Canadian Outbound Planning:
Selected Canada-US Corporate Tax Strategies Under the New Tax Rules

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Canadian Outbound Structuring – Passive Income

- Canada's CFC rules tax passive or mobile income of a controlled foreign affiliate on an accrual basis
  - Foreign accrual property income (FAPI)
  - Simulated credit for foreign tax paid
  - On repatriation of profits, simulated credit for "taxable surplus" dividends and previously-taxed FAPI

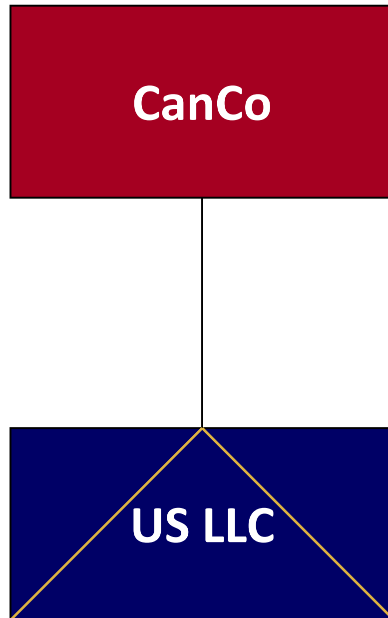
Canadian Outbound Structuring – Active Business

- Active business income of a foreign affiliate: no accrual tax
- Exemption/Credit mechanism for dividends paid to Canadian parent corporation
  - **Exempt surplus** – active business income earned in a country with Tax Information Exchange Agreement or Tax Treaty
  - **Taxable surplus** – all income earned in other countries

Historical Structuring from Canada Into the U.S.

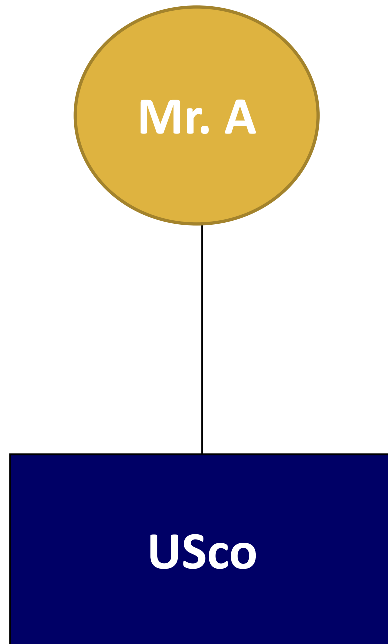
- U.S. tax rates were 35% + state tax
- Canadian rates: 26% ~ 31%
- Results: combined corporate tax rates of ***54% - 61%*** or higher (absent tax planning, pre-2018)
- Incentives to create financing structures ("Repo" or "Tower" structures)
- Or, flow through entities (partnerships)

Common Mistakes: Use of LLCs



- LLC treated as a corporation for Canadian tax purposes
- CRA requires LLC's income to be calculated using Canadian tax rules for exempt and taxable surplus
- Risks of double tax or timing problems because of hybrid mismatch

Common Mistakes: Individual Ownership of a Foreign Affiliate

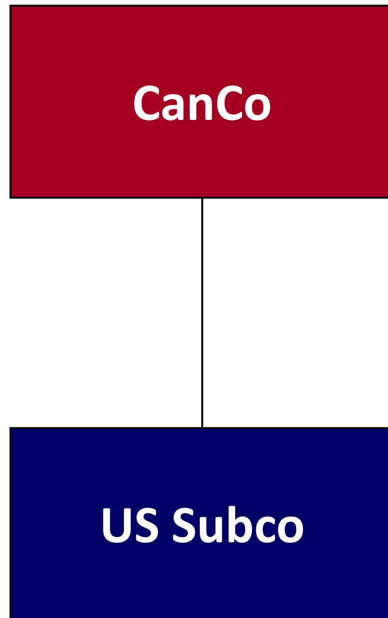


- Individual exposed to negative aspects of FA rules (FAPI)
- But cannot benefit from positive aspects (exempt surplus)
  - Dividends taxed as portfolio income
- Using an LLC equally problematic

Common Mistakes: Partnerships?

- Historically, may have been more tax-efficient than corporate structures
- Canadian tax issues where there are non-Canadian partners:
  - Transfer of partnership interests taxed at double the capital gains rate (e.g. 27% instead of 13.5%)
  - Withholding tax on income allocations
  - Options for tax-deferred reorganizations or transfers of partnership property eliminated or severely restricted

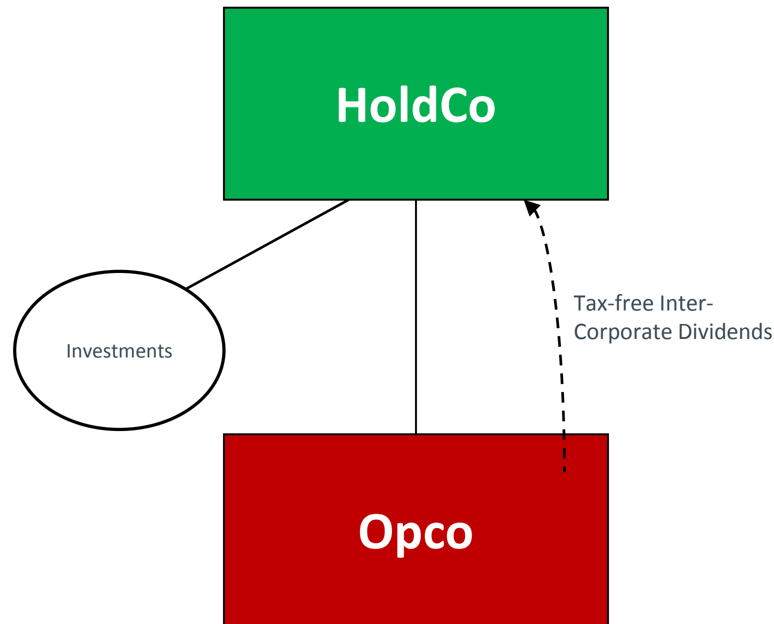
Current Techology: Keep It Simple



- C-corporation in the U.S.
- Dividends from US Subco should generally be subject to little or no tax in Canada

Canadian Tax Reform for Private Companies

Holdco Structure for Tax Deferral



Tax for Passive Holdcos

- Investment income is taxed at a high corporate rate of about 50% (most provinces)
  - Policy is the combined corporate + personal tax is approximately the same in the long run, after the corporation pays a dividend (integration)
- *Refundable tax* returned when dividend is paid to an individual shareholder
- “Long run” corporate tax rate on investments: 20%

New Tax Rules for Passive Investments

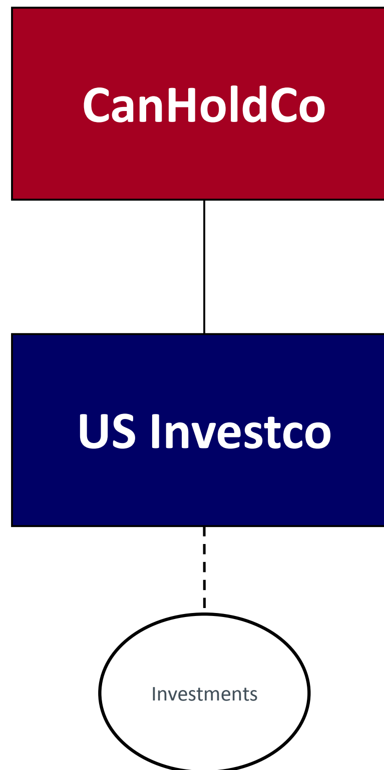
- Normally, a Canadian-controlled private corporation (CCPC) is taxed at a low rate (12%) on its first $500,000 of active business income.
- New rules reduce the $500k “small business limit” if an “associated” corporation has more than $50,000 of investment income.
- Privately-owned corporate groups with between $3 M - $10 M of assets are most affected.

