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In this article, the authors consider the effect the U.S. Tax Cuts and Jobs Act may have on Canada regarding both U.S. inbound and outbound investments.

According to the Office of the United States Trade Representative, U.S. goods and services trade with Canada totaled an estimated $673.9 billion in 2017. In 2016 U.S. foreign direct investment into Canada was $363.9 billion, and Canada's foreign direct investment in the United States was $371.5 billion. With bilateral trade of more than $1.8 billion daily, Canada and the United States clearly have an important trading relationship and a high level of economic integration.

Given that relationship, it is unsurprising that anything that affects Americans could also affect Canadians, and the recent U.S. Tax Cuts and Jobs Act (P.L. 115-97) is no exception. Therefore, it is necessary to consider the effects those changes could have on both inbound and outbound U.S. investment. Much has already been written about what impact the reform will have on more aggressive tower and repo structures designed to create advantageous tax outcomes, but relatively little has been said about some of the more common cross-border investment and business vehicles.

While refinements are coming out almost daily as regulations are drafted, it is still useful to take stock of what we know so far about the tax reform. Of benefit to taxpayers is the 21 percent corporate tax rate, the ability to immediately expense new and used business assets, and special deductions based on a company's foreign-derived intangible income (FDII). Those changes would seem to make the United States an attractive place for both Americans and Canadians to grow their businesses. On the flip side, the reform introduced several detriments for U.S. persons who have investments on the other side of the border — for example, the global intangible low-taxed income tax and expanded subpart F.

Because of those changes, cross-border structures that until now have been tried and true must be reconsidered. Cross-border businesses and investors who might previously have considered holding investments through a Canadian corporation might lean heavily toward holding investments, particularly in intangibles, through U.S. corporate structures instead. Several changes have made U.S. C corporations more attractive, which is good news for both Americans wanting to do business in Canada and Canadians wanting to do business in the United States.

Historically, many U.S. taxpayers who do business in Canada — and vice versa — have used hybrid entities like limited liability companies that have not elected to be classified as corporations, limited liability partnerships, and limited liability limited partnerships (LLLP). The use of those hybrid entities in a cross-border capacity frequently results in surprisingly high effective tax rates, so it is useful to consider the changes affecting U.S. corporations and the result that has on the equation for those hybrid entities.

The History of Hybrids

Pre-reform, it was common to see investments from Canada into the United States take place either through a U.S. LLC, LLLP, or limited partnership (LP). Given the restrictions on the use of S corporations, those entities were generally not an option, and the high U.S. corporate tax rates paid by C corporations meant those entities also were rarely used. The use of an LLC or LLLP often has unfortunate tax consequences in a cross-border context, however. For a Canadian investing into the United States — even before tax reform — the use of a C corporation (or in some cases, a trust) at times would arguably have resulted in better preservation of after-tax capital than an LLC, LLLP, or LLP; however, rarely were those structures used. And even for a U.S. resident investing into Canada, again, an LLC really didn't produce great results, as discussed below.

For a U.S. tax adviser, unless those hybrid entities file a Form 8832 and elect to be treated as a corporation, they are all substantively the same thing — a partnership or a disregarded entity. But from a Canadian perspective, a U.S. LLC or LLLP is substantively different from an LP, with substantively different Canadian tax results.

Foreign entity classification in Canada is based on comparing the legal nature of a foreign entity with the types of entities recognized in Canada. Occasionally an entity being classified will become a hot topic for Canadians, particularly if it is a domestic U.S. entity — and sometimes the process has unexpected results. That is the case regarding the classification of LLCs, LLLPs, and LLPs that have not elected to be treated as a corporation for U.S. purposes. In the United States, all those entities are effectively partnerships or disregarded entities, but the presence of legal personality and broad limited liability for all members caused Canadian tax authorities to consider them corporations.

