Tax Topics

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THE APPLICATION OF THE US PFIC REGIME TO CANADIAN START-UPS

— *Max Reed, BCL, LLB*[1]

Many Canadian start-ups, whether junior mining, biotech, or tech, receive funding from investors in the United States (or from US taxpayers who reside in Canada). If the proper steps are not taken, a punitive US tax regime (the passive foreign investment company or "PFIC" rules) may increase the tax cost on an exit of these investors. Amongst other things, the PFIC regime can easily double the tax cost on exit from the investment. These adverse tax consequences can be mitigated if addressed in the first year the investment is owned. Consequently, to ensure tax efficiency for investors and avoid potential civil liability, early stage companies should make US investors aware of the potential application of the PFIC regime and take the steps necessary to address it.

The PFIC regime is a set of US tax rules that are designed to prevent US taxpayers from using foreign corporations to defer US tax on investment income. Importantly, the PFIC regime applies to the US shareholders who are subject to the US tax code and not to the foreign corporation itself (over which the Internal Revenue Code has no claim unless the corporation does business in the US). The PFIC regime was designed to prevent a US taxpayer from setting up a corporation in a tax haven and using that corporation to defer investment income offshore. However, the rules are broadly drafted and they apply to many more innocuous situations as well. The US tax code defines a PFIC as any foreign corporation for which:

- at least 75% of the corporation's gross income is passive (investment) income, or
- at least 50% of a corporation's assets produce passive income.

Passive income is generally defined to include interest, dividends, certain capital gains, and other income that is not generated from an active business. Although unintentional, these rules often apply to foreign, early stage companies. To illustrate, consider the income statement and balance sheet of a classic start-up. The primary asset of most early stage companies is cash that the company has raised from founders or investors. Cash is a passive asset as it only produces interest income. Because the company is in its early stages, the value of the cash will often exceed the real business assets of the corporation. This means that more than 50% of the corporation's assets are "passive", and thus it likely meets the definition of a PFIC. Once a foreign corporation has been classified as a PFIC, it remains that way even if the corporation stops meeting the PFIC test in future years.

If an investment is classified as a PFIC, the tax results can be very expensive for a US shareholder. While the PFIC rules are onerous and complex, it is worthwhile to highlight simply one potential consequence of their application. A US taxpayer who sells shares of a PFIC pays US tax at the highest marginal rate, plus an interest charge in certain cases.

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For a long-term investor, the US federal tax can easily exceed 50% of the gain on the sale of the investment. By contrast, the top US federal tax rate that applies to the sale of a non-PFIC investment that has been held for more than a year is 23.8%. In short, the application of the PFIC rules can double the tax cost to an investor on the sale of the investment or an IPO.

Thankfully, the Internal Revenue Code provides a solution to the PFIC problem. A US taxpayer can make an election on their individual US tax return, the technical name of which is the qualified electing fund or "QEF" election. The QEF election removes the punitive taxation of the PFIC regime. For instance, when an investor sells an investment to which the QEF election applies, the normal long-term capital gains tax rate (23.8%) will apply. The potential downside to making the QEF election is that it will treat the investment as a flow-through entity for US tax purposes.

This means that a US taxpayer will be taxed on their share of the foreign corporation's profits on a current basis even if no cash is distributed to that investor. To illustrate, assume that a US taxpayer owns 50% of a foreign corporation named InvestCo whose assets are 75% cash, and that corporation makes $100 of business income each year. Because of its high percentage of passive assets, InvestCo would be classified as a PFIC. If the US taxpayer makes the QEF election on their US tax return, then they would pay tax on $50 of interest income even if they never receive that cash. At first glance, then, the QEF election may appear unattractive. But under the QEF election only a taxpayer's share of *net income* is taxable. Most early stage companies do not have net income. If the QEF election is made in the first year that the investor owns the investment, it is not necessary for any year in which the foreign corporation would not be otherwise considered a PFIC. Reprise the above example of InvestCo to illustrate. The US taxpayer makes the QEF election in the first year that they own the investment and pays tax on the $50 of interest income. The following year InvestCo's business assets exceed the value of its cash holdings (meaning that the percentage of passive assets is below 50%) and it earns $150 of business income. Since InvestCo is no longer qualified as a PFIC, then the US taxpayer who has made a QEF election no longer needs to include their share of the profits in their taxable income (unless they are distributed). Under this example, which is a very common trajectory for early stage companies, the downside of the QEF election is no longer applicable once the company is a healthy, growing business. Making the QEF election requires the foreign corporation to provide QEF statements to the investor and those statements must be in accordance with US income tax principles.

