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# Tax Considerations in Structuring Foreign Investment in the United States

Thomas H. Olsen

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# Tax Considerations in Structuring Foreign Investment in the United States

*Thomas H. Olson\**

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## I. INTRODUCTION

Proper tax planning for foreign investment<sup>1</sup> in the United States is crucial because foreign investors may be subject to both United States and foreign taxes on income from their United States investments or businesses. The United States income tax, which may exceed 50% of the profit from an investment or business,<sup>2</sup> when combined with additional income taxes in the United States or in foreign countries, can create cumulative income taxes so substantial that they destroy the economic feasibility of a proposed investment.<sup>3</sup> If foreign countries tax income

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1. All references to foreign investment include both direct and indirect investment unless the context otherwise requires. Foreign direct investment refers to direct ownership of, or ownership of a controlling interest in, a business by a foreign person. Foreign indirect investment refers to noncontrolling portfolio investment in a business.

2. The United States federal corporate income tax rate is 46% of taxable income exceeding \$100,000. I.R.C. § 11 (1982). In Colorado the state corporate income tax rate is 5% of adjusted federal taxable income. COLO. REV. STAT. § 39-22-301 (Bradford Supp. 1983). The highest marginal federal individual income tax rate is 50%. I.R.C. § 1 (1982). The highest marginal Colorado individual income tax rate is 8%. COLO. REV. STAT. § 39-22-104 (Bradford Supp. 1983). Thus, the combined federal and state income tax rates for both corporations and individuals may exceed 50%.

3. Income tax is only one of many taxes that may burden the profits from foreign investment in the United States. Other United States taxes include estate, gift, generation-skipping, transfer, Federal Insurance Contributions Act (FICA), State Employees Compensation Act (SECA), and Federal Unemployment Tax Act (FUTA) taxes. The impact of these taxes, along with other nonincome taxes in foreign countries, can be significant. Although this article deals only with income taxes, proper tax planning for foreign investments must deal with all taxes that affect the investment.

from investments or businesses in the United States more heavily than comparable domestic income,<sup>4</sup> the impact of multiple taxation becomes even more severe. Because the risk of prohibitive cumulative income taxes on foreign investments in the United States is high, proper tax planning for such investments is essential.

Tax planning for foreign investment in the United States involves unique and complex legal issues. Rote application of conventional tax wisdom is never a substitute for thorough individualized tax planning, and no single investment holding structure is optimal for all investments or businesses. This article is intended to help the tax advisor identify some of the factors that affect the cumulative income taxes burdening foreign investments in the United States.<sup>5</sup>

## II. A BASIC APPROACH TO ANALYZING MULTIPLE TAXATION AND EVALUATING ITS IMPACT

### A. Definition of "Multiple Taxation"

The term "multiple taxation" is broadly defined as the imposition of more than one tax on an item or stream of income generated by a business or investment. Multiple taxation typically arises from the imposition of an income tax (1) by a single country on more than one person with respect to a stream of income (hereinafter referred to as "taxation of multiple persons"), or (2) by more than one country on a single person with respect to an item of income (hereinafter referred to as "taxation by multiple nations").

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4. For example, under Canada's tax law the small business deduction is available for domestic but not foreign source business income. Income Tax Act, ch. 63, § 125(1)(a), 1970-72 Can. Stat. 825, amended by Act of Feb. 26, 1981, ch. 48, § 70(1), 1980-81-82-83 Can. Stat. 1410 [hereinafter cited as I.T.A.].

5. For purposes of illustration, this article will specifically discuss some of the tax consequences of Canadians investing in the United States. However, this article is not intended to provide a complete summary of the income tax laws of the United States, Canada, or any other country that relate to taxation of foreign investment in the United States. Furthermore, this article does not incorporate the Tax Convention of 1984, United States-Canada, or the Tax Reform Act of 1984, which became effective after this article had been submitted to the printer. The nonimplementation of these provisions in this article has no impact on its thesis since the income tax laws incorporated herein are simply illustrative.

### 1. *Taxation of multiple persons*

Taxation of multiple persons results primarily from the treatment of business entities as taxpayers separate from the individuals who own or are beneficially interested in them. The best example of taxation of multiple persons is the so-called double tax on income earned by a corporation. In the United States and many foreign countries, income earned by corporations and other similar entities is initially subject to tax whether or not the income is distributed.<sup>6</sup> When the corporate income is distributed to the stockholders as dividends, it is again subject to tax.<sup>7</sup> This type of multiple taxation is based on the concept that each entity or person in the chain of ownership, from the operating entity to the ultimate individual owner, is a different taxpayer. Thus, only so much of the income as is actually distributed downward is subject to subsequent income tax, and the portion of income that is paid as taxes at the corporate level is not typically subject to a subsequent tax.<sup>8</sup>

Nevertheless, the cumulative tax burden resulting from taxation of multiple persons is significant. For example, assuming a 50% marginal corporate and individual income tax rate, each dollar of corporate income is subject to at least \$.75 of income tax if the income is fully distributed to the stockholders.<sup>9</sup>

Multiple taxation arising from taxation of multiple persons does not necessarily occur in the year in which the income is originally earned. Instead, subsequent income taxes are incurred at the time the income flows or is deemed to flow to the owners of the previously taxed entity. The ability to defer the subse-

6. L.R.C. § 11 (1982). However, corporations that elect to be taxed under subchapter S of the Internal Revenue Code are taxed in much the same manner as partnerships, i.e., the individual stockholders are taxed on their pro rata share of corporate income, and no separate income tax is imposed on the corporation. *Id.* §§ 1361-1379.

7. *Id.* § 61(a)(7).

8. It is important to note the many exceptions to the general rule, especially with respect to tax laws that deem corporate income to be distributed to stockholders. In Canada, for example, the full amount of nonactive business income of certain Canadian owned foreign corporations is deemed to be distributed to controlling Canadian stockholders at the time it is earned. A deduction for foreign income taxes paid by the foreign corporation is allowed only if paid in the year earned or one of the five succeeding years. L.T.A., *supra* note 4, § 91(4).

9. The corporation is subject to \$.50 of tax on each dollar of income, and the shareholder is subject to \$.25 of tax on the remaining \$.50 of income when distributed. This significant overlapping tax on corporate earned income accounts for the formation of increasingly large numbers of limited partnerships. Some of these partnerships have tens of thousands of partners and are larger than many corporations.

quent income taxes reduces the potential impact of those taxes and provides important tax planning opportunities.

## 2. *Taxation by multiple nations*

Taxation by multiple nations results primarily from multiple jurisdictional bases for taxing of foreign income. As a general rule, the United States taxes the United States source income of all persons<sup>10</sup> and all income of United States residents and citizens regardless of its source.<sup>11</sup> The United States has multiple jurisdictional bases for income taxation that are broad and that are not mutually exclusive of foreign countries' jurisdictional bases for income taxation. Consequently, foreign investment in the United States incurs a high risk of taxation by multiple nations.<sup>12</sup>

The most common example of taxation by multiple nations is the double tax on income earned by foreign persons doing business in the United States. Such income is subject to United States income tax because it has a United States source<sup>13</sup> and may also be subject to the home country's income tax because the foreign taxpayer resides in, is a citizen of, or was created under the laws of such country. Because this type of multiple taxation results from multiple jurisdictional bases for taxation, the entire income from a United States business may be subject to multiple taxation at the time it is earned. Thus, unless an

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10. There are several exceptions to this general rule provided in the Code and income tax treaties to which the United States is a signatory. See *infra* text accompanying notes 21-25, 58-59.

11. Although all United States citizens and residents are subject to United States income tax on their worldwide income, certain United States citizens and residents living abroad may be entitled to exclude foreign source earned income up to a maximum of \$85,000 for 1984. I.R.C. § 911 (1982).

12. Certain countries like Venezuela, Panama, and Costa Rica tax only domestic source income. M. LANGER, *PRACTICAL INTERNATIONAL TAX PLANNING* 8 (2d. ed. 2d printing 1979). Investors from such countries can largely avoid taxation by multiple nations on income from an investment in the United States. Many of the developed nations, however, tax on the basis of residence as well as domestic source income. For example, Canada taxes Canadian source income of all persons and income of Canadian residents. I.T.A., *supra* note 4, § 2(1), (3). As a result, many foreign investors and their operating entities are subject to United States tax on United States investment income (because the income has a source in the United States) and to tax in a foreign county on the same income (because the income was received or deemed to be received by a person residing in such foreign country).

13. I.R.C. §§ 871(b), 882 (1982). Certain foreign source income of foreign persons doing business in the United States may also be subject to United States income tax. *Id.* § 884(c)(4).

appropriate relief provision is available, the tax can exceed the total income.

### *B. Basic Steps in Analyzing Multiple Taxation*

#### *1. Gather relevant facts*

As with all types of legal analysis, the first step in structuring foreign investments in the United States is to gather all the relevant information. For tax planning, relevant information about an investor includes his residency and citizenship, his other proposed and existing investments, his intentions with respect to the use of income generated by the investment, the nature of the proposed investment or business, the dollar amount of investment, the potential financing sources, and the projected amount and timing of the profits.

#### *2. Identify all applicable income taxes*

The second step is to identify all the taxes that may burden the income from the investment between the time the income is earned and the time the investor benefits economically from the investment.<sup>14</sup> During the life of every United States foreign investment, several events may affect the amount of income taxes arising therefrom. The four most common events are (1) the generation of profits or losses from ongoing business operations; (2) the repatriation or distribution of profits to the foreign investor; (3) the reorganization of the structure of the investment; and (4) the liquidation or disposition of the investment. Each of these events may trigger multiple income taxes; therefore it is necessary to identify each tax resulting from each event likely to occur during the life of the proposed investment or business.<sup>15</sup> Of course, the tax advisor must be aware of the investor's intentions regarding the flow and use of the investment income in order to accurately identify applicable income taxes.<sup>16</sup>

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14. The investor is often a business entity such as a corporation or partnership. With the exception of some widely held corporations that truly act as independent persons, business entities are simply vehicles for investment by their owners. Therefore, the tax advisor must analyze the tax consequences not only for the business entity but also for the shareholders or partners owning the entity.

15. For a discussion of the tax impact of these events see *infra* text accompanying notes 144-188.

16. To ensure that the tax advisor correctly understands the tax laws of foreign countries, it is generally necessary and advisable to retain a foreign tax professional.

3. *Determine timing and amount of total cumulative income taxes*

After identifying the applicable income taxes, the tax advisor must determine the timing and amount of the total cumulative taxes resulting from the application of each identified income tax. In many circumstances the total income tax from multiple taxation is far less than the cumulative total of each separate tax because of the application of relief provisions such as credits for foreign taxes paid.<sup>17</sup> Relief provisions intended to eliminate or reduce overlapping taxes are generally of two types. The first type simply eliminates income taxes and is a result of income tax treaties and special taxing statutes relating to foreign source income. The second type compensates the investor for taxes paid to other countries or offsets the impact of the additional income taxes imposed by the home country.

But uncertainty hinders the tax advisor's efforts to precisely determine the effects of either type of provision. Projections of the nature, amount, and timing of income are incomplete or inaccurate. Thus, the tax advisor must realize that overlapping taxes may be even greater if his projections are inaccurate. Recognizing the risks associated with the use of particular relief provisions is crucial in analyzing the potential impact of multiple income taxes.

