Canadians beware… Do accidental US tax inversions apply to you?

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Phaedrus, the ancient Athenian aristocrat associated with the philosopher Socrates, was famous for the following quote: “Things are not always as they seem; the first appearance deceives many.” The US inversion tax rules that you may have read about in connection with the Burger King – Tim Horton’s deal or the scuttled Pfizer – Allergan deal reminds me of Phaedrus’ quote… while the rules might appear conceptually simple, the reality is that they are very nasty. Under certain circumstances, the foreign (non-US) acquiring company of the US target is treated as a US domestic corporation for income tax purposes under the US Internal Revenue Code.

I can see you scratching your head. Why does the US have these inversion rules? Two reasons. Firstly, the US has an income/foreign tax credit regime for dividends received by the US parent from foreign subsidiaries. This has the effect of bringing the effective tax rate of foreign income up to the US domestic rate of taxation when those foreign earnings are repatriated in the form of dividends. Contrast this with the Canadian foreign affiliate regime that generally exempts dividends received from foreign affiliates – where such surplus was derived from active business operations – from Canadian taxation. Secondly, the US generally has a comparatively higher corporate tax rate than other western countries (Canada has a federal corporate income tax rate of 15% and the US has a federal rate of 35%). For these two reasons, a multinational corporate group would much prefer to have its parent corporation formed in a country such as Canada rather than the US. Rather than deal with its uncompetitive corporate tax rates, the US has chosen to attack the flow of corporate groups into other jurisdictions by introducing and then tightening the corporate inversion rules.

There are two thresholds that yield different results under the inversion rules: the 60% threshold and the 80% threshold. The 80% threshold works as follows: If a foreign corporation (Canadian corporation in this example, “Canco”) acquires a US corporation (USco), the former shareholders of USco own at least 80% of the shares (by vote or value) of Canco by virtue of their former USco shareholdings and following the acquisition neither Canco nor its affiliated group has “substantial business activities” in Canada compared with the total worldwide business activities of the affiliated group, Canco will forever be treated as a US corporation for all US tax purposes. The 60% threshold is crossed by substituting 60% for 80% in the above formula. Under the 60% threshold, Canco continues to be respected as a foreign corporation, but the “inversion gain” continues to be taxed in the hands of USco for a 10-year period. The adverse tax consequences of the 60% threshold are only present in asset reorganizations. Since this article is about accidental inversions, I’m going to only focus on the 80% threshold situation.

A couple of points are worth highlighting. First, when determining the 80% threshold, you don’t count Canco shareholdings that are in place before the acquisition. So, if Shareholder A owns 10 shares of Canco and 10 shares of USco, then receives 20 shares of Canco on the acquisition of USco by Canco, only the 20 shares are counted in determining whether Canco is at least 80% owned by former USco shareholders.

Second, in order to meet the “substantial business activities” test, (1) the number of group employees based in Canada must be at least 25% of the total number of employees in the worldwide group AND the employee compensation of these Canadian-based employees must be at least 25% of the worldwide group employee compensation; (2) the value of the group assets located in Canada is at least 25% of the total value of worldwide group assets; and (3) the group income derived in Canada is at least 25% of the worldwide group income.

Let's assume US operating company (USOpco) wants to go public and take advantage of the more lenient listing requirements in Canada on the TSX vs. the US exchanges. A Canadian holding company (Canco) is formed to be the listed public company. Canco could also be a Capital Pool Company (CPC) on the TSXV. Shareholders of USOpco exchange their USOpco shares for shares in Canco. If former USOpco shareholders own at least 80% of the shares in Canco after the exchange, for US income tax purposes, Canco is treated as a US corporation going forward since it can't meet the substantial business activity test as I've discussed above.

A more egregious example of these rules is as follows: Mr. A is a Canadian resident businessman. Mr. A wants to commence operations in the US, and because he is wary of potential disputes and lawsuits in the US, he forms a Delaware corporation (USco) to carry on the US business. Subsequent to that time, Mr. A meets with his tax advisor who suggests that a better structure would be to have a Canadian holding company (Canco) hold the shares of USco. This is because dividends received by Canco from USco are tax deferred in Canada and only subject to a 5% US nonresident withholding tax. Alternatively, dividends paid directly from USco to Mr. A would be subject to ordinary income tax rates in Canada (currently 48% in Alberta) and a fully creditable 15% US nonresident withholding tax. Moreover, the dividends from USco to Canco form part of Canco's General Rate Income Pool (GRIP) which can be later distributed out to Mr. A as an "eligible dividend" subject to the lower preferential rate of tax (currently 31.7% in Alberta).

If we assume USco doesn't hold any US real estate, the shares of USco can be contributed to Canco without incurring a US tax liability. For Canadian tax purposes, Mr. A can transfer the shares of USco to Canco in exchange for Canco shares and elect to defer any gain under subsection 85(1) of the Canadian Income Tax Act. Unfortunately and, perhaps, unbelievably, Mr. A has just walked into the US inversion rules. Because USco has been acquired by Canco and the former USco shareholders (Mr. A) own at least 80% of the Canco shares by virtue of their USco shareholdings (100%), and Canco as a pure holding company can't meet the "substantial business activity" test, Canco will be treated as a US corporation for US tax purposes and subject to UScorporate income tax. In addition, any future distributions of surplus from Canco to Mr. A would likely be subject to US withholding tax. If Mr. A had formed Canco right from the start to be the shareholder of USco, these rules wouldn't apply.

Fortunately in the vast majority of our client situations, the "substantial business activity" test can be met since the expansion into the US generally follows a successful business carried on in Canada. The transfer of the USco shares into a Canadian corporate structure with substantial Canadian business activities should be able to be undertaken on a tax-deferred basis and without application of the inversion rules. Care must be taken, however, to consider these rules whenever an acquisition of a US corporation by a Canadian corporation occurs. As Phaedrus' famous quote reminds us, good vanilla planning that many Canadian tax advisors are familiar with may actually not be the cuddly kitten you think you are holding; instead, you may have just walked into a lion's den.