Unfortunately, because of that classification, the use of a U.S. LLC, LLLP, or LLP could come with a high tax cost that wouldn't exist for Canadian taxpayers investing or doing business in the United States through a U.S. LP or C corporation. Many Canadians find themselves partners in U.S. LLLPs purely by happenstance. To a U.S. corporate lawyer, an LLLP, LLP, and LP are all partnerships, so if a client asks to form a partnership and is in a state that provides for LLLPs, that is often the entity provided.

Pre-Reform

Canadians Investing Into the U.S.

So what causes the problem? The root of the issue is that an LLC, LLLP, or LLP is not itself liable for U.S. tax, but Canada sees it as a distinct legal entity. That results in a mismatch in the treatment of those entities from one side of the border to the other, leading to serious tax problems, including double taxation for Canadians who invest into the United States through one of those entities.

As a starting point, consider the question of tax residency. Under the Canada-U.S. income tax treaty, just being formed in the United States is not enough for an LLC, LLLP, or LLP to be recognized as U.S. resident. Under treaty Article IV on residence, to be "found resident of a contracting state" under the laws of that state, a corporate entity or flow-through entity (FTE) must be "liable to tax" there. Because an LLC, LLLP, or LLP that has not elected to be treated as a corporation is not itself taxable, Canada takes the position that those entities are not U.S. resident entities entitled to full treaty benefits.[1]

Article IV(6) of the treaty provides some limited relief from Canadian withholding tax on payments made to an LLC, LLLP, or LLP, but if one of those entities has its central management and control in Canada, Canada might deem it Canadian resident and impose Canadian corporate tax on its worldwide income. In most cases, there will be no foreign tax credit relief for that additional tax.

That differential treatment between Canada and the United States can create several challenges because tax is imposed by Canada at the partnership level, rather than at the partner level like in the United States. While the full impact on a Canadian resident taxpayer of its investment in a U.S. LLC, LLLP, or LLP will depend to some degree on what it has invested in, because those entities are foreign corporations and thus foreign affiliates, Canada might impose a reporting obligation regarding the entity.

If the end investment is, for example, U.S. real estate to be used for rental income, and the Canadian owners — or potentially a group of Canadian owners or related parties — control the entity, the taxpayer must consider whether any passive foreign income might be foreign accrual property income. FAPI is Canada's equivalent to

[1]The Canadian tax authorities have, however, made an administrative concession, saying an S corporation will be deemed U.S. resident under the treaty.

subpart F income and is similarly recognized as it is earned, rather than when distributed. FAPI is mechanically difficult because it must be calculated using Canadian, rather than U.S., income tax rules.

Historically, one of the big differences between the Canadian and U.S. regimes has been that U.S. tax depreciation rules are far more generous than Canada's — a differential that will likely become even more pronounced post-TCJA. So while an LLC's U.S. tax forms might show a loss for U.S. tax purposes, when the income is recalculated using Canadian rules, there may often be FAPI, which must be reported and taxed in Canada.

Because an LLC, LLLP, or LLP is fiscally transparent in the United States, taxes are paid by the members rather than by the entity, and any distributions are made from pretax income. Further, except when the hybrid is a controlled foreign affiliate with passive income that is deemed to be FAPI, and thus taxed in the hands of its Canadian owner in the year earned, there is no recognition of income from a Canadian tax perspective until a dividend is paid. So while the United States will tax the members, the Canadian FTC deduction regime looks for tax that was paid by the LLC, LLLP, or LLP itself because the Canadian system treats those entities as corporations, not FTEs.

For example, if the hybrid entity is held by an individual who recognizes income on its ownership in a tax year, either from an actual distribution or from FAPI, a foreign tax deduction will be available under section 20(11) of Canada's Income Tax Act if the U.S. tax paid by the individual exceeds 15 percent. Any U.S. tax not deductible under section 20(11) will be treated as a nonbusiness FTC under section 126(1) if the individual has adequate nonbusiness U.S.-source income to support the credit. As a result, however, there will be some tax leakage because section 20(11) provides for a deduction rather than a dollar-for-dollar credit.

