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CROSS-BORDER INVESTMENTS STRATEGIES:
THE RIGHT ENTITY & THE RIGHT CAPITALISATION

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PROLOGUE

The globalisation of trades and convolution of financing arrangements, require the understanding of international taxation rules. Hence, this essay will stress different fiscal features of cross-border investment strategies. The critical purpose of this essay is to assist investors in the choice of the right entity and the right capitalisation while investing abroad.

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Finally, footnotes and bibliography references included in this essay follow the guidelines provided by *La recherche en fiscalité canadienne*, par Marie-Pierre Allard, Carswell, 2008.

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TABLE OF ABRIVIATIONS

BLT	Branch level tax
Can-Us Convention	Canada US Convention on Taxes Income & Capital C-Corp
CND	Canadian dollars
CRA	Canada Revenue Agency
DEA	Dividend equivalent amount
D/EQ	Debt/Equity ratio
EQ	Equity
E&P	Earnings and profits
E/S	Earnings per share ratio
ESR	Earning stripping rule
IRC	Internal revenue code (United-States)
IRS	Internal revenue services
ITA	Income Tax Act (Canada)
LLC	Limited Liability Company
M&A	Mergers and acquisitions
NOL	Net operating losses
OECD	Organisation economic co-operation development
OECD Model	OECD model tax convention on income and on capital
RMV	Real market value
ROI	Return on investment
RP	Reinvested profits
S-Corp	S Corporation
USD	United state dollars

INTRODUCTION

In a world characterised by global exchanges and complex investment structures, the understanding of international taxation fundamentals is an essential requirement for any legal practitioner who evolves in the environment therein. Therefore, the following essay will highlight different aspects of cross-border investment strategies. The ultimate object of this essay is to help investors become conversant with the different concerns regarding the choice of the right entity and the choice of the right capitalisation.

Pertaining to the choice of the right entity surrounding a foreign investment, two options are available to a corporation willing to expand its market abroad (1). The implantation of a corporate branch is the first option offered for outbound investments (1.1). Alternatively, the parent corporation may penetrate a novel market by the creation of a subsidiary in the host jurisdiction (1.2). Thus, prior to a foreign investment, a subtle analysis of relevant factors pertaining to the characterizing elements of the respective structures shall be made (1.1.1; 1.2.1). Consequently, elements such as the benefits (1.1.2; 1.2.2), the disadvantage (1.1.3; 1.2.3) and the inherent tax consequences of each arrangement shall not be disregarded (1.1.4; 1.2.4). As a result, tax planning shall be established in accordance with the previously stated elements and with the needs of the case at issue (1.1.5; 1.2.5).

Subsequently, corporations ready to expand their market abroad shall opt for the right kind capitalisation which will increase financial effectiveness (2). The financing of the foreign investment may occur by way of debt (2.1) or alternatively by means of a capital investment (2.2). Thus, an assessment of the relevant factors regarding the characterizing elements of each form of capitalisation shall be made (2.1.1; 2.2.1). Moreover, prior to the investment, corporations shall evaluate the benefits (2.1.2; 2.2.2), the disadvantages (2.1.3; 2.2.3) and the tax considerations of the respective modes of investments (2.1.4; 2.2.4). Accordingly, tax planning shall be pursued in

correlation with the previously depicted rudiments and the needs of the case at issue (1.1.5; 2.1.5).

Ultimately, subsequent to effectuating the business decisions related to the choice of the right entity and the choice of the right capitalisation, a favourable investment strategy must be established (3). While structuring the appropriate transactions, tax and legal counsels must focus on avoiding the reclassification of debt as equity by fiscal authorities (3.1). Thus, tax specialists shall draft financial instrument, which correlates with the previously portrayed elements characterizing each form of capitalisation (3.1.1). Additionally, tax counsels shall provide corporations with the relevant documentation surrounding yield transactions (3.1.2) and ensure effective follow-trough (3.1.3). Moreover, while investing abroad, the rules regarding to the repatriation of foreign earnings shall be kept in sight (3.2). Focus will be made on key features of the foreign affiliate regime such as the foreign active business income rule (3.2.1) and the foreign accrual property income rule (3.2.2). Furthermore, as interest deduction is the rudiment of most corporate tax planning's, fiscalists ought to be aware of its legislative limitations (3.3). In a will of protecting their respective tax bases, most developed countries provide for rules limiting the interest deductions such as inclusion/deduction matching rules (3.3.1) and earning stripping rules (3.3.2). Finally, appropriate comments will be made pertaining to tax planning (3.4).