Because the United States taxes income from United States sources, structuring the transaction to eliminate the initial United States income taxes is difficult—sometimes impossible.<sup>18</sup> For this reason, analyzing the cumulative effect of multiple income taxes by reference to taxes that overlap the initial income tax is often helpful. The term “overlapping taxes” refers to the portion of the total cumulative income taxes payable with re-

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Nevertheless, the tax advisor must know enough foreign tax law to be able to identify which countries may assert an income tax at some point in time on the stream of income from investment or business. Countries typically base their jurisdiction to tax income on two factors: (1) the residence or citizenship of the investor, the operating entity, and intermediary entities; and (2) the source of income.

17. For example, both the United States and Canada may assert a 50% income tax on a Canadian corporation's total United States business income. However, the net total income taxes may be reduced from 100% to 50% through the application of foreign tax credits in Canada for United States income tax paid. *See infra* text accompanying notes 78-103.

18. Generally United States income tax is totally avoided only when a foreign person conducts business in the United States without a permanent establishment. *See infra* text accompanying note 58.



spect to an item or stream of income which would not have been payable if the first income tax had been fully credited against the subsequent income taxes.<sup>19</sup> Overlapping taxes can arise from either type of multiple taxation, and in many cases the overlapping taxes will consist partly of subsequent United States income taxes and partly of foreign income taxes.

#### 4. *Repeat the process for all alternative holding structures*

The prudent tax advisor must also identify each conceivable holding structure for the investment, identify the income taxes that apply to these structures, and determine the impact of these taxes on the investment.

#### 5. *Compare cumulative tax consequences of each structure*

After the cumulative income tax burden for each alternative investment structure is carefully analyzed, the tax advisor must help the investor evaluate the comparative advantages and disadvantages of each holding structure. This comparison will include evaluations of the cumulative income tax burden using the projected income stream and of the risk that a relief provision on which the investor may want to rely will not be effective.

### III. UNITED STATES TAXATION OF FOREIGN PERSONS

#### A. *United States Source Income*

If income from a foreign person's investment or business in the United States is subject to multiple taxation, at least one of the income taxes will probably be levied in the United States. Consequently, some fundamental concepts of United States income tax law relating to foreign persons must be understood to identify, analyze, and evaluate the cumulative income taxes burdening alternative holding structures for foreign investment in the United States.<sup>20</sup>

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19. Overlapping taxes are the portions of the total cumulative income taxes that exceed the greatest of each separate income tax.

20. Income tax is only one of many taxes that may burden the profits from a foreign investment in the United States. For example, the foreign investor may also be subject to United States federal estate and gift taxes. Federal estate taxes are imposed on the taxable estate of a nonresident alien individual. *See infra* note 21. A nonresident alien individual's taxable estate is equal to his gross estate minus allowable deductions. The gross estate includes all property having a situs in the United States. A nonresident alien individual may deduct from his gross estate certain expenses, losses, indebtedness, and taxes,

Foreign persons<sup>21</sup> are generally not subject to United States income tax unless they have United States source income.<sup>22</sup> United States source income is generally defined as income generated when a person provides goods, services, or capital to someone within the United States. Although easily defined, United States source income is subject to technical and inconsistent rules found in the Internal Revenue Code (hereinafter referred to as "the Code") and Treasury Regulations.<sup>23</sup> For example, interest paid to a foreign person by banking institutions in the United States is not United States source income,<sup>24</sup> but interest paid to a foreign person by certain foreign corporations is United States source income.<sup>25</sup>

United States source income of foreign persons is subject to

as well as transfers for certain public, charitable, and religious uses. The marginal federal estate tax rates for 1977 and succeeding years on the taxable estate are as follows:

Not over \$100,000	6%
Over \$100,000 but not over \$500,000	12%
Over \$500,000 but not over \$1,000,000	18%
Over \$1,000,000 but not over \$2,000,000	24%
Over \$2,000,000	30%

I.R.C. § 2101(d) (1982).

A nonresident alien is entitled to a credit of \$3,600 against the estate tax otherwise payable. *Id.* § 2102(c)(1). The executor of a nonresident alien individual's estate must file an estate tax return within nine months after the individual's death if the value of the gross estate exceeds \$60,000. *Id.* §§ 6018(a)(2), 6075(a).

Federal gift taxes are imposed on the taxable gifts made by a nonresident alien individual. *Id.* § 2501(a). A nonresident alien individual's taxable gifts are equal to the total amount of gifts of property having a situs in the United States minus allocable deductions. Each nonresident alien individual may deduct from taxable gifts an annual \$10,000 exemption per donee, gifts to certain charities, and gifts to individuals for school tuition and medical expenses. *Id.* §§ 2503(b),(c), 2522(b).

The gift tax applies only to taxable gifts made during the year, but the marginal tax rate is determined by reference to the sum of the taxable gifts for the year plus the taxable gifts from all preceding years. The 1984 marginal federal gift tax rates range from 18% for cumulative taxable gifts not exceeding \$10,000 to 55% for cumulative taxable gifts exceeding \$3,000,000. *Id.* §§ 2001(c), 2501, 2502.

21. "Foreign persons" as used in this article means foreign corporations and nonresident aliens collectively. A "foreign corporation" is any corporation not created or organized in the United States or under the laws of the United States or of any state therein. A "nonresident alien" is an individual who is neither a resident nor citizen of the United States. *See id.* § 7701; *see also* Treas. Reg. § 301.7701-5 (1960).

22. I.R.C. §§ 871, 872, 881, 882 (1982). In certain circumstances, however, foreign source income of foreign persons is also subject to United States income tax. *Id.* § 864(c)(4).

23. *Id.* §§ 861-63 and corresponding Treasury Regulations.

24. I.R.C. § 861(a)(1)(A), (c)(1) (1982).

25. Interest paid by a foreign corporation in which 50% or more of the gross income for the preceding three-year period was effectively connected with a United States trade or business is treated as United States source income. *Id.* § 861(a)(1)(C).

either the regular graduated rate tax or the flat rate tax depending on whether the United States source income is effectively connected with the conduct of a trade or business within the United States.<sup>26</sup> For purposes of examining these two income taxes, items of United States source income are categorized as follows: (1) income (including certain types of foreign source income) that is effectively connected with the conduct of a trade or business by the foreign person within the United States;<sup>27</sup> (2) fixed or determinable annual or periodical income that is not effectively connected with the conduct of a trade or business by the foreign person within the United States;<sup>28</sup> and (3) gains from the disposition of interests in United States real property.<sup>29</sup>

*1. Income effectively connected with United States trade or business*

Income can be effectively connected with a United States trade or business only if the recipient of the income is engaged in a trade or business in the United States.<sup>30</sup> Investing in United States corporations and making other passive investments in the United States does not cause one to be engaged in a United States trade or business,<sup>31</sup> nor do organizing personal United States corporations,<sup>32</sup> investigating business opportunities in the United States,<sup>33</sup> selling goods on consignment in the United States,<sup>34</sup> or owning relatively minor United States mineral working interests.<sup>35</sup> However, engaging in activities in the United States that are more substantial than these described may be

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26. *Id.* §§ 871(a), (b), 881(a), 882(a), 897(a).

27. *Id.* § 864(c).

28. *Id.* § 864(c)(2).

29. *Id.* § 897(a).

30. See *Higgins v. Commissioner*, 312 U.S. 212, 217 (1941). However, gain from the sale or exchange of an interest in United States real property is treated as income effectively connected with a United States trade or business regardless of whether the taxpayer is engaged in a United States trade or business. I.R.C. § 897(a) (1982). See *infra* text accompanying notes 67-69.

31. *Higgins* 312 U.S. at 218.

32. *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963).

33. *Werner Abegg v. Commissioner*, 50 T.C. 145, 153-54 (1968), *aff'd on other grounds*, 429 F.2d 1209 (2d Cir. 1970), *cert. denied*, 400 U.S. 1008 (1971).

34. *Cf. Rev. Rul.* 76-322, 1976-2 C.B. 487.

35. *Di Portanova v. United States*, 690 F.2d 169, 177 (Ct. Cl. 1982); see also *Cataphote Corp. v. United States*, 535 F.2d 1225 (Ct. Cl. 1976); *John Provence #1 Well v. Commissioner*, 37 T.C. 376 (1961), *aff'd*, 321 F.2d 840 (3d Cir. 1963). But see *Namours Corp. v. Commissioner*, 38 T.C. 585 (1962), *aff'd on other grounds*, 325 F.2d 559 (3d Cir. 1963).

sufficient.<sup>36</sup> Further, a foreign person who is a member of any partnership that is engaged in a United States trade or business is deemed to be engaged in a United States trade or business.<sup>37</sup>

Except for fixed or determinable annual or periodical income and capital gains or losses that are not derived from the assets or activities of a United States trade or business,<sup>38</sup> the entire amount of United States source income of a foreign person engaged in United States trade or business is effectively connected with the conduct of a United States trade or business.<sup>39</sup> In rare circumstances items of foreign source income are also taxed as income effectively connected with the conduct of a United States trade or business.<sup>40</sup>

Income that is effectively connected with the conduct of a United States trade or business by a foreign person is taxed in much the same manner as income of United States persons. The tax is computed by multiplying the applicable corporate or individual income tax rate by the foreign person's net income. Corporate income tax rates for 1983 and succeeding years are graduated from 15% of net income not exceeding \$25,000 to 46% of net income exceeding \$100,000.<sup>41</sup> Individual income tax rates generally applicable to nonresident aliens<sup>42</sup> for 1984 and succeeding years are graduated from 11% of net income exceeding \$2,300 to 50% of net income exceeding \$81,800.<sup>43</sup>

A foreign person's taxable net income is determined by subtracting from gross income the expenses, losses, and other items that are deductible by United States persons, but only to the

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36. For example, the ownership of real property in the United States does not constitute the conduct of a United States trade or business, but the active management of a real estate property is a trade or business. *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940); Rev. Rul. 73-522, 1973-2 C.B. 226.

37. I.R.C. § 875 (1982).

38. *Id.* § 864(c)(2). Gain derived from the disposition of United States real property interests is also taxed as income effectively connected with a United States trade or business. *Id.* § 897.

39. *Id.* § 864(c)(3).

40. *Id.* § 864(c)(4).

41. *Id.* § 11(b).