If the hybrid was engaged only in an active business and thus did not have FAPI, and the member share of the income earned in the year was $100, the members will likely pay $37 of U.S. taxes but would receive a distribution of only $37 to cover the taxes. Under section 20(11), only a small portion of the U.S. tax paid can be used for an FTC because the resulting deduction will be based on $37, not $100. When a distribution is made, if the distributed amount does not equal taxable income for the year, the FTC may be lost because Canada does not allow a nonbusiness FTC to be carried forward.

When a Canadian corporation operates directly in the United States as a branch, it will receive a one-time C $500,000 exemption, with a branch tax of 5 percent in addition to regular U.S. corporate income tax due on any excess.

In contrast, if the same Canadian corporation expanded into the United States by forming an LLC, the United States would tax the income that is effectively connected to a U.S. trade or business; however, because the LLC is an FTE, the United States will also apply a branch profits tax. In that case, because Article IV(7) of the treaty denies treaty benefits for a Canadian-owned LLC, the income will likely be subject to a 30 percent withholding tax with no exemption amount.

Americans Investing Into Canada

From a pre-reform perspective, if a U.S. LLC expands into Canada as a branch, its treatment will depend on its ownership. If it has members who are U.S. individuals or are not U.S. resident, Canada will apply a branch tax of 25 percent. If the LLC is owned by U.S. corporations, the reduced 5 percent branch tax rate plus the C $500,000 one-time exemption should apply. The branch tax is a proxy for withholding tax that would normally apply to dividends and is in addition to regular Canadian corporate income tax.

In contrast, if a U.S. C corporation expands into Canada as a branch, it automatically receives the 5 percent branch tax rate and the C $500,000 exemption.

In most cases, where the treaty does not apply, domestic Canadian withholding tax rates are 25 percent. As mentioned, if a U.S. hybrid entity has investments in Canada, Article IV(6) of the treaty will provide U.S. residents with only limited relief from Canadian withholding tax. Non-U.S. members of one of those entities would not get any relief from full Canadian withholding tax, even if they usually would have received lower withholding tax rates under their home country's treaty with Canada. Effectively, non-U.S.-resident taxpayers are punished for investing through a U.S. entity.

Post-Reform Cross-Border Considerations

So what changes post reform?[2] For Canadians investing into the United States, LLCs, LLLPs, and LLPs seemed like terrible options before reform, and now, relatively speaking, they seem like even worse options.[3] Similarly, investing into Canada through an LLC often does not yield a great tax result for Americans. Does U.S. tax reform make that any better or worse?

Many of the changes would seem to favor the use of U.S. corporations rather than an LLC, LLLP, or LLP to hold cross-border investments. A C corporation might seem like a more attractive vehicle — but is it?

Corporate Tax Rate Cut

While U.S. individual rates came down slightly, the dramatic drop in the corporate rate from 35 percent to 21 percent swings the pendulum sharply in favor of using U.S. corporations as a way to hold cross-border business, or other investment, in the United States. The post-reform average combined U.S. federal and state effective corporate rate is around 27 percent, which is roughly in line with combined Canadian rates. Compare that with the average combined top U.S. or Canadian individual rates of 43 percent and 47 percent, respectively, and a U.S. C corporation starts to look pretty good from a deferral perspective.

That said, the 20 percent accumulated earnings tax imposed on corporate accumulated income, as well as the 20 percent penalty tax on personal holding company income that constitutes undistributed passive income in closely held C corporations, will require consideration for a taxpayer hoping to defer taxation.[4]

Dividends Received Deduction

Much like the Canadian exempt surplus rules, which apply to dividends from foreign affiliates of Canadian corporations, the new U.S. dividend participation exemption provides favorable treatment for foreign dividends received by U.S. corporations. That treatment is unavailable for individuals or FTEs. Given that Canadian corporate tax rates for non-Canadian-controlled companies are generally more than 13.125 percent, the new provision should allow U.S. corporations to receive Canadian dividends substantively free from additional tax (Canadian withholding tax will apply). However, the participation exemption does not apply in all cases; for example, there is no relief on the gain from the sale of a U.S. corporation's foreign subsidiary.