While terminology may deferrer among different countries, fundamentals are essentially analogous. The similarity in taxation policies is due to the commitment of countries to attract foreign investments on one hand and the determination of preserving their fiscal base on the other. Explaining the technical differences in the application of the referred rules in respect with each country would be dreadfully exhaustive. Consequently, to curtail the analysis, the terminology in this study will merely refer to the vocabulary established by the American Internal Revenue Code.[1] Accordingly, the United–States will be the contracting state hosting the investments and investors will be established residents of the contracting states of Canada. In accordance, references will be made to relevant bilateral tax treaty agreed upon by

[1] *Internal Revenue Code*, Title 26 of the U.S. Code (26 USC) (hereinafter IRC)

the concerned states.[2] Furthermore, acknowledging that international tax treaties habitually follow OECD guidelines, references will also be made to the OECD model tax convention on income and on capital.[3]

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[2] *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital*, 26 September 1980, SC 1984, c 20, Part I as amended by the protocols done in 1983, 1984, 1995, 1997 and 2007 (hereinafter Can-U.S. Convention)

[3] *OECD Model Tax Convention on Income and on Capital*, Paris, 2010 (hereinafter OECD Model)

1. THE RIGHT ENTITY

Prior to investing capital abroad, choosing the legal mechanism thought which the investment shall be executed is quintessential. Two main options are available pertaining to foreign investments. First, the extension of the corporation may be made by means of a corporate branch. Secondly, the parent corporation may establish a distinct subsidiary abroad.

1.1 Branch

Extending the corporation by way of a corporate branch shall require minimal legal framework and is the least complex scheme for investing in a foreign country. Therefore, the corporate branch approach of market penetration will be stress initially. From an American standpoint, the two main types of branch structure available are proprietor ship and partnership.

1.1.1 Characterizing elements

In relation with cross-border investments, a corporate branch has three key distinctive elements. The most significant characteristics pertaining to a branch in a foreign investment environment are the absence of legal personality (1.1.1.1), the fiscal transparency (1.1.1.2) and the fact that it creates a permanent establishment (1.1.1.3).

1.1.1.1 Absence of legal personality

The focal feature characterizing a branch structure is its economic extension of the existing corporation in the target country. Accordingly, in the presence of a branch structure there is absence of a distinct legal entity with the mother corporation. The head corporation extends its business operations abroad without the creation of a separate legal vehicle. As a result, the branch is not a legal person and is not doted of a distinct patrimony.

1.1.1.2 Fiscally transparent entity

A branch is a fiscally transparent entity creating a flow-thought structure. Consequently, it has no fiscal residency in the country where it is located. Therefore, a country has no basis of taxation on branch. Nevertheless, the majority of tax treaties provide that business profits attributable to a permanent establishment may be taxed in the host country. Thus, the OECD Model,[4] the Can-U.S. Convention [5] and also most of most bilateral tax treaties, grants a legal tax base to the benefit of the host country of a fiscally transparent entity provided that a permanent establishment is created therein.

1.1.1.3 Creation of a permanent establishment

For the purposes of numerous tax treaties, the term "permanent establishment" is explicitly defined as a fixed place of business through which the business of a resident of a contracting state is wholly or partly carried on in the other contracting state.[6] Furthermore, bilateral tax conventions create irrefutable presumptions regarding places through which a business is carried. Accordingly, every relevant tax treaty in occurrence delineate that the term "permanent establishment" explicitly includes a branch.[7]

1.1.2 Benefits

There are various beneficial considerations regarding a branch structure. Pertaining to a legal and tax perspective, the benefits among others are the absence of a legal framework (1.1.2.1), ability to offset the entity's profits with its losses (1.1.2.2) and the creation of a corporate synergy (1.1.2.3).

1.1.2.1 Absence of a legal framework

Usually, a branch does not require registration requirements since it is the extension of a pre-existing corporation. Considering that a creating a branch structure does not entail the complexity and the fees related the registration of a corporation, cost effectiveness is increased accordingly. In reason of its informal requirements and the lack of a legal framework, a branch is often used as a default structure.