42. Nonresident aliens are generally not permitted to file joint returns. *Id.* § 6013(a)(1).

43. *Id.* § 1(d). Actually, the tax rates described in § 1 of the Code apply to taxable income of individuals in excess of the zero bracket amount. The zero bracket amounts are \$2300 for single taxpayers, \$3400 for married taxpayers filing jointly, and \$1700 for married persons filing separately. *Id.* § 63(d). However, nonresident aliens are required to add to their taxable income the excess of the zero bracket amount over itemized deductions. *Id.* § 63(e).

extent that such deductions are connected with and directly or indirectly allocated and apportioned to income effectively connected with the conduct of the foreign person's United States trade or business.<sup>44</sup> (Deductions that are connected with income which is effectively connected with the conduct of a United States trade or business are hereinafter referred to as "connected deductions.") A nonresident alien may also deduct from gross income a personal exemption of \$1,000.<sup>45</sup>

Trade or business expenses or losses and state and local taxes incurred by a foreign person are often connected deductions. Other deductions, such as depreciation and depletion deductions and in the case of individuals the 60% long-term capital gains deduction, are probably also connected. Contributions to charitable United States organizations are deemed to be connected deductions, as are casualty and theft losses incurred by nonresident aliens with respect to property located in the United States.<sup>46</sup>

The rules for allocating and apportioning connected deductions to income effectively connected with a foreign person's United States trade or business are very complicated. Items that are otherwise deductible and that are incurred as a result of, or incident to, an activity or in connection with property are allocated to the class or classes of gross income derived therefrom.<sup>47</sup> Examples of classes of gross income for allocation purposes include gross income derived from business or property dealings, interest income, and royalties. Deductible items that cannot be directly allocated to any class of gross income are allocated to all classes of gross income on a proportional basis.<sup>48</sup> The portion of each deductible item allocated to a class of gross income must be apportioned between income effectively connected with a United States trade or business and all other income of that class.<sup>49</sup> A connected deduction is deductible for United States income tax purposes only to the extent that it is allocated and apportioned to income that is effectively connected with a United States

44. *Id.* §§ 873(a), 882(c)(1)(A).

45. *Id.* § 873(b)(3). In the case of residents of Canada and Mexico, a nonresident alien is also entitled to deducted exemptions of \$1000 for each dependent and for the spouse if the spouse does not have any United States source income. *Treas. Reg.* § 1.873-1(c)(3) (1957); *see also* *I.R.C.* § 151 (1982).

46. *Id.* §§ 873(b), 882(c)(1)(B).

47. *Treas. Reg.* § 1.861-8(b)(1), T.D. 7456, 1977-1 C.B. 200, 202.

48. *Treas. Reg.* § 1.861-8(b)(5), T.D. 7456, 1977-1 C.B. 200, 203.

49. *Treas. Reg.* § 1.861-8(c)(1), T.D. 7456, 1977-1 C.B. 200, 203-04.

trade or business.<sup>50</sup>

An alternative minimum tax equal to 20% of the excess of alternative minimum taxable income over the exemption amount is imposed on nonresident aliens, other than corporations, to the extent that it exceeds the regular tax.<sup>51</sup> Alternative minimum taxable income<sup>52</sup> is adjusted gross income<sup>53</sup> increased by tax preference items<sup>54</sup> and reduced by the following items: limited contributions to certain charitable United States organizations; limited United States casualty and theft losses; and connected and allocable interest expense that is not deducted in arriving at adjusted gross income and that is not in excess of "qualified net investment income."<sup>55</sup> The exemption amount of a married nonresident alien individual is generally limited to \$20,000.<sup>56</sup>

If a nonresident alien individual disposes of a United States real property interest during the taxable year, the alternative minimum tax must be greater than 20% of the lesser of (1) the individual's alternative minimum taxable income before subtraction of the exemption amount and (2) the net gain from the disposition of United States real property interests.<sup>57</sup>

Some of the provisions of the Code relating to taxation of income effectively connected with a United States trade or business have been modified by tax treaties. The Canada-United States Income Tax Convention of 1942 provides that industrial and commercial profits and capital gains of a Canadian corporation are exempt from United States taxation unless the corporation has a permanent establishment in the United States.<sup>58</sup> This treaty further provides that Canadian corporations whose outstanding voting stock is predominantly owned directly or indi-

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50. I.R.C. §§ 873(a), 882(c)(1)(A) (1982).

51. *Id.* § 871(b)(1).

52. *Id.* § 55(b).

53. Adjusted gross income is gross income reduced by certain deductions such as trade or business deductions. *Id.* § 62.

54. *See id.* § 57(a).

55. *Id.* §§ 55(e)(1), (3), 873.

56. *Id.* § 55(f)(1)(C); *see supra* note 42.

57. I.R.C. § 897(a)(2)(A) (1982). The United States tax consequences of disposing of United States real property interests are discussed later in this article. *See infra* text accompanying notes 67-72.

58. Tax Convention, March 4, 1942, United States-Canada, arts. I, III, VII, 56 Stat. 1399, T.S. No. 983, *amended by* Supplementary Tax Convention, June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347, *amended by* Supplementary Tax Convention, Aug. 8, 1956, 8 U.S.T. 1619, T.I.A.S. No. 3916 [hereinafter cited as 1942 Canada-United States Treaty].

rectly by Canadian residents who are not United States citizens, are not subject to additional taxes assessed under the Code such as the accumulated earnings tax.<sup>59</sup>

## 2. *United States source income not effectively connected with United States trade or business*

United States source fixed or determinable annual or periodical income of foreign persons that is not effectively connected with the conduct of a United States trade or business<sup>60</sup> is taxed at a flat rate of 30% of gross income.<sup>61</sup> Income subject to this flat rate tax includes interest, dividends, rents, royalties, salaries, and other fixed or determinable annual or periodical gains, profits, and income.<sup>62</sup> This flat rate tax is often referred to as a withholding tax because it is withheld at its source by the payor.<sup>63</sup>

The rate of the United States withholding tax is reduced or eliminated for foreign persons residing in countries that have a tax treaty with the United States. Under the Canada-United States Income Tax Convention of 1942, the withholding tax rate on interest and dividends is reduced to 15%.<sup>64</sup>

United States source income of foreign persons derived from the sale or exchange of capital assets is subject to United States income tax only if the foreign person is an individual present in the United States for a total of 183 days or more<sup>65</sup> or if the capital asset is a United States real property interest.<sup>66</sup>

## 3. *Taxation of dispositions of United States real property interests*

Gain or loss resulting from the sale or exchange of an interest in United States real property by a foreign person is treated as income effectively connected with a United States trade or

59. *Id.* art. XIII.

60. Such income may not be effectively connected with the conduct of a United States trade or business either because the recipient is not engaged in a United States trade or business or because the income is not derived from the assets or activities of the United States trade or business. I.R.C. § 864(c)(2) (1982); see *supra* text accompanying notes 30-40.

61. I.R.C. § 881(a) (1982).

62. *Id.* § 881(a)(1).

63. *Id.* §§ 1441, 1442.

64. 1942 Canada-United States Treaty, *supra* note 58 art. XI.

65. I.R.C. § 871(a)(2) (1982).

66. *Id.* § 897(a)(1).

business regardless of whether the foreign person is engaged in a United States trade or business.<sup>67</sup> An "interest in United States real property" is defined broadly and includes an interest in a mine, well, or other natural deposit located in the United States and stock in certain corporations that own interests in United States real property.<sup>68</sup> These provisions, enacted in 1980 in the Foreign Investment in Real Property Tax Act, will supersede conflicting tax treaty provisions beginning on January 1, 1985.<sup>69</sup>

To illustrate the significant differences between the regular and withholding taxes, assume that a foreign corporation not engaged in a United States trade or business owns United States rental property generating \$10,000 in rents and having a depreciation allowance of \$5,000. The rental income is subject to withholding tax unless the corporation elects to treat the income as effectively connected with a United States trade or business.<sup>70</sup> The following tax consequences arise depending on whether the foreign corporation makes the election.

	<u>Income Effectively Connected</u>	<u>Income Not Effectively Connected</u>
Tax Base <sup>71</sup>	\$5,000	\$10,000
Tax Rate <sup>72</sup>	15%	30%
Tax	<u>\$ 750</u>	<u>\$ 3,000</u>

### *B. Tax Consequences of Acquisitions*

Foreign investment in the United States often involves acquisition of an existing United States business. The tax paid by the seller on the sale of the business will often be reflected in the

67. *Id.*

68. *Id.* § 897(c).

69. Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, § 1125(c), 94 Stat. 2599, 2690-91.

70. Nonresident alien individuals and foreign corporations may elect to treat income which is otherwise subject to withholding tax as income effectively connected with a United States trade or business. I.R.C. §§ 871(d), 882(d) (1982).

71. The income tax base for income effectively connected with a United States trade or business is the gross amount of income reduced by allowable deductions. Depreciation is an allowable deduction. See *supra* text accompanying notes 44-50. The income tax base for taxable income not effectively connected with a United States trade or business is gross income before deductions. Treas. Reg. § 1.871-7(b), T.D. 7332, 1975-1 C.B. 204, 210; see, e.g., Rev. Rul. 73-522, 1973-2 C.B. 226.

72. The corporate income tax rate on \$5,000 is 15%. I.R.C. § 11(b) (1982). The withholding tax rate is 30% unless modified by treaty. *Id.* §§ 871(a), 881(a).



selling price. Therefore, the investor should structure the acquisition of the United States business to minimize the tax consequences to the seller in order to reduce the purchase price.

Acquisitions of United States businesses may be taxable or nontaxable to the seller and may involve the purchase of stock of the target corporation or its assets. Taxable acquisitions typically result from the payment of cash and other property for the assets or stock of the target corporation. The basic tax result is that the seller recognizes gain or loss on the transaction. Nontaxable acquisitions typically result from the exchange of stock of the purchaser or a related corporation for the stock or assets of the target corporation.<sup>73</sup>

In a taxable acquisition of stock of a target corporation, the seller recognizes gain or loss on the disposition of the stock. Because the seller does not maintain a continuing equity interest in the corporation, the purchaser acquires the target corporation subject to liabilities incurred under previous ownership.<sup>74</sup> The purchaser's basis in the stock is the stock purchase price. No part of the purchase price of the stock is subject to depreciation, amortization, or investment tax credit, except in the case of a corporate purchaser that makes an appropriate election triggering recapture of previously deducted depreciation and investment tax credits.<sup>75</sup>

In a taxable acquisition of assets of a target corporation, the seller recognizes gain or loss as well as recapture of depreciation and investment tax credit with respect to the disposed assets.<sup>76</sup> Because the stockholders of the target corporation maintain their interests in the corporation, they essentially retain all existing business liabilities. The purchaser takes the assets with a basis equal to the purchase price. In many cases the purchase price of the assets is subject to depreciation or amortization and investment tax credit.

73. *Id.* § 368(a).

74. This transfer of liability to the purchaser can be limited if the acquiring corporation obtains warranties or indemnities from the seller.

75. Carry-over basis is not a disadvantage when it is greater than the actual value of the underlying assets such as when acquired assets have become functionally obsolete.

76. However, if the target corporation sells the assets pursuant to a plan of liquidation and within the 12-month period beginning when the plan is adopted, the selling corporation does not recognize gain or loss on the sale of the assets. L.R.C. § 337 (1982). The shareholders of the liquidating corporation recognize gain on the excess of the value of the proceeds of liquidation over the shareholders adjusted basis in the stock of the liquidating corporation. *Id.* §§ 331, 1001.