In contrast, a dividend from a foreign corporation to a U.S. individual shareholder or hybrid entity will be fully taxed in the individual's hands. Higher dividend withholding tax rates will likely apply, although offsets for foreign taxes should be available so that the individual is not taxed above the higher of the rates between the two jurisdictions.

GILTI

Under IRC section 951A, U.S. corporate shareholders of controlled foreign corporations with foreign intangible assets will be subject to a current minimum tax of 10.5 percent on their GILTI. The policy intent of that provision appears to be to capture the offshore intangible income not subject to U.S. tax and to encourage U.S. multinational companies with substantial intellectual property outside the United States to repatriate their IP to maximize their FDII deductions and minimize their GILTI tax base.

[2] The one-time transition tax payable by U.S. persons who own at least 10 percent of the voting shares in a controlled foreign corporation if at least one of its U.S. shareholders is a U.S. domestic corporation is based on the higher of the earnings and profits balances on November 2 and December 31, 2017. Thus, it is now water under the bridge and will not be discussed in this article.

[3] If the entity is a grandfathered LLLP or LLP, which historically filed as, and was treated like, a partnership in Canada, it generally should be able to continue as a partnership if there are no material changes in its activity or its members.

[4] The top U.S. marginal tax rate of 37 percent applies to the first $500,000 of taxable income. Canada's top marginal tax rate of 33 percent applies to taxpayers with taxable income over $205,843; in the United States, the individual rate would be 35 percent. The next lower tier in Canada is taxable income of $144,490, which Canada would tax at 29 percent and the United States at just 24 percent.

Specific provisions allow U.S. domestic corporate shareholders to claim a special deduction for 37.5 percent of FDII provided under new section 250,[5] and a 50 percent deduction for GILTI for tax years beginning after December 31, 2017, and before January 1, 2026. Corporate shareholders can also claim FTCs of up to 80 percent of foreign taxes paid on that CFC-tested income based on the inclusion ratios in section 951a, with the result that potentially no residual U.S. tax would be owed on GILTI if the foreign tax rate is at least 13.125 percent.

FTEs do not receive similar treatment, and no comparable deduction is available for them. They also continue to be unable to credit foreign taxes paid by the CFC, with the result that an incremental U.S. tax of 37 percent will be paid on an FTE CFC's net foreign inclusion from the GILTI tax.

U.S. individual shareholders or hybrid entities that own CFCs with offshore IP are at a disadvantage because they cannot claim the FDII or GILTI deductions, nor FTCs for foreign taxes paid. Their only option to reduce this tax would be to work within the GILTI provisions themselves; for example, by loading up on tangible property investments to increase their specified tangible property basis and thus decrease the net CFC-tested income base for the GILTI tax.

For Canadian-resident U.S. citizens who own service businesses, GILTI will be punitive. Take a U.S. citizen lawyer residing in Canada who operates her practice through a Canadian professional corporation. She will pay Canadian corporate income tax and report that same income on her U.S. income tax return; however, she will not be permitted any deductions or FTCs for the Canadian corporate income taxes paid.

Similarly, Canada will not grant any FTCs for the U.S. GILTI tax paid because the source of the income is Canada. Finally, Canada will tax the same income one last time when it is paid to the lawyer as a dividend. The result is slightly improved if the lawyer draws all the income as a salary rather than through dividends because that will create a deduction in the professional corporation; however, that eliminates any tax advantage from having a professional corporation in the first place.

Passthrough Entities

Passthrough entities are entitled to relief under new section 199A, which provides a 20 percent deduction on qualified business income received by a U.S. individual taxpayer from noncorporate entities, including partnerships. The full 20 percent deduction would reduce the top marginal individual rate on that income from 37 percent to 29.6 percent.

The deduction is the lesser of 20 percent of the taxpayer's combined qualified business income; or the greater of (a) 50 percent of the Form W-2 wages paid for the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages for the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquiring all qualified property (currently being used and depreciated as part of a qualified business). The relevant W-2 wages base includes all wages, including withholding and deferred compensation amounts. The deduction expires after December 31, 2025.

For the deduction, qualified business income includes income that is effectively connected to a U.S. trade or business other than: (1) a specified trade or business including health, law, accounting, or any trade or business in which the principal trade or business is the reputation or skill of at least one its employees; or (2) the trade or business of performing services as an employee. Qualified business income excludes guaranteed payments and compensation paid to a partner.

The rules provide an incentive for U.S. partners and shareholders of passthrough entities not engaged in one of the specified trades or businesses to invest in tangible depreciable property and hire employees in the United States rather than Canada.

Foreign inbound businesses operating service-based businesses through passthrough entities will likely want to consider:

- moving the service-based portion of their business into different passthrough entities than those holding the nonservice-based

[5] The FDII deduction is available only to U.S. corporate shareholders of U.S. corporations earning income from licensing U.S. IP to non-U.S. persons or using IP to service non-U.S. persons.

portions that have real property or other tangible assets;
- diluting the service-based business with nonrestricted business activities to transform the specified trade or business into a nonrestricted service line; or
- having partners and shareholders of service-based passthrough entities reduce their taxable income base by, for example, reducing partner or shareholder compensation to no more than $157,000 each.

Any restructuring must consider the requirements for receiving capital gains treatment under new section 1061. Also, Canadian-resident U.S. citizens will want to consider the corresponding treatment under Canadian tax law to ensure they do not create a further FTC mismatch.

Canadian-resident U.S. citizens are generally subject to Canadian tax on their worldwide income, and thus are probably indifferent to the amount of any qualified business income deduction. A reduction in their U.S. tax payable through the deduction would simply reduce the amount of the FTC available for Canadian tax purposes, without appreciably changing the total amount of global taxes paid.

The qualified business income deduction might be important for Canadian individual taxpayers who have invested through a U.S. LLC, LLLP, or LLP. In that case, the inherent FTC mismatch means a reduction in their U.S. tax burden could reduce their overall global tax bill.

Section 1202

Under IRC section 1202, a noncorporate taxpayer may exclude from taxable gross income a gain resulting from the disposition of qualified small business stock held more than five years. While tax reform did not change that provision, the combination of the lower corporate tax rate and the section 1202 exclusion of some sales of shares of C corporations adds to the attractiveness of a C corporation.

Expanded Subpart F Regime

The expanded subpart F regime applies to a CFC earning passive income when U.S. shareholders own more than 50 percent of the CFC's votes or value. If the CFC earns passive income such as interest, dividends, rents, or royalties, as well as some other kinds of income, the U.S. shareholders would have a taxable income inclusion even if there is no distribution from the CFC.

Effectively, the reform enlarges the number of U.S. shareholders who will be subject to subpart F as well as the foreign corporations that are considered CFCs.[6] For Canadian tax and estate planning purposes, nonvoting preferred shares are often issued to freeze the value held by a shareholder.

Previously, a U.S person who owned those shares would not have been considered a U.S. shareholder for determining subpart F income; that is no longer true. Also, the changes to the constructive ownership rules in section 958(b) mean that generally, foreign corporate stock owned by another person or entity may be treated as if owned by a U.S. person for determining if that person was a U.S. shareholder of a CFC, or if a foreign corporation is actually a CFC.

Again, corporations are treated differently than hybrids. Subpart F income recognized by a C corporation is subject to a maximum tax rate of 21 percent, while for individuals or hybrids the maximum rate is 37 percent.

A taxpayer may elect to exclude subpart F income that qualifies for a high-tax exception; for example, if the foreign country taxed the income at a rate greater than 90 percent of the highest U.S. corporate tax rate. With the U.S. corporate rate now at 21 percent, the threshold rate of foreign income tax needed to qualify for the high-tax exception is 18.9 percent, meaning most subpart F income from Canadian CFCs should qualify for the exemption. The threshold rate is the same for corporations and individuals.

Also, U.S. corporate shareholders are eligible for an FTC for foreign income taxes paid on subpart F income (the amount of subpart F income is grossed-up for the amount of the

[6]Under prior law, a U.S. shareholder was defined as a person that owned at least 10 percent of a CFC's voting power. Under the amended tax code, a U.S. person can be a U.S. shareholder if it owns either 10 percent of a CFC's voting power or value. For example, a U.S. person that owns 10 percent of the value of a CFC's stock, but only 6 percent of the voting power, would now be a U.S. shareholder.

deemed paid taxes), now based on the actual taxes paid on that income. Any excess FTCs can be carried back one year and forward 10 years. No comparable credit is available to U.S. shareholders that are not C corporations.

CFC Distributions

Another difference in the treatment of corporations and FTEs or individuals can be found with CFC distributions. U.S. corporate shareholders now get a 100 percent deduction for CFC distributions of foreign earnings that were not subject to taxation under subpart F.[7]

In contrast, U.S. individual shareholders have an income inclusion of 100 percent of dividends received from CFCs that are not distributed from previously taxed income. Those amounts are now taxed at 37 percent, but if the foreign corporation qualifies for U.S. treaty benefits, the dividends can qualify for a reduced rate of 20 percent. Further, under the ordering rules, CFC distributions are treated as being made first out of the CFC's current and accumulated previously taxed income.

Base Erosion and Antiabuse Tax

While the new base erosion and antiabuse tax in section 59A will apply only to the biggest entities, it is more likely to have negative consequences for corporations than individuals or hybrids. It is a minimum tax on specific deductible payments to related foreign corporations, and applies to large multinationals with revenue over $500 million. Designed to prevent the use of deductible payments to related foreign corporations to shift profits outside the United States, the tax will increase from 5 percent in 2018 to 10 percent in 2019-2025 and 12.5 percent thereafter.

The BEAT will apply regardless of the tax rate of the foreign affiliate to whom payments are made, and is an unabashedly U.S.-centric policy. The payments potentially caught by the BEAT include royalties, interest, and service fees, as well as payments for depreciable property paid by a U.S. person to a foreign affiliate. Like the FDII, the BEAT regime will affect how multinationals design their supply chain processes and structures. It will be interesting to see how the international trade arena reacts to the new tax.

Conclusion

Is U.S. tax reform going to result in decreased use of LLCs that have not elected to be treated as corporations? Perhaps, but LLCs are probably not going away any time soon. The LLC will remain a flexible and useful tool in many cases; but it and other hybrid entities are not particularly great Canada-U.S. cross-border vehicles. Also, following U.S. tax reform, C corporations might work well for both Canadians and Americans, along with the tried and true LP or trust-based structures.

Historically, the preferred vehicle for many Canadians investing into the United States was an LP. A U.S. corporate general partner would often hold a small equity interest in the partnership, and at least one limited partner would hold the lion's share of the ownership. By operating that way, not only is there some liability protection, but the FTCs also generally line up if tax is seen to be paid by the partner (both in the United States and in Canada), with the result that the Canadian partner can usually claim an FTC for U.S. taxes paid.

Which entity will be better for a taxpayer will depend on its facts and circumstances. In many cases, however, simply converting from a hybrid into a nonhybrid could have repercussions. For example, in the United States it is relatively simple to convert from an LLC to an LP without incurring U.S. income tax. In Canada, however, the tax authorities would consider that conversion a taxable windup of a foreign corporation followed by a contribution of property to a partnership. If the property owned by the LLC has accrued gains, the Canadian members are taxed in Canada on the conversion.

Entity selection is only a small part of the puzzle in cross-border financing and investing, but can be important for minimizing taxes on operational profits, creating a tax-efficient pipeline for repatriation of profits, and ensuring a low-tax exit strategy. ■

[7] This rule has a one-year ownership requirement and does not apply to dividends that are deductible by the CFC in calculating its foreign income taxes.