In sum, there is a significant risk that the PFIC regime will apply to US investors in Canadian early stage companies, because the balance sheet of those companies is likely to be cash heavy. The application of the PFIC regime can easily double the US tax cost on exit from the investment. The PFIC regime can be negated if the QEF election is filed in the first year that the investment is owned. If done in a timely fashion, future adverse US tax consequences can be negated. Left unaddressed, the PFIC regime poses a material risk to the US investor. A failure to disclose this material risk may incur a civil liability risk on behalf of the company. The PFIC regime packs a punch and should not be discounted.

CURRENT ITEMS OF INTEREST

Interest Rates for Second Calendar Quarter

The CRA announced the prescribed annual interest rates applicable to amounts owed to/from the CRA for the second calendar quarter (April 1–June 30, 2017). None of the rates have changed since last quarter except for the rate applicable to corporate taxpayers' pertinent loans or indebtedness, which is 4.47% (down from 4.50% for the first quarter).

CRA Introducing ReFILE

The CRA has launched its new ReFILE service, which allows EFILE service providers to send T1 adjustments electronically for the 2015 and 2016 tax years. This service basically allows for changing the same lines on a return that individual taxpayers can change through *My Account*. Since ReFILE is intended to replace filing T1 Adjustments on paper, adjustments will hopefully be processed more quickly. For more information on the new service see: http://www.cra-arc.gc.ca/esrvc-srvce/tx/bsnss/rfl/menu-eng.html

RECENT CASES

Corporate documentation rectified, but without a declaration that such documentation having retroactive legal effect

The appellant Anderson was the sole director and shareholder of the corporate appellant (the "Company"). The Company was advancing money to Anderson by way of a shareholder loan, and the Company's accounting advisors (the "Accountants") were concerned that this loan could result in deemed income in Anderson's hands for 2011. The solution proposed by the Accountants in October 2011, was a section 85 rollover involving the transfer by Anderson to the Company of land and equipment owned by him personally. Nothing was documented, however, until May 2013, when the Accountants instructed the Company's lawyers to prepare the necessary documentation implementing the section 85 rollover. This was done in a series of documents dated January 1, 2011 and executed in June 2013. After examining this documentation, the CRA determined that a proper section 85 rollover had not been accomplished. As a result, a reassessment would likely result in a substantial increase in Anderson's taxable income. The appellants therefore sought rectification from the Court of Queen's Bench for Saskatchewan on the ground that the documentation executed in June 2013 allegedly did not reflect the oral agreement reached in 2011. The Chambers judge rectified the documents by correcting the specified effective date from January 1, 2011 to October 6, 2011 but declined to declare them to be retroactively legally effective and binding as of October 6, 2011, as the appellants had requested. However, he did not see the equitable remedy of rectification as being available to change the erroneous dates in the corporate documents (i.e., the corporate resolutions and share certificates), saying that they were not agreements that failed to reflect the intention of the parties. Conversely he determined that he had the authority to correct the documents under the provisions of section 236 of the *Business Corporations Act*. The appellants appealed to the Court of Appeal for Saskatchewan.

The appellants' appeal was dismissed. The documentation in this case was in fact rectified. But the appellants were seeking a secondary remedy, which was to have the Court declare the rectified documentation as having a decided legal effectiveness as of a specific date. In refusing to make such a declaration the Chambers judge correctly recognized that such a declaration was "an attempt to bind the CRA in such a fashion as to prevent the Tax Court of Canada from reviewing any eventual appeal of a reassessment". Under section 12 of the *Tax Court of Canada Act*, the Tax Court has exclusive original jurisdiction to hear appeals relating to federal income tax assessments. Accordingly the Chambers judge properly limited his decision in this case to the issue between the appellants themselves. He correctly identified the intended purpose of their application and recognized the specialized nature of the Tax Court and its jurisdiction to decide the ultimate issue concerning the tax implications of the rollover in question, and the effectiveness of the tax planning activity of the appellants. He therefore correctly declined to pronounce on that issue. As a result the documents were rectified but the tax effect of those corporate documents would fall to be determined by the Tax Court, and not by the Chambers judge who lacked the jurisdiction to assess such tax effect.

¶49,613, *Anderson v. Benson Trithardt*, 2017 DTC 5022

Order requiring taxpayer to provide information upheld

The taxpayer was appealing a Federal Court order requiring it to comply with requests for documents and information issued against it during an audit. The taxpayer refused to comply, arguing the request was subject to legal professional privilege and the Federal Court committed a reviewable error. For the Federal Court of Appeal to intervene the taxpayer must show that the Federal Court erred in law or on legal principles or committed a palpable and overriding error on a question of fact.

The appeal was dismissed. Proving a palpable and overriding error is a high standard to meet and the taxpayer failed to meet that burden. The taxpayer raised a new argument, purely legal in nature, based on Supreme Court decisions released since the date of the Federal Court order. The respondent had no objection to the argument being raised and as further evidence was not needed to raise the argument, it was acceptable. The Supreme Court decisions held that the requirements to provide information do not apply to lawyers or notaries. As the request for information was made to the taxpayer, who is neither a lawyer nor a notary, the decisions do not impact the taxpayer. The taxpayer also raised the argument that the Federal Court order directly or indirectly ordered the taxpayer's law firm to disclose information in contravention of the Supreme Court decisions. The Federal Court order was directed only against the taxpayer, requiring it to disclose all documents in its power, possession or control. The concern of the Supreme Court was that requests issued against lawyers could subvert a client's legal professional privilege. However, the taxpayer had a full opportunity to contest issues relating to legal professional privilege and that privilege was fully respected.

¶49,608, *Revcon v. MNR*, 2017 DTC 5019

Tax Court judge recusing himself as case management judge

A Tax Court judge was appointed as the case management judge in respect of appeals brought by three taxpayers. While the appeals were outstanding, the judge attended a conference reception sponsored by a law firm which was involved in the appeals. That fact came to the judge's attention through media reports, and he was also advised that a preliminary investigation into the matter had been commenced by the Canadian Judicial Council. The Tax Court judge determined that it was necessary, in the circumstances, for him to recuse himself from further action as case management judge for the appeals.

Order issued providing for recusal. The Tax Court judge held that where there was an investigation into his conduct specifically connected with the appeals before him, his purpose as a servant of the Court in the appeals had been questioned. There was, consequently, justification and cause for his recusal. As well, although he had not to date been asked to rule on any matters in dispute with respect to the appeals, the requirement for him to do so could arise in the future, providing another reason for recusal. The judge issued an order providing for his recusal and providing for the return of the matters to the Chief Justice of the Tax Court of Canada for assignment to a new case management judge.

¶49,611, *Cooper v. The Queen*, 2017 DTC 1017

Plaintiffs granted judgment against their legal representatives who had failed to protect them from tax resulting from conveyance to them of property owned by non-resident without previously obtaining section 116 certificate

The plaintiffs purchased real property (the "Property") and engaged the defendant and the defendant notary corporation to complete the conveyance of the Property to them. The engagement letter provided, in part, that the defendants would "negotiate appropriate closing undertakings" with the vendor's solicitors, and would "make inquiries as to the residency status of the Seller pursuant to the *Income Tax Act* as required". The seller, CEIR, was a creditor of the registered owners of the property, and had conduct of the sale pursuant to a Court Order. CEIR refused to sign the statutory declaration provided to them by the defendants concerning the residency status of the registered owners of the Property on the grounds that the sale was a court ordered one, and that their client was neither the vendor nor the owner of the Property. The defendants, however, proceeded with the conveyance of the Property despite not having any indication as to whether the registered owners were non-residents of Canada. The CRA subsequently assessed the plaintiffs for $695,000 on the ground that no certificate of compliance with the non-resident provisions of section 116 of the Act had been obtained. In an action for damages instituted against the defendants in the Supreme Court of British Columbia, the plaintiffs applied for summary judgment, and for an award of damages to be assessed. The defendants applied for an order permitting them to deliver a third party notice against the defendants.

The plaintiffs' application was granted, and the defendants' application was dismissed. The defendants agreed to make "reasonable inquiry" concerning the section 116 certificate of compliance issue, but failed to do so. As a result, the plaintiffs were assessed for non-compliance with section 116 because at least one of the registered owners of the Property was not a resident of Canada at the time when title to the Property was conveyed to them. Conversely, the defendants were refused an order permitting them to institute third party proceedings to recover damages from CEIR, its lawyers, and others because of the following factors: (a) the lengthy delay by the defendants in applying for such an order; and (b) the forceful submission by the proposed third parties (with which the Court agreed) referring to the significant legal deficiencies in the defendants' draft third party material, and to the fact that, in the third parties' view, the proposed third party proceedings against them would be bound to fail. It was also left to the defendants to take advice as to whether they ought to bring a separate action.

¶49,609, *Mao and Li v. Liu et al.*, 2017 DTC 5020

INTERNATIONAL NEWS

US Tax Reform Timetable Uncertain, Spicer Says

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 229.

White House Press Secretary Sean Spicer has discussed the timetable for US tax reform.

His comments follow the setback to US President Trump's plans following the decision to pull the American Health Care Act ("AHCA") prior to a vote.

Speaking on March 27, Spicer was asked about Treasury Secretary Steven Mnuchin's comments that tax reform could proceed in August. Spicer cited the large number of stakeholders that would be involved in the process as potentially constraining that deadline.

He said: "I know that Secretary Mnuchin has talked about August as a target date. And I think it depends. I mean, as you point out, these are big things. There's a lot of groups that are going to want a ton of input because of the very nature that it's been 30 years. But I think part of this is going to be dependent on . . . the degree to which we can come to consensus on a lot of big issues. But I know that we have a goal and it will depend on a lot of these issues, both on the corporate side and on the individual side, how that process evolves."

With health care reform shelved, Trump has said that tax reform is now a priority.

However, business leaders are skeptical that US tax reform can be achieved quickly. In a recent KPMG survey, more than half of respondents (53 per cent) predicted that significant business tax reform will not arrive until 2018. Only 16 pe rcent of more than 1,000 respondents polled during a recent webcast expect tax reform to be achieved in 2017, while 11 per cent do not expect reform until 2019, and 21 per cent said they are unsure of when tax reform might be achieved.

Hong Kong's New Chief Executive To Pursue Competitive Tax Regime

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On March 26, Carrie Lam was elected Hong Kong's new chief executive, with a promise that she would pursue a "new tax policy direction" in the territory.

In her manifesto, Lam promised to maintain Hong Kong's simple tax regime and low tax rates, and to encourage research and development ("R&D"), which accounts for a small proportion of the territory's gross domestic product ("GDP") relative to Hong Kong's regional peers.

She said Hong Kong should introduce additional tax breaks for R&D expenditure to ensure its regime is competitive with other territories. Additional tax deductions may also apply to spending on environmental protection initiatives, culture, arts, and design, she said, to promote the development of these industries.

Lam also promised a reduction in the tax burden for small, medium-sized, and startup enterprises. She said she would look to lower the tax rate from 16.5 per cent to 10 per cent on the first HK$2 million (US$257,460) of a company's profits.

She said the territory would consult with stakeholders on any changes, and also seek to expand its double tax agreement network.

MEPs Approve Hybrid Mismatch Proposals

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Members of the European Parliament's Economic and Monetary Affairs Committee have backed proposals to further tackle hybrid mismatch arrangements.

Such mismatches can result in either double deductions for the same expense, or deductions for an expense without the corresponding receipt being fully taxed. Hybrid mismatch outcomes can arise from hybrid financial instruments (both equity and debt) and hybrid entities, and from arrangements involving permanent establishments. They can also arise from hybrid transfers and dual resident companies.

The latest measures to tackle hybrid mismatches follow the adoption of measures that focused solely on transactions involving only companies resident in EU member states. The intention of the new proposal is to capture all hybrid mismatch arrangements where at least one of the parties involved is a corporate taxpayer in a member state.

The proposal is now moved to the European Council for consideration. The measure would be applied throughout the EU from 2019 as part of the new Anti Tax Avoidance Directive.

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