The types of nontaxable acquisitions are far too numerous and complex for discussion in this article. It is important to note, however, that certain investment holding structures may effectively preclude the use of one or more types of nontaxable acquisitions. For example, the exchange of stock in a Canadian corporation for the stock of the target corporation will not receive tax-free treatment for the United States stockholders of the target corporation unless the Internal Revenue Service issues a ruling to that effect.<sup>77</sup>

#### IV. RELIEF PROVISIONS

##### A. *Types of Relief Provisions*

Multiple taxation arising from the taxation of multiple persons has been engrained in the United States income tax system since 1913.<sup>78</sup> Because this type of multiple taxation is not generally considered unfair or burdensome, tax laws and treaties typically include few provisions to eliminate or reduce its impact.<sup>79</sup>

One of the best known relief provisions for taxation of multiple persons applies when one or more corporations are interposed between the corporation that earned the income and the individual stockholders. Many countries do not fully tax dividend income received by corporate stockholders. In the United States dividends received by a corporation from United States corporations and from certain foreign corporations engaged in a trade or business in the United States are partially or wholly exempt from taxation.<sup>80</sup> In Canada dividends received by Canadian corporations from Canadian corporations<sup>81</sup> or from certain foreign corporations<sup>82</sup> may be partially or wholly exempt from

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77. *Id.* § 387(a).

78. Revenue Act of 1913, Pub. L. No. 63-16, § G(a), 38 Stat. 114, 172 (current version in L.R.C. § 61 (1982)). The accumulated earnings tax was first introduced in the Revenue Act of 1921, Pub. L. No. 67-98, § 220, 42 Stat. 227, 247 (current version in L.R.C. § 531 (1982)), and the personal holding company tax was first introduced in the Revenue Act of 1934, Pub. L. No. 73-216, § 351, 48 Stat. 680, 751 (current version in L.R.C. § 541 (1982)).

79. Certain corporations that make an appropriate election under subchapter S of the Code are not taxed on their income; rather, the stockholders are taxed on their pro rata share of corporate income. L.R.C. §§ 1363(a), 1366 (1982). Unfortunately, however, a corporation is disqualified from this special treatment if it has any stockholders that are foreign persons. *Id.* § 1361(b)(1). Therefore, subchapter S is of little value for international tax planning purposes.

80. *See id.* §§ 243-248.

81. I.T.A., *supra* note 4, § 112(1).

82. Dividends from certain foreign corporations that carried on business in Canada

Canadian income tax.<sup>83</sup>

Under a variation of this relief provision, a corporate stockholder may be allowed a credit against its income tax for the pro rata share of the income tax paid by the distributing corporation. In the United States a credit is allowed against the United States income tax of United States corporations owning 10% or more of the voting stock of a foreign corporation for the pro rata share of foreign income tax allocable to dividends received from the foreign corporation.<sup>84</sup> In Canada corporate stockholders<sup>85</sup> receive a similar benefit for the pro rata share of the foreign income tax allocable to dividends<sup>86</sup> deemed to be received from foreign corporations that are controlled foreign affiliates.<sup>87</sup>

Another type of relief provision eliminates or reduces the rate of income tax imposed on dividends paid to foreign stockholders.<sup>88</sup> The United States income tax on dividends paid by United States corporations to Canadian stockholders is reduced from 30% to 15%.<sup>89</sup> Dividends paid by Canadian corporations to stockholders who are not citizens or residents of the United

at any time during the taxable year or that are foreign affiliates are subject to special tax treatment. *Id.* §§ 112(2), 113, 186. A "foreign affiliate" of a Canadian resident person is any corporation not resident in Canada in which the Canadian resident has at least a 10% ownership interest. *Id.* § 95(1)(d).

83. Private corporations (as defined in *id.* § 89(1)(f)) may be subject to an income tax of 25% of any dividend that is otherwise exempt from income tax. *Id.* § 186(1). When the exempt dividend flows through to the stockholder, the 25% tax is refunded to the corporation. *Id.* § 129.

84. I.R.C. § 902(a) (1982).

85. This relief provision also applies to individual stockholders with respect to whom the foreign corporation is a controlled foreign affiliate. A "controlled foreign affiliate" is any foreign affiliate of a Canadian resident taxpayer that is controlled directly or indirectly by the taxpayer, a group of five or fewer persons residing in Canada of which the taxpayer is a member, or a related group of which the taxpayer is a member. I.T.A., *supra* note 4, § 95(1)(a). See *supra* note 82 for the definition of "foreign affiliate."

86. A person resident in Canada is deemed to receive on an annual basis dividends consisting of his pro rata share of all income of a controlled foreign affiliate, other than income from an active business of that controlled foreign affiliate. I.T.A., *supra* note 4, § 91(1). See *supra* note 85 for the definition of "controlled foreign affiliate."

87. I.T.A., *supra* note 4, § 91(4). Unlike the comparable United States relief provision, this relief is structured as a deduction from income rather than as a credit against tax. The income deduction is equal to the allocable foreign tax multiplied by 2.17. *Id.* See *supra* note 85 for the definition of "controlled foreign affiliate."

88. This type of relief provision is typically found in income tax treaties.

89. 1942 Canada-United States Treaty, *supra* note 53, art. XI. In some United States income tax treaties, the rate of tax on dividends paid to certain stockholders has been reduced even further. See 3 R. RHOADES & M. LANGER, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS* § 12.02[3] (1983).

States are exempt from United States income tax.<sup>90</sup> Provisions like these, typically found in treaties, are intended to eliminate or reduce both types of multiple taxation.

An important relief provision, especially with respect to structuring investments for Canadians, is a tax credit for individual stockholders for part of the corporate tax paid on corporate income that is distributed as a dividend. Under the Canadian dividend tax credit rules, individual stockholders resident in Canada are required to include in gross income 150% of dividends received from corporations resident in Canada,<sup>91</sup> but are entitled to a tax credit approximately equal to 22.7% of the amount of the grossed up dividend.<sup>92</sup> The result is that the effective tax rate on dividends received from corporations resident in Canada is generally reduced by 20% to 100%, depending on the stockholder's marginal tax rate.<sup>93</sup>

Multiple taxation arising from taxation by multiple nations has been generally considered by tax policy makers as undesirable and perceived by investors and their tax advisors as unacceptable. Several relief provisions can eliminate or reduce the impact of taxation by multiple nations. One of the best known types of relief provisions allows the investor a foreign tax credit for foreign tax paid or incurred on the investor's foreign source income against the tax otherwise payable on that income to the investor's home country. The amount of foreign tax credit is typically limited to the lesser of the income tax paid to the host country and the amount of income tax levied by the home country on the foreign source income. Notwithstanding these limitations, the allowance of foreign tax credits should theoretically eliminate the entire burden of the home country's income tax except to the extent that it exceeds the host country's income tax. The investor is required to pay to the home country the excess of the home country's income tax over the host country's tax. (This excess is hereinafter referred to as the "foreign tax credit premium.")

An alternative type of relief provision allows the investor an income deduction in the investor's home country for foreign

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90. 1942 Canada-United States Treaty, *supra* note 58, art. XII(1).

91. I.T.A., *supra* note 4, § 82(1).

92. *Id.* § 121.

93. For individuals whose tax rate is less than 22.7%, the dividend tax credit can offset tax on the individual's other income. *Id.*

taxes paid or incurred on the investor's foreign source income.<sup>94</sup> However, the right to deduct foreign income taxes is often limited. In Canada only foreign income taxes from passive investments may be deducted from taxable income, subject to certain other restrictions.<sup>95</sup>

Other relief provisions exempt certain income from taxation in either the host or home country. These provisions are typically found in income tax treaties but are sometimes found in the tax legislation of the home country. Pursuant to the United States-Canada Income Tax Convention of 1942,<sup>96</sup> United States source business income of persons resident in Canada, other than United States citizens and entities created under United States law, is exempt from United States income tax unless such person has a permanent establishment in the United States.<sup>97</sup> Under Canadian tax law dividend income received by a Canadian corporation from foreign corporations that are foreign affiliates<sup>98</sup> is exempt from Canadian income tax to the extent that the dividend is paid out of the foreign affiliate's income derived from an active business in a country with which Canada has a bilateral income tax treaty.<sup>99</sup>

In determining the total cumulative income taxes for a particular holding structure, the tax advisor must do more than merely determine that the theoretical application of relevant relief provisions will eliminate or reduce the overlapping taxes. Many relief provisions when applied do not provide the maximum amount of relief because of inadequate draftsmanship of the relevant legislation or intentional limitations. Therefore, the tax advisor must analyze in detail how effective each available relief provision will be in eliminating or reducing overlapping taxes given the nature, amount, and timing of the foreign investment income<sup>100</sup> as well as the investor's intentions with respect to the use of the income.

94. See *id.* § 20(11), (12); L.R.C. § 164(a) (1982).

95. L.T.A., *supra* note 4, § 20(11), (12).

96. 1942 Canada-United States Treaty, *supra* note 58.

97. *Id.* arts. I, III. In addition, articles V, VI, VIA, VII, VIII, VIIIA, IX, X, XII, XIII, XIII B, XIII C, and XIII E of the same treaty provide that certain income of certain Canadian residents is also exempt from United States income tax.

98. See *supra* note 82 for the definition of "foreign affiliate."

99. L.T.A., *supra* note 4, § 113(1). This special rule was probably intended to eliminate the burden arising from taxation by multiple nations rather than the burden arising from taxation of multiple persons.

100. See *supra* text accompanying notes 17-19.

Foreign tax credits illustrate the restrictive nature of relief provisions.<sup>101</sup> Foreign tax credits are theoretically intended to eliminate overlapping taxes by allowing a credit against the investor's home country income tax liability for foreign income tax paid.<sup>102</sup> However, the limitations on the amount of foreign tax credit allowed are sometimes deceptively restrictive. Typically, the amount of foreign tax credit allowed is based on a statutory formula under which the credit is limited to the lesser of (1) the amount of income tax actually paid to the host country and (2) the amount of income tax levied by the home country on the foreign source income. These limitations create a serious risk of overlapping taxes to the extent that the rules for the recognition, timing, and taxation of income differ between the host country and the home country. More specifically, the foreign tax credit is typically limited to the home country's tax allocable to the amount of foreign income as computed under the home country's tax accounting and income sourcing rules, whereas the foreign tax is computed on the amount of foreign income as determined under the host country's tax accounting and income sourcing rules.<sup>103</sup> If the amount of foreign source income as determined under the home country's rules is significantly less than that determined under the host country's rules, the allowable foreign tax credit may be far less than the actual foreign taxes paid.

### *B. Inadequacies of Relief Provisions*

The serious risk that relief provisions will not provide expected relief can be demonstrated by examining the foreign tax credit limitations under Canadian tax law.<sup>104</sup> The allowable foreign tax credit in Canada is limited to the lesser of (1) Canadian income tax allocable to the United States source income and (2) the amount of United States income tax paid during that taxable year or, in the case of business income, during the five

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101. See *infra* text accompanying notes 102-34.

102. Foreign tax credits may also eliminate some of the overlapping taxes from taxation of multiple persons, but only with respect to corporate income that is distributed to certain corporate shareholders. See *supra* text accompanying notes 78-79.

103. The host country's tax is levied on the tax base as computed under the host country's tax laws. The computation of the tax base is made using the host country's tax accounting rules (i.e., determination of the proper year for recognition of income and the proper timing of deductions).

104. I.T.A., *supra* note 4, § 126.

preceeding taxable years to the extent that those taxes have not already been credited. Foreign tax credits are computed separately with respect to foreign source nonbusiness income and foreign source business income from each foreign country.<sup>105</sup> The basic formula describing the limitation is as follows:

$$\text{Canadian tax otherwise payable}^{106} \times \frac{\text{Net income from a foreign country}^{107}}{\text{Total net income}^{108}}$$

### 1. *Income sourcing problems*

The allowable foreign tax credit is limited to the Canadian tax allocable to foreign source income. The source of income for purposes of this formula is determined under Canadian law rather than the laws of the foreign host country. As a result, Canada may not allow a foreign tax credit for foreign income tax paid because under Canadian law the host country is not the source of the income, whereas under the host country's law the host country is the source of income. For example, the following items of income arising from a Canadian person's investment or business in the United States are treated as having a Canadian source under Canadian tax law and a United States source under the Code: (1) gains realized by a Canadian person from the sale in Canada of stock of a corporation owning United States real property interests the value of which exceeds 50% of the value of all corporate property;<sup>109</sup> (2) dividends and interest from a United States corporation controlled and managed in Canada,<sup>110</sup> or from a Canadian corporation that has income effectively connected with the conduct of a trade or business in the

105. *Id.* § 126(1), (2), (6).

106. Canadian tax otherwise payable generally means the amount of Canadian tax that would be eligible before the application of various tax credits such as foreign tax credits, provincial corporate tax credits, and small business tax credits. *Id.* § 126(7)(d).

107. Net income from a foreign source generally means net nonbusiness income and net business income calculated separately and under the rules of the Canadian Income Tax Act. *Id.* § 126(1), (2.1).

108. Total net income generally means net income from all sources reduced by capital losses and deductions allowed to corporations for intercorporate dividends. *Id.* § 126(1)(b)(ii), (2.1)(a)(ii).

109. Interpretation Bulletin No. IT-395 ¶ 2, 1979 CAN. TAX REP. (CCH) ¶ 52,400 (Oct. 3, 1977); see, e.g., *Ericksen v. Last*, 8 Q.B.D. 414 (1881); I.R.C. § 861(a)(5) (1982). However, this income is not subject to United States tax if the Canadian stockholder does not have a permanent establishment in the United States 1942 Canada-United States Treaty, *supra* note 58, art. VIII.

110. Interpretation Bulletin No. IT-270 ¶ 22, 1978 CAN. TAX REP. (CCH) ¶ 52,274 (Nov. 17, 1975); I.R.C. § 861(a)(1), (a)(2)(A).

United States equal to 50% or more of its gross income for the preceding three-year period;<sup>111</sup> and (3) profit from the sale of Canadian goods shipped f.o.b. a United States destination pursuant to a contract for sale that is completed in Canada.<sup>112</sup>

Because Canadian foreign tax credits are calculated separately for each foreign country,<sup>113</sup> the income sourcing problem also causes overlapping taxes when an item of income incurring tax in one foreign country is deemed under Canadian law to have a source in a second foreign country.<sup>114</sup> This per country limitation problem can be illustrated by the following example.

A Canadian corporation is engaged in the manufacturing business in the United States through a permanent establishment and has a branch office in the United Kingdom, where contracts for the sale of the United States manufactured goods are negotiated and completed. The United States manufactured goods sold in the United Kingdom are shipped f.o.b. a United States port. Under United States tax law the entire profit is United States source income<sup>115</sup> effectively connected with the conduct of a United States trade or business and is fully subject to United States income tax.<sup>116</sup> Under Canadian tax law part of the income from this transaction has a United States source and part has a source in the United Kingdom. The United States income tax allowed as a foreign tax credit is limited to the Canadian tax otherwise payable on only that portion of the income having a United States source as determined under Canadian

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111. See Interpretation Bulletin No. IT-270 ¶ 22, 1978 CAN. TAX REP. (CCH) ¶ 52,274 (Nov. 17, 1975); L.R.C. § 861(a)(1)(C), (a)(2)(B) (1982). Only a portion of a dividend or interest paid by such corporation is treated as United States source income under the Code. Article XII of the 1942 Canada-United States Treaty exempts these dividends from United States income tax even though they would otherwise be taxed as United States source income under L.R.C. §§ 871(a)(1)(A) or 881(a)(1) (1982).

112. L.R.C. § 861(a)(8) (1982), Treas. Reg. § 1.861-7 (1957). In this example the sale of personal property in the United States creates United States source income. However, that income is not taxable unless the seller is engaged in a trade or business in the United States through a permanent establishment. Treas. Reg. § 1.871-7(a)(1), T.D. 7332, 1975-1 C.B. 204, 211; 1942 Canada-United States Treaty, *supra* note 58, art. I. The temporary presence of the Canadian person or its employee in the United States to solicit orders may cause the Canadian person to be engaged in a trade or business in the United States through a permanent establishment. Rev. Rul. 56-165, 1956-1 C.B. 849.

113. L.T.A., *supra* note 4, § 126(6). This per country limitation no longer exists under the Code.

114. Interpretation Bulletin No. IT-270 ¶ 20, 1978 CAN. TAX REP. (CCH) ¶ 52,274 (Nov. 17, 1975).

115. Treas. Reg. § 1.861-7(c) (1957).

116. L.R.C. § 864(c)(3) (1982).



law.

## 2. *Income and tax timing problems*

A second problem with the Canadian foreign tax credit is that the credit is generally limited to the foreign tax paid or accrued during the same taxable year that the foreign source income is recognized in Canada. This limitation does not create a risk of overlapping taxes if the amount of income computed under Canadian tax accounting rules equals the amount of income computed under the tax accounting rules of the foreign country. As a result of this difference in timing of recognition and taxation of income, some of the foreign income tax paid may not be credited against the Canadian tax, thereby causing overlapping taxes.

This timing problem is critical with respect to foreign income tax paid on nonbusiness income because these taxes may not be allowed as foreign tax credits unless the income is recognized and taxed in the United States in the year that it is taxed in Canada.<sup>117</sup> The timing problem is not as critical with respect to foreign income tax paid on business income because these taxes may be allowed as foreign tax credits if the income is fully recognized and taxed in the foreign country within the six-year period beginning five years before the year in which it is recognized and taxed in Canada.<sup>118</sup> If income is recognized and taxed in the United States in a taxable year subsequent to the year in which it is recognized and taxed in Canada, no foreign tax credit is allowed for the United States tax on such income regardless of whether the income is business or nonbusiness.

The timing problems are generally attributable either to (1) differences in tax accounting rules regarding the proper year for including an item of income or the proper year for deducting an expenditure or (2) differences in the rules allowing deductions (i.e., whether an expenditure may be expensed or amortized, and if amortized, the rate of amortization).

The first type of timing difference can be illustrated by examining the tax consequences of a long-term installment sale. In Canada the income is recognized over no more than five years in

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117. Unused foreign tax credits for nonbusiness income tax may not be carried forward nor back. I.T.A., *supra* note 4, § 126(1).

118. The unused foreign tax credits for business income tax credits may be carried forward for up to five years but not back. *Id.* § 126(2), (7)(b).

the case of capital property, and no more than three years in other cases, whereas in the United States the income is generally recognized as the payments are received over the life of the installment contract.<sup>119</sup>

The second type of timing difference, more difficult to analyze but more consequential, can be illustrated with the following examples. First, gain from the sale or exchange of a mineral interest in the United States or any other foreign resource property<sup>120</sup> is computed for United States purposes as the excess of the amount realized over the seller's adjusted basis in the particular mineral interest.<sup>121</sup> However, the gain is computed for Canadian purposes as the excess of the amount realized over the seller's undeducted "foreign exploration and development expenses" pool.<sup>122</sup> If the seller's adjusted basis in the property sold is less than its foreign exploration and development expenses pool, some or all of the gain recognized and taxed in the United States at the time of the sale will not be recognized and taxed in Canada until a subsequent sale when the seller's foreign exploration and development expenses pool is less than its adjusted basis in the subsequent property sold. In other words the foreign source income is recognized in Canada during a year different from the one in which the United States income tax accrued.<sup>123</sup>

Second, depreciation allowed for tangible personal property and buildings used in a business differs between Canada and the United States. Of course, differences in allowable depreciation cause differences in the amount of income recognized during a tax year. For example, manufacturing equipment placed in service in the United States after December 31, 1980,<sup>124</sup> is subject to a depreciation deduction in the United States under the accelerated cost recovery system equal to 15% of the unadjusted basis in the equipment in the first year, 22% in the second year,

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119. *Id.* §§ 18(1)(c), 20(1)(n), 40(1)(a)(iii); I.R.C. § 453 (1982).

120. See L.T.A., *supra* note 4, § 66(15)(f) for the definition of "foreign resource property."

121. I.R.C. §§ 897(a), 1001(a) (1982).

122. L.T.A., *supra* note 4, §§ 59(1), 66(4). This pool includes drilling or exploration expenses incurred outside of Canada as well as acquisition costs of foreign resource properties. *Id.* § 66(15)(e).

123. If the gain from the sale constitutes nonbusiness income, the unused tax credits for United States taxes paid may not be carried forward to the year in which the gain is recognized in Canada. *Id.* § 126(1). If the gain constitutes business income, the unused foreign tax credits may only be carried forward five years. *Id.* § 126(2), (7)(b).

124. See I.R.C. § 168(e)(1) (1982).

and 21% in each of the following three years.<sup>125</sup> However, the equipment is subject to a depreciation deduction (capital cost allowance) for Canadian income tax purposes equal to 20% of the declining adjusted basis of all equipment in the same class.<sup>126</sup>

Assume a Canadian corporation purchases manufacturing equipment worth one million dollars for use in the United States. Further assume that except for the amount of allowable depreciation, the net income is computed the same in Canada and the United States and that the effective Canadian and United States income tax rates are 50%. The entire cost of the equipment will be deducted from income for United States tax purposes during the first five years, but only \$672,320 of the cost will be deducted for Canadian tax purposes.<sup>127</sup> After the fifth year the Canadian tax and the foreign tax credit limitation will be computed on income that is reduced by the undepreciated capital cost of the equipment (\$327,680). However, the United States tax will be computed on income that is not reduced by depreciation. After the fifth year the United States tax will exceed the Canadian tax in the amount of \$163,840 because the United States tax base is \$327,680 higher. This excess United States tax will not be allowed as a foreign tax credit in Canada. Consequently, the corporation's income will be subject to \$163,840 of overlapping taxes even though the United States and Canadian income taxes on the stream of income are equal over the life of the equipment.<sup>128</sup>

125. *Id.* § 168(b)(1), (c).

126. I.T.A., *supra* note 4, § 20(1)(a); Income Tax Reg. (Can.) § 1100(1)(a)(viii) (1978).

127. If the equipment cost was \$1,000,000, the allowable depreciation deduction in the United States would be \$150,000 and \$220,000 for the first two years respectively and \$210,000 for the following three years. No depreciation deduction would be allowed thereafter. The allowable depreciation deduction in Canada would be \$200,000 for the first year, \$160,000 for the second year, \$128,000 for the third year, \$102,400 for the fourth year, \$81,920 for the fifth year, and so on until the equipment were effectively fully depreciated.