[4] Can-U.S. Convention, *supra* note 2, art. 7
[5] Can-U.S. Convention, *supra* note 2, art. 7
[6] Can-U.S. Convention, *supra* note 2, art. 5 (1); OECD Model, *supra note* 3, art. 5(1)
[7] Can-U.S. Convention, *supra* note 2, art. 5 (2) b); OECD Model, *supra note* 3, art. 5(2) b)

1.1.2.2 Offset of entity's profits

Generally, the first years of a new business are devoted to product and market development. Therefore, the initial years of a new trade are usually non profitable. Hence, the prevalent benefit of operating through a branch resides in the fact that the head corporation may immediately use its branch's deficits in opposition of its worldwide income. Provided by its fiscal flow-through feature, losses attributable to a branch are allowable against the entity's global earnings. Consequently, the corporate group will acquire the immediate benefit of a branch's accounting deficits offsetting its proceeds.

1.1.2.3 Corporate synergy

Whereas a branch is operated through the head corporation within the investor's contracting state, there is only one core administration in this business structure. The presence of a sole head administration is customarily effective resource utilization and creates economic synergy. Accordingly, resource efficacy is not of negligible value for return on investment efficiency.

1.1.3 Disadvantages

Notwithstanding the benefits mentioned previously, in frequent cases, it is preferable to overlook a branch structure due to the weight of the various disadvantages. Without being exhaustive, the most significant drawbacks of a branch are the fact that it is usually forbidden for a branch to carryover losses in the host contracting state (1.1.3.1) and that a branch lacks to offer efficient asset protection to the head corporation (1.1.3.2). Furthermore, the isolation of a branch's financial statements is often a complex task (1.1.3.3). Finally, regulatory requirements of incorporation if any will not be fulfilled (1.1.3.4).

1.1.3.1 Absence of carryover

Although branch losses are allowable to offset the company's profits in the investing contracting state, unless providing otherwise by a tax treaty it is not possible to carryover branch losses in the host contracting state. In accordance, a branch's deficits will be forever lost in the host contracting state. Furthermore, the absence of carryover of losses in the host state unless provide otherwise by treaty is a

considerable disadvantage acknowledging that losses are immensely valuable offsetting a profitable corporation's proceeds. Exceptionally, the Can-U.S. Convention provides for a prospective and timeless carryover of branch losses.[8] The ODCE model tax convention does not provide of the possibility of carrying over branch losses in the host contracting state. Another example is the US-France Treaty, which is silent regarding the possibility of carrying over branch losses.[9]

1.1.3.2 Lack of asset protection

An additional inconvenience of the flow-thought principle related to a branch is the fact that the creditors have a direct claim against the worldwide assets of the head corporation. This aspect is especially considerable when operating a high risk business. The Branch does not shelter the parent corporation from liability incurred by its operations. As a consequence, liability in the host country at the branch level would expose the foreign headquarters to liability. Nevertheless, this disadvantage may also be present with a subsidiary structure as most creditors will require that the parent corporation acts as a guarantor for the subsidiaries undertakings. Therefore, this downside is essentially theoretical and not as much of practical with regards to contractual undertakings.

1.1.3.3 Isolation of financial statements

It is frequently a thorny task to establish the ratio of the effective administrative expenses incurred by the head corporation solely attributable to a branch. Consequently, valuable administrative resources shall be deployed to segregate a branch's financial statements such as balance sheets, treasury cash flows and its income statements. These documents are essential while preparing corporate tax returns. The isolation of financial statements may perhaps be the most salient concern in regards of accounting tasks.

1.1.3.4 Regulatory requirements of incorporation

Some public regulations in the host contracting state may require the entitlement of a licence for the conduct of particular commercial activities. Most often, the beneficiary of a given licence shall be a local corporation. Thus, in the occurrence of a regulation

[8] Can-U.S. Convention, *supra* note 2, art. 10(6) a)

[9] *US-France Income Tax Treaty* signed in 1994 amended by Protocol 2004, art. 10(7) a)

providing for a requirement of a local incorporation, a branch structure will not be feasible and the establishment of a subsidiary structure will be inevitable.

1.1.4 Tax considerations

Although a branch is a flow-through structure, tax treaties provide that, by operating a foreign branch, the fiscal burden will be supported at two echelons. On one hand, a branch will be fiscally liable upon its business profits (1.1.4.1). On the other hand, the earnings and profits yield to the head corporation abroad shall be imposed a branch level withholding tax (1.1.4.2). Consequently, most tax treaties treat a branch and a subsidiary in a similar fashion.

1.1.4.1 Business profits taxation

Most bilateral tax treaties provide a fiscal base for contracting countries regarding the business profits attributable to a permanent establishment.[10] Nevertheless, contracting countries may only tax profits that are attributable to the permