 245A and the GILTI provisions has resulted in a significant reduction in the effective tax rate for U.S. companies. According to calculations by the International Tax Policy Forum, the effective rate for U.S. companies is now 16.1%, down from 35% before the tax reform.

TAXING GAINS ON FOREIGN PERSON'S SALE OF A PARTNERSHIP INTEREST

Foreign Derived Intangible Income (FDII) is conceptually related to GILTI but applies to foreign earnings streams. The FDII provision, effective in 2018, results in an effective rate of U.S. tax of 13.125%. After 2025, the deduction ratchets down to 7.5%

A U.S. corporation with GILTI is entitled to take a deduction (under Section 250 of the Code) which has been subject to a downward adjustment of 90% attributable to the deduction limitation. Accordingly, GILTI income earned by Canadian corporations as of November 2, 2017, or December 31, 2017, whichever is greater.

In a much-vaunted move toward a territorial system, new Section 245A of the Code generally provides a deduction for foreign-source income. Investors of Canadian businesses and multinational groups will benefit from this provision.

PRIVATE EQUITY

U.S. subsidiaries of Canadian businesses and foreign subsidiaries of the U.S. affiliates will be subject to the new tax rules. However, non-U.S. subsidiaries are not controlled by the U.S. affiliates and even if the U.S. affiliates do not own any stock owned by a foreign person to a U.S. person. The applicability of the downward deduction rules can be disrupted.

OTHER KEY INTERNATIONAL TAX CHANGES

DOMESTIC U.S. TAX CHANGES AFFECTING CROSS-BORDER MARKETS

In addition, because the tax bill was co-habiting of both "old" and "new" tax rules makes for new levels of complexity. Broadly speaking, most part, the basic architecture of the "old" U.S. tax system remains intact but with drastic reform actions.

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More opportunities for fresh thinking about how cross-border businesses and investments should be structured, and new levels of complexity.
The new legislation significantly strengthens the Section 163(j) earnings limitation. Beginning in 2018 (and continuing through 2025), non-corporate taxpayers are subject to a new limitation on the deduction of interest expenses. This limitation applies to taxpayers that have average total gross liabilities exceeding $250 million over the preceding 12-month period. The limitation reduces the interest deduction by the lesser of (1) the aggregate base erosion percentage and (2) the amount of net operating loss carryforwards.

The BEAT (Base Erosion and Anti-Abuse Tax) is effective for “base erosion payments” paid or accrued in taxable years after December 31, 2017. This tax applies to certain payments to a related party, including payments of interest or royalties. The tax is equal to the lesser of (1) the aggregate base erosion amount and (2) the aggregate base erosion percentage of net operating loss carryforwards.

“Base erosion payments” do not include payments to a related party that are (1) effectively connected with the trade or business of the related party or (2) payments of interest or royalties that are effectively connected with the trade or business of the related party. “Base erosion payments” also do not include payments to a related party that are deductible by the related party for income tax purposes.

SECTION 163(J)

The Section 163(j) limitation on the deduction of interest expenses applies to tax years beginning after December 31, 2017. The limitation reduces the interest deduction by the lesser of (1) the aggregate base erosion percentage and (2) the amount of net operating loss carryforwards.

The Section 163(j) limitation is calculated using the base erosion percentage, which is the ratio of the aggregate base erosion amount to the aggregate base erosion percentage. The aggregate base erosion amount includes payments of interest or royalties to a related party, subject to certain exceptions. The aggregate base erosion percentage is calculated by dividing the aggregate base erosion amount by the aggregate base erosion percentage of net operating loss carryforwards.

The Section 163(j) limitation applies to taxpayers that have average total gross liabilities exceeding $250 million over the preceding 12-month period.

New Subsection 864(c)(8) reverses the one-time repatriation tax because the aggregation mechanics for computing GILTI can blend high-taxed and low-taxed income. Certain triggers, such as a sale of all of the assets of the taxpayer, can accelerate these limitations.

Corporations “are CFCs and any foreign corporations with at least one 10% corporate U.S. shareholder.” Specified foreign corporations as of November 2, 2017, or December 31, 2017, whichever is greater. "Specified foreign corporation" means a foreign corporation that is a subsidiary of a U.S. corporation, and is engaged in a trade or business in the United States, and is not a CFC.

The GILTI = “Net-Tested Income” – “Net-Deemed Tangible Income Return.” Net-tested income is the excess of the aggregate taxable income of the U.S. subsidiary over the aggregate taxable income of the foreign subsidiary. Net-deemed tangible income return is the deemed tangible income return of the U.S. subsidiary.

The Grecian Magnesite Mining Indus. & Shipping Co. v. Commissioner example illustrates how these U.S. tax changes demand fresh thinking about “established” tax rules, and the extreme interconnectivity between the Canadian and U.S. markets, both U.S.-inbound and U.S.-outbound investments. These changes are particularly relevant to Canadian businesses with U.S. investors will also have to carefully consider the potential impact of these rules in light of any undertakings they may have previously provided.