128. The excess credit for United States income tax from the first year may be carried forward to the second year because Canadian income tax in the second year on the foreign income exceeds the United States income tax. However, the excess credit for United States income tax accruing after the fifth year may not be carried back. Therefore, the overlapping taxes on the United States source stream of income arising from the second type of timing problem is \$163,840.

### 3. *Disproportionate Canadian income tax*

A third problem with the Canadian foreign tax credit limitation formula is that it assumes the Canadian tax resulting from inclusion of foreign source income is the amount of Canadian tax that is proportional to the ratio between the foreign source income and total income. However, there are at least two instances in which this assumption is incorrect.

The first instance is when the Canadian person incurs a loss from domestic sources. The formula does not allow any credit for foreign income taxes paid on the portion of foreign source income that offsets the loss that would otherwise offset future income of the Canadian person. In other words, if the Canadian person does not pay income tax in Canada because of an overall loss, no credit is allowed for United States income tax paid on United States source income even though the United States income reduces the amount of the loss that can be carried forward for Canadian tax purposes. Consequently, the United States source income increases the amount of Canadian taxable income in subsequent years by an amount equal to the lesser of the United States source income and the loss.

For example, assume that before the inclusion of United States income three Canadian corporations incur an overall loss in year 1 of \$100 and an overall profit in year 2 of \$100. Assume that Corporation 1 has \$100 of United States source income in year 2, that Corporation 2 has \$100 of United States source dividend income in year 1, and that Corporation 3 has \$100 of United States source business income in year 1. Further assume that the United States and Canadian income tax rates are 50% and that the United States withholding rate is 15%.

The inclusion of \$100 of United States source income by Corporation 1 creates \$50 of United States income tax and \$50 of Canadian income tax. However, because the United States income was recognized in a profit year, the \$50 of United States tax is allowed as a foreign tax credit, totally eliminating the Canadian tax. Thus, the net total tax on the \$100 of United States income is reduced to \$50.

The inclusion of \$100 of United States source income by Corporation 2 creates \$15 of United States income tax and \$42.50 of Canadian income tax.<sup>129</sup> Because the United States in-

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129. Foreign nonbusiness income tax that is not allowed as a foreign tax credit may be deducted in computing Canadian taxable income. I.T.A., *supra* note 4, § 20(12).

come was recognized in a loss year, the \$15 of United States tax is not allowed as a foreign tax credit. The total net tax on the \$100 of United States income is \$57.50.

The inclusion of \$100 of United States source income by Corporation 3 creates \$50 of United States income tax and \$50 of Canadian income tax.<sup>130</sup> Because the United States income was recognized in a loss year, the \$50 of United States tax is not allowed as a foreign tax credit. The total net tax on the \$100 of United States income is \$100.<sup>131</sup>

	<u>Year</u>	<u>Total Income</u>	<u>U.S. Tax</u>	<u>Canadian Tax</u>	<u>Foreign Tax Credit</u>	<u>Total Net Taxes</u>
Corp. 1	1	(\$100)	0	(\$ 50.00)	0	(\$ 50.00)
	2	\$200	\$50	\$100.00	(\$50)	100.00
						<u>\$ 50.00</u>
Corp. 2	1	(\$ 15)	\$15	(\$ 7.50)	0	\$ 7.50
	2	\$100	0	\$ 50.00	0	50.00
						<u>\$ 57.50</u>
Corp. 3	1	0	\$50	0	0	\$ 50.00
	2	\$100	0	\$ 50.00	0	50.00
						<u>\$100.00</u>

The second instance in which the assumption regarding the Canadian tax allocable to foreign source income proves to be incorrect occurs when the average Canadian income tax rate on total income differs from the marginal or effective Canadian income tax rate on the United States income. This occurs when the income tax rate is graduated, such as for individuals,<sup>132</sup> and when some portion of the total income is taxed at a rate lower than the rate applicable to foreign source income, such as income subject to the small business deduction<sup>133</sup> or the manufacturing and processing deduction.<sup>134</sup>

130. A foreign business income tax may not be deducted in computing Canadian taxable income even if it is not allowed as a foreign tax credit. See *Roenisch v. Minister of Nat'l Revenue*, [1931] 2 D.L.R. 90 (Can. Ex. 1930).

131. The United States income taxes incurred in year 1 will expire as a foreign tax credit unused if Corporation 3 does not receive any United States source business income during the four years following year 2 or if the United States tax incurred on the United States source business income received during those four years does not exceed the Canadian tax.

132. I.T.A., *supra* note 4, § 117(5.1).

133. *Id.* § 125.

134. *Id.* § 125.1.

## V. COORDINATING UNITED STATES AND FOREIGN TAX LAWS

Each foreign investment holding structure is made up of several structural elements. The number of potential holding structures equals the total number of combinations of each variable in each structural element. Although there are many potential holding structures for each foreign investment, the chance of omitting a potentially advantageous investment structure is reduced if the tax advisor has a working knowledge of the Code and other relevant income tax laws and also has a thorough understanding of each structural element relevant to the proposed investment. The following are key elements common to all foreign investment structures:

- (1) the type of business entity managing the investment or operating the business;
- (2) the country in which the managing or operating entity has been created or resides; and
- (3) the capital structure of the operating entity.

Each of these elements determines in part the extent and type of multiple taxation and its impact on the cumulative income tax burden payable on income from the investment. Of course, as the proposed investment becomes more complicated, more structural elements are introduced.<sup>135</sup>

### A. *Choice of Operating Entity*

The extent of multiple taxation arising from the taxation of multiple persons largely depends upon the type of business entity or entities directly or indirectly owning and managing the investment. Some entities are taxed as separate taxpayers, and others are treated as aggregations of the taxpayer-owners. The tax laws of each country asserting taxing jurisdiction determine whether an entity is to any extent a separate taxpayer. Fortunately, the United States tax treatment of business entities is often similar to the tax treatment of comparable business entities in many other countries.

Profits from an investment in the United States that is owned by a corporation are subject to United States corporate

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135. This article does not discuss the use of tax haven countries to reduce taxes on income from United States investments. For an excellent discussion of tax havens, see M. LANGER, *supra* note 12.

income tax when earned<sup>136</sup> and to United States individual income tax when distributed to individual domestic<sup>137</sup> or foreign stockholders.<sup>138</sup> On the other hand, profits from an investment in the United States owned by a partnership or proprietorship are subject only to individual income tax.<sup>139</sup> The profits are taxed to the partner or proprietor annually regardless of whether the profits are actually distributed to that person.<sup>140</sup> Losses incurred by a partnership or proprietorship offset other income of the partners or the proprietor, whereas losses incurred by a corporation do not offset the individual stockholder's other income.

The use of a corporation to conduct a trade or business usually results in taxation of multiple persons. This result, however, should not cause the tax advisor to discourage automatically the use of holding structures involving corporations. In some cases it is necessary to use a corporation for nontax reasons. Furthermore, although corporate taxes create more layers of taxation, the number of relief provisions available may result in a lower overall tax assessment. In addition to the exemption from taxation for some or all intercorporate dividends, Canadian tax law allows a dividend tax credit for taxable dividends received by individuals from corporations residing in Canada. This tax credit represents the income taxes already paid by the corporation on the distributed income.<sup>141</sup>

Even without relief provisions, taxation of multiple persons may not be a concern to an investor that is a corporation not controlled by an identifiable group of stockholders. The performance of a corporation's stock on the market is typically based on the amount of the corporation's after-tax profits rather than the amount of the stockholders' after-tax dividends. Consequently, the management of a widely held corporation may only be concerned about taxation of multiple persons to the extent that it affects the cumulative tax burden computed at the corporate level rather than at the stockholder level. Because there are many relief provisions to eliminate or reduce the overlapping

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136. L.R.C. §§ 11, 882 (1982).

137. *Id.* §§ 1, 61(a)(7).

138. *Id.* §§ 871, 881, 882.

139. *Id.* § 701.

140. *Id.* § 702.

141. I.T.A., *supra* note 4, § 121. However, this tax credit does not eliminate the overlapping taxes if the shareholder is in a high individual income tax bracket. See *supra* text accompanying notes 91-93.

taxes on intercorporate dividends, some foreign corporate investors may select an investment structure that is beneficial to the corporation but detrimental to the stockholders.

If for any reason one or more corporations are used as part of the investment holding structure, the extent of the multiple taxation on the corporate income can be minimized through the use of the appropriate capital structure, in addition to all of the other statutory and treaty relief provisions.<sup>142</sup>

### *B. Country of Residence or Incorporation*

The extent of multiple taxation arising from taxation by multiple nations depends to some extent on the country of residence or formation of the managing or operating entity. The operating entity may reside in or be created under the laws of the United States, the home country of the foreign investor, or a third country having beneficial tax laws or treaties. As discussed previously, at least four separate events in the life of an investment may trigger income tax in one or more countries asserting tax jurisdiction or over the operating entity or over the investor: (1) the generation of profits from ongoing business operations; (2) the repatriation of investments or distribution of profits to the foreign investor; (3) the reorganization of the structure of the investment or business; and (4) the disposition of the investment or liquidation of the operating entity.

In the following discussion specific examples are given to help identify and analyze the impact of taxation by multiple nations. In all the examples assume that the foreign investor is a Canadian corporation and that the operating entities were incorporated in either Canada or the United States.<sup>143</sup>

#### *1. Taxation of profits from ongoing business operations*

*a. Portfolio investments.* Assume that the investor desires to make passive portfolio investments in stock of United States corporations and intends to profit from appreciation of the stock rather than from dividend income.

If the entity doing business in the United States is a branch of a Canadian corporation (hereinafter referred to as "CANCO"), neither owning stock in United States corporations

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142. See *infra* text accompanying notes 189-93.

143. The choice of operating entity in these examples is limited to a branch or United States subsidiary of the Canadian corporation.



nor effecting stock or securities transactions in the United States causes it to be engaged in a trade or business in the United States.<sup>144</sup> Therefore, CANCO is subject only to withholding tax on certain types of passive United States source income such as dividends. CANCO is exempt from United States income tax on gain from the sale of the stock that is not a United States real property interest<sup>145</sup> regardless of whether the stock is traded in or out of the United States.<sup>146</sup> CANCO is subject to Canadian income tax on its worldwide income, which includes net taxable gains from the sale of stock in the United States corporations.<sup>147</sup> Consequently, CANCO is subject only to one income tax on its major item of income.

If the entity doing business in the United States is a United States subsidiary of a Canadian corporation (hereinafter referred to as "USCO"), it is subject to United States income tax on its worldwide income, including gain from the sale of stock.<sup>148</sup> Although USCO is not subject to Canadian income tax, the Canadian parent corporation is subject to Canadian income tax on passive income of its United States subsidiary, generally including net taxable capital gains.<sup>149</sup> A deduction from income that has a similar result to foreign tax credit is allowed for United States tax paid by USCO on the passive income.<sup>150</sup>

Structuring this portfolio investment so that USCO rather than CANCO holds the investment causes the gain from the sale of stock to be subject to taxation by multiple nations. This creates a risk that the cumulative income tax burden will be in-

144. Treas. Reg. § 1.884-2(c)(1), T.D. 6948, 1968-1 C.B. 327, 329-30.

145. Stock in a United States real property holding company constitutes a United States real property interest. L.R.C. § 897 (1982). However, under the 1942 Canada-United States Treaty, gain from the sale of a United States real property interest may also be exempt from United States tax. 1942 Canada-United States Treaty, *supra* note 58, art. VIII.

146. The Code does not tax gain from the sale of capital assets in the United States unless the seller is an individual who has been present in the United States for periods of 183 days or more during the taxable year. L.R.C. § 871(a)(2) (1982). In any event, Article VIII of the 1942 Canada-United States Treaty exempts from United States taxation gains from the sale of capital assets by a Canadian corporation that does not have a permanent establishment in the United States.

147. The net taxable gain from the sale of a capital asset is 50% of the gain. I.T.A., *supra* note 4, § 38(a).

148. Upon the distribution of the profits to the Canadian corporation, the profits are also subject to the United States withholding tax at the rate of 15%. Rev. Rul. 61-103, 1961-1 C.B. 853.

149. I.T.A., *supra* note 4, §§ 91(1), 95(1)(b)(ii).

150. *Id.* § 91(4); see *supra* text accompanying notes 80-85.

creased through overlapping taxes and the foreign tax credit premium.<sup>151</sup>

*b. Active business.*<sup>152</sup> Assume that the investor desires to establish or acquire an active business in the United States and that all United States source income will be derived exclusively from the business.

CANCO is subject to both United States and Canadian income tax on its United States source income from an active business.<sup>153</sup> The United States income tax is computed on the corporation's net United States source income,<sup>154</sup> and the Canadian income tax is computed on CANCO's net worldwide income, both of which include the profits and losses from the United States business.<sup>155</sup> A Canadian foreign tax credit is allowed for United States income tax paid.<sup>156</sup>

USCO is subject only to United States income tax on its United States business income.<sup>157</sup> Neither USCO nor its Canadian parent are subject to Canadian income tax on USCO's profits or losses.<sup>158</sup>

Because the income of USCO is not subject to multiple taxation and the income of CANCO is, there is a likelihood that the total income tax burden from the generation of profits by USCO will be less than it would be if earned by CANCO. First, CANCO will likely pay a foreign tax credit premium because the Canadian tax on United States source business income is typically higher than the United States tax as a result of United States income tax incentives to United States businesses. Second, CANCO incurs the risk of overlapping taxes because the United States income tax paid may not be fully allowed as a Canadian foreign tax credit.<sup>159</sup> However, the multiple taxation allows CANCO to offset other worldwide income for Canadian tax purposes with losses from the United States business, whereas the Canadian parent corporation of USCO is unable to

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151. See *supra* text accompanying notes 100-03.

152. These observations may not apply in some factual circumstances. Furthermore, tax consequences not noted here may become highly consequential for some industries or businesses.

153. I.R.C. § 882(a)(1) (1982); I.T.A., *supra* note 4, §§ 2(1), 250(4).

154. I.R.C. § 882(a)(2) (1982).

155. I.T.A., *supra* note 4, § 3(a).

156. *Id.* § 126(2); see *supra* text accompanying notes 101-34.

157. I.R.C. § 11(a) (1982).

158. See *supra* text accompanying note 98.

159. See *supra* text accompanying notes 101-34.

take advantage of such losses directly.

*Example A.* The taxable income from an active United States business is \$100,000 for the first year, \$500,000 for the second year, and \$10,000,000 for the third year. Assume that the Canadian federal and provincial income tax rate is 47%, that the United States federal income tax rate is 26% on the first \$100,000 of taxable income and 46% of the excess over \$100,000, and that the applicable United States state income tax rate is 5% (which is deductible from United States federal taxable income). Assume that United States income tax paid is fully credited against the Canadian tax.<sup>160</sup>

	Year	U.S. Tax	Canadian Tax	Total Taxes For Year	Foreign Tax Credit Premium <sup>161</sup>
CANCO	1	\$ 29,700	\$ 47,000	\$ 47,000	\$17,300
USCO		\$ 29,700	0	\$ 29,700	0
CANCO	2	\$ 223,500	\$ 235,000	\$ 235,000	\$11,500
USCO		\$ 223,500	0	\$ 223,500	0
CANCO	3	\$4,850,000	\$4,700,000	\$4,850,000	0
USCO		\$4,850,000	0	\$4,850,000	0

*Example B.* Assume that the income from United States oil and gas production business is \$10,000,000 after deduction for royalties and that there are deductible costs, other than royalties and depletion, of \$3,000,000. Further assume that all income tax rates are as stated in Example A.

For purposes of calculating United States taxable income, assume that a deduction equal to 16% of the income is allowed to represent depletion.<sup>162</sup> For purposes of calculating Canadian taxable income assume that no such depletion deduction is allowed with respect to United States oil and gas production.<sup>163</sup>

160. This assumption is often incorrect.

161. See *supra* text accompanying notes 93-94 for definition of "foreign tax credit premium."

162. The depletion rate for primary production in 1984 and thereafter is 15%. I.R.C. § 613A(c)(5) (1982).

163. The depletion allowance under the Canadian Income Tax Act is not available for production from foreign resource properties. I.T.A., *supra* note 4, § 65; Income Tax Reg. (Can.) §§ 1201, 1204, 1205 (1979).

	U.S. Income (and Tax)	Canadian Income (and Tax)	Total Taxes	Foreign Tax Credit Premium
CANCO	5,400,000 (2,609,800)	7,000,000 (3,290,000)	3,290,000	680,200
USCO	5,400,000 (2,609,800)	0	2,609,800	0

Examples A and B illustrate that the foreign tax credit premium can be significant if the Canadian income tax significantly exceeds the United States income tax. In Example A the difference in tax is due to differences in tax rates, whereas in Example B the difference in tax is due to differences in computing the tax base.

## 2. Repatriation of profits

Both types of multiple taxation can occur in certain holding structures when corporate profits are distributed and repatriated. The additional income taxes include the United States withholding tax and the foreign country's income tax on the repatriated income when received by the investor stockholder. As a general rule, a Canadian corporation is not subject to United States withholding tax nor Canadian income tax on income repatriated from its United States branch business. A Canadian corporation owning stock in a United States corporation is subject to United States withholding tax when dividends from the United States corporation are paid.<sup>164</sup> The distributed income is also subject to Canadian income tax unless the Canadian corporate stockholder owns 10% or more of the United States corporation's stock.<sup>165</sup> The Canadian income tax, if any, may be partially or completely offset with foreign tax credits for United States withholding tax but not income tax paid by the United States corporation.

*Example C.* Assume the same facts as in Example A except that all after-tax income is repatriated as it is earned. The United States withholding tax on Canadian stockholders is 15% of the dividend.<sup>166</sup>

164. I.R.C. § 881(a). See *supra* text accompanying notes 60-66.

165. Under the Canadian "foreign affiliate" rules, if a Canadian corporation owns 10% or more of a foreign corporation, the dividends paid to the Canadian corporation from the foreign corporation which are paid out of active business profits are exempt from Canadian income tax. I.T.A., *supra* note 4, §§ 95(1)(d), 113(1).

166. 1942 Canada-United States Treaty, *supra* note 58, art. XI.

	Year	Total Corporate Taxes	Withholding Tax	Total Taxes For Year
CANCO	1	\$ 47,000	0	\$ 47,000
USCO		\$ 29,700	\$ 10,545	\$ 40,245
CANCO	2	\$ 235,000	0	\$ 235,000
USCO		\$ 223,500	\$ 41,475	\$ 264,975
CANCO	3	\$4,850,000	0	\$4,850,000
USCO		\$4,850,000	\$772,500	\$5,622,500

In this example the total taxes for year 1 are less for USCO than CANCO even if the profits are repatriated. The total taxes incurred by USCO for year 2 are less unless the profits are repatriated. In year 3 the total taxes are equal unless the profits are repatriated, in which case the total taxes for CANCO are less.

*Example D.* Assume the same facts as in Example B except that all after-tax income is repatriated as it is earned.

	Total Corporate Taxes	Withholding Tax	Total Taxes For Year
CANCO	\$3,290,000	0	\$3,290,000
USCO	\$2,609,800	\$658,530	\$3,268,330

These examples demonstrate that the withholding tax may dramatically change the cumulative taxes on income earned by USCO that is distributed to foreign corporate stockholders. Examples C and D illustrate that the tax advisor must analyze the impact of the withholding tax in deciding whether to use a branch rather than a domestic subsidiary in circumstances in which the investor intends to repatriate its income. In all likelihood the decision whether to use a branch or subsidiary will depend largely on whether the investor intends to repatriate the income through corporate distributions.

### 3. Reorganization

Reorganizations are adjustments in businesses or holding structures that may require the inclusion of new investors, the combining or splitting up of businesses, or changes in structure or form of business entities operating the business. The major income tax concern is that the adjustment in the business structure may cause the recognition of taxable gain or loss in the United States or a foreign country.

Generally, an entity selling United States business assets is subject to United States income tax on the gain regardless of the

country of incorporation or residence of such entity.<sup>167</sup> If the operating entity is a corporation owning the business, the stockholders may be subject to United States and foreign income taxes upon the sale or exchange of the corporation's stock.<sup>168</sup> Except in special circumstances the recognition of ordinary income or capital gain in such a transaction can be a great disincentive to streamlining business structures.

The United States, Canada, and other countries have special provisions allowing for tax-free reorganizations. However, these provisions often apply only if the reorganization meets specific technical requirements. Because these requirements differ from country to country, the investment should be structured to allow for maximum flexibility so that reorganizations will be tax free under the tax laws of all relevant countries.

#### 4. *Disposition or liquidation*

When the foreign investor no longer wishes to retain an investment in the United States, it may dispose of the investment by selling some or all of the investment assets. In addition, if the foreign investor has created or acquired a United States subsidiary to manage or hold the investment, the investor may also dispose of the stock of the subsidiary.

Generally, gain on the sale or exchange of the United States business assets of a Canadian corporation or its United States subsidiary is subject to United States income tax.<sup>169</sup> Gain on the sale of the assets of a Canadian corporation is also subject to Canadian income tax.<sup>170</sup> If distributed as a dividend, the gain on the sale of assets of a United States subsidiary is subject to United States withholding tax but is not subject to Canadian income tax unless the stockholder is a Canadian corporation owning less than 10% of the stock of the subsidiary or an individual.<sup>171</sup>

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167. The gain realized will usually be capital except for recaptured depreciation, which is treated as ordinary income. The capital gain is not recognized by a liquidating corporation that complies with § 337 of the Code.

168. I.R.C. §§ 871(a)(2), 897(a)(1) (1982).

169. *Id.* §§ 61(a)(3), 100L.

170. L.T.A., *supra* note 4, § 3(b).

171. The gain from the disposition of property used by a foreign affiliate principally for the purpose of gaining or producing income from an active business is excluded from foreign accrual property income. *Id.*, § 95(1)(b)(ii). Therefore, the entire gain is treated as income from an active business and is included in the exempt surplus of the foreign affiliate. Income Tax Reg. (Can.) § 5907(1)(b)(i)(B) (1978). Dividends from a foreign af-

If the United States subsidiary is completely liquidated within the twelve-month period beginning on the date on which a plan of liquidation is adopted, it may not recognize gain from the sale of the assets during the twelve-month period.<sup>172</sup> The Canadian parent must treat proceeds of liquidation as a capital gain from the sale of the stock of the United States subsidiary.<sup>173</sup> However, this capital gain is exempt from United States income tax if the Canadian stockholder does not have a permanent establishment in the United States.<sup>174</sup>

The portion of the proceeds of liquidation that approximates the retained earnings of the United States subsidiary, including retained business earnings and gain from the sale of business assets, may be exempt from Canadian income tax if the Canadian parent makes the appropriate election.<sup>175</sup> Thus, United States and possibly Canadian income tax may be totally avoided on the disposition of an investment or business in the United States.