New Tax Rules for Passive Investments

- Reduces your $500,000 small business limit by $5 for every $1 of investment income, over and above $50,000

- Bottom line: if you have corporate income with more than $150,000 of investment income, the small business deduction may be lost (absent tax planning)

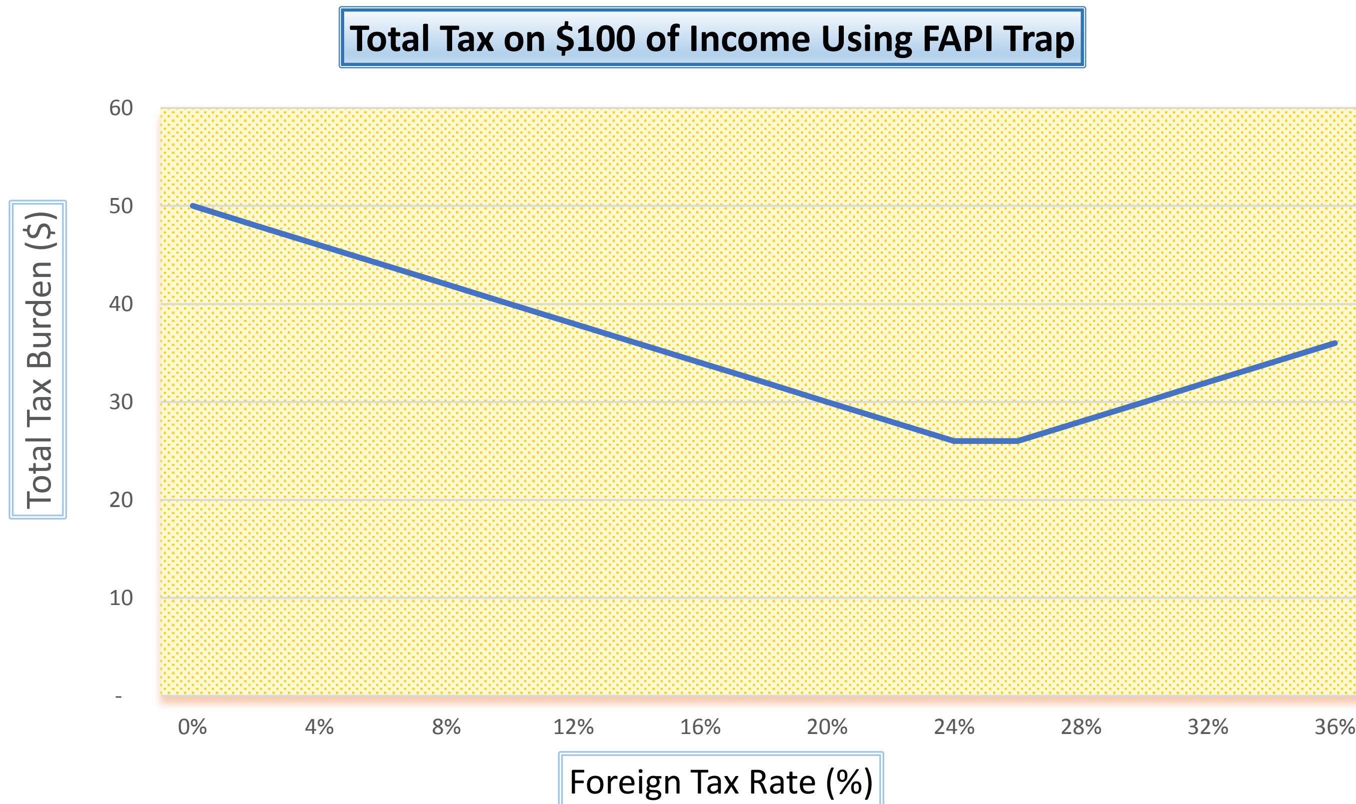
Possible Solution: “FAPI Trap”



Possible Solution – FAPI Trap

- Choose a state such that total US corporate tax optimizes Canadian deductions
- Incorporate a controlled foreign affiliate, generate FAPI, but claim a FAT deduction.
- Reduces corporate tax from approx. 50% to 27% (depending on province)
- Reduces personal tax to Canadian shareholder from approx. 41% to 31% (eligible dividends from GRIP)

Selecting Jurisdiction for Tax Optimization



Tax Deferral Using U.S. Investco

Investment Income	$100
US Corporate Tax (Federal + select state)	(26)
Canadian Tax on FAPI	(1)
Cash available to reinvest	$73
Tax Deferred	**$21**

Conclusions

- Structuring active business from Canada into the U.S. is greatly simplified.
- For passive corporate income, the U.S. is a respectable tax haven for Canadian private clients.

Questions?