*Example E.* Assume that in 1984<sup>176</sup> a Canadian corporate

filiate to its Canadian corporate stockholders that are paid out of the foreign affiliate's exempt surplus are exempt from Canadian income tax. I.T.A., *supra* note 4, § 113(1).

172. I.R.C. § 337 (1982). Section 337 does not apply to sales or exchanges by collapsible corporations, nor does it apply if the liquidation is governed by § 332. *Id.* § 337(c). Section 332 applies if a corporate stockholder owns at least 80% of the voting power and at least 80% of the shares of all classes of stock. *Id.* § 332(b). However, § 367 provides that § 332 does not apply if the corporate stockholder is a foreign corporation unless the stockholder first obtains permission from the Secretary of the Treasury. Nevertheless, the Commissioner of the Internal Revenue Service has taken the position that he can waive the requirements of § 367, thus causing § 332 to apply and disqualifying treatment under § 337. Treas. Reg. § 7.367(a)-1(g), T.D. 7530, 1978-1 C.B. 92, 101; Rev. Rul. 76-90, 1976-1 C.B. 101. Therefore, if the corporate stockholder owns at least 80% of the voting power and of all the shares of all classes of stock, there is a substantial risk that § 337 will not apply. In these circumstances the corporate assets can be sold free from United States taxes if the liquidating corporation distributes the corporate assets to the stockholder, which sells the assets to unrelated third parties. I.R.C. § 336 (1982). *But see* Commissioner v. Court Holding Co., 324 United States 331 (1945).

173. I.R.C. § 331 (1982).

174. 1942 Canada-United States Treaty, *supra* note 58, art. VIII.

175. The proceeds of liquidation of a foreign affiliate may be treated as a dividend from the foreign affiliate if the corporate shareholder so elects. I.T.A., *supra* note 4, § 93(1). A dividend representing the gain from the sale of business property is exempt from Canadian income tax. *See supra* text accompanying notes 169-71.

176. After 1984 the provisions of the Foreign Investment in Real Property Act, which is Subtitle C of the Omnibus Reconciliation Act of 1980, will supersede art. VIII of the 1942 Canada-United States Treaty. Under the Foreign Investment Real Property Act, gain from the sale of stock of United States real property holding companies is no longer exempt from United States taxation. Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, § 1125(c) 94 Stat. 2599, 2690-91.

stockholder that does not have a permanent establishment in the United States desires to sell its United States business assets consisting exclusively of resource properties for \$1,100,000 and that the basis in the assets for United States and Canadian income tax purposes is \$100,000.

If the United States business is owned and operated by CANCO, the gain is subject to \$280,000 of United States income tax<sup>177</sup> and \$500,000 of Canadian income tax.<sup>178</sup> If the United States income tax is fully credited against the Canadian tax, the total net taxes on the disposition of the United States business assets is \$500,000. If the entire amount of United States tax is not credited, the total net taxes will be between \$500,000 and \$780,000.

If the United States business is operated by USCO, the gain is subject to \$280,000 of United States income tax<sup>179</sup> and is exempt from Canadian income tax.<sup>180</sup> Thus, the total net taxes on the disposition of the United States business assets is \$280,000. If the United States business is liquidated and appropriate Canadian tax elections are made, there will be no Canadian tax incurred by the Canadian stockholder with respect to the gain.<sup>181</sup>

However, if the United States business is owned by USCO and USCO is liquidated within a twelve-month period beginning on the date on which a plan of liquidation is adopted, the gain from the sale of the assets may be exempt from United States tax.<sup>182</sup> Consequently, the proceeds of liquidation, including the gain from the disposition of the business assets, may be completely exempt from United States<sup>183</sup> and Canadian income tax.<sup>184</sup> This example demonstrates how initial tax planning can affect subsequent corporate events such as reorganizations and liquidations.

Interestingly, a Canadian investor can effectively avoid United States withholding tax on dividends from a United

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177. I.R.C. § 1201 (1982).

178. The gain from the sale of foreign resource property is fully subject to Canadian tax. I.T.A., *supra* note 4, § 59(1).

179. I.R.C. § 1201 (1982).

180. Gain from the sale of business assets of a foreign affiliate is not foreign accrual property income and therefore is not deemed to be distributed to the controlling Canadian stockholders. I.T.A., *supra* note 4, §§ 91(1), 95(1)(b)(ii).

181. See *supra* text accompanying notes 171-75.

182. I.R.C. § 337 (1982); see *supra* note 172.

183. See *supra* text accompanying notes 172-74.

184. See *supra* text accompanying note 175.



States subsidiary by retaining the subsidiary's earnings until such time as the subsidiary is liquidated. The proceeds of liquidation, including the retained earnings, that are paid to a Canadian resident who does not have a permanent establishment in the United States are exempt from United States income tax.<sup>185</sup> As described above, they may also be exempt from Canadian income tax. Of course, this strategy is useful for tax planning purposes only if the Canadian investor knows in advance that it intends to dispose of its United States business in the foreseeable future<sup>186</sup> and if the retention of the earnings will not trigger the tax on accumulated earnings<sup>187</sup> or undistributed personal holding company income.<sup>188</sup>

### C. Capital Structure

The capital structure of the entity managing or holding the United States investment or business becomes important if the entity's income is subject to United States withholding tax upon repatriation. One of the ways in which foreign investors minimize the United States income tax is to capitalize the United States corporation with debt rather than equity. The interest payments to the foreign investor are subject to United States withholding tax<sup>189</sup> but are deductible from the United States corporation's income.<sup>190</sup> The principal payments are not subject to withholding tax. On the other hand, dividends are not deductible from the United States corporation's income and are fully subject to United States withholding tax when paid to the foreign investor.<sup>191</sup> The following example illustrates the tax benefit of capitalization using debt.

*Example F.* Assume that a wholly owned United States subsidiary of a Canadian corporation carrying on an active business requires from its parent \$1,000,000 in working capital. The United States subsidiary expects to be able to return the initial

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185. See *supra* text accompanying notes 173-75.

186. When any corporation is formed or availed of principally for the manufacture, production, or purchase of property with a view toward liquidation, sale, or distribution before the corporation has realized a substantial portion of the taxable income to be derived from the property, the gain is taxed as ordinary income for United States income tax purposes. L.R.C. § 341 (1982).

187. *Id.* §§ 531-532.

188. *Id.* §§ 541-542.

189. *Id.* §§ 871(a)(1)(A), 881(a)(1).

190. *Id.* § 163(a).

191. *Id.* §§ 871(a)(1)(A), 881(a)(1).

contribution over a seven-year period.

If the capital is contributed as equity, the repayment will be treated as a dividend to the extent that the United States subsidiary has earnings and profits. The dividend income will be subject to \$150,000 in United States withholding tax but will not be subject to any Canadian tax.

If the capital is contributed 25% as equity and 75% as debt, the following would be the tax consequences assuming a simple 9% interest rate with annual interest payments. The United States subsidiary would deduct \$472,500 in interest payments over the seven-year period netting \$236,250 in United States tax savings<sup>192</sup> to the United States subsidiary. The Canadian corporation would be subject to \$70,875 in United States withholding tax and \$236,250 in Canadian income tax. If the withholding tax is fully credited against the Canadian tax, the total cumulative taxes of the Canadian investor will be \$236,250, and the net tax savings of the United States subsidiary will be \$236,250. The \$750,000 principal repayment in year 7 will not be subject to United States or Canadian income tax. Therefore, there will be effectively no net taxes on the distribution of profits in the form of interest and principal payments of the Canadian corporation.

In each fact pattern described above the United States subsidiary pays to the Canadian parent approximately 1,000,000 after-tax dollars. However, the Canadian corporate parent received \$850,000 after taxes in the first fact pattern compared with approximately \$1,000,000 after taxes in the second fact pattern.

Because of the potential for abuses in capitalizing the operating entity, the Internal Revenue Service may attempt to recharacterize certain debt obligations as equity. Therefore, the tax advisor must be familiar with applicable law.<sup>193</sup>

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192. This assumes a United States and Canadian corporate tax rate of 50%.

193. Section 385 of the Code authorizes the Secretary of the Treasury to prescribe regulations to determine whether any particular obligation or interest is debt or equity. However, no final regulations have been prescribed. Proposed regulations were published March 24, 1980, and final regulations were issued on December 29, 1980. T.D. 7747, 1981-1 C.B. 141. The regulations have since been modified, and the effective date of the final regulations will be 90 days after the final revisions have been published in the Federal Register. T.D. 7822, 1982-2 C.B. 84, 85.

## VI. CONCLUSION

For foreign investments in the United States it is best to select a holding structure that does not subject the stream of income to multiple taxation. The avoidance of multiple taxation completely eliminates the risk that the income will incur either the foreign tax credit premium or overlapping taxes.

If the investment cannot practically be structured to completely avoid multiple taxation, the next best investment structure is typically one in which the multiple taxation is eliminated through one or more relief provisions that exempt the income from the additional income taxes. These relief provisions are usually limited in scope, but if the taxpayer qualifies for the exemption, the provision is generally effective.<sup>194</sup>

The third best investment structure is one in which the overlapping taxes are eliminated or reduced through compensatory relief provisions such as treaty reductions on withholding rates or foreign tax credits. These relief provisions do not eliminate overlapping taxes in many circumstances, especially those in which the overlapping taxes arise from taxation of multiple persons. In the case of foreign tax credits, the cumulative income tax burden is also increased by the foreign tax credit premium, which may be very substantial.<sup>195</sup>

Successfully structuring foreign investments in the United States requires proper analysis of many tax considerations. Awareness of these factors, along with a thorough understanding of the Code and proper advice from foreign tax professionals, will prevent income taxation from being a significant barrier to foreign investment in the United States.

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194. A typical relief provision found in treaties provides that business income of persons who do not have a permanent establishment in the host country is exempt from the host country's income tax. 1942 Canada-United States Treaty, *supra* note 58, art. I. However, permanent establishment is defined broadly to include certain interests in mineral properties, general agency arrangements, and the use of substantial equipment or machinery within the United States. *Id.* Protocol ¶ 3(f). Therefore, the provision is more restrictive than one might otherwise infer.

195. To the extent that the United States income tax is less than the foreign tax as a result of various tax incentives provided in the Code to encourage investment in the United States, the tax benefit from those incentives accrues to the foreign country asserting the subsequent income tax as a result of the foreign tax credit premium. Examples of United States income tax incentives available to United States businesses which may not be available to United States businesses under the foreign tax laws include investment tax credits, percentage depletion for certain resource income, and graduated corporate income tax rates on the first \$100,000 of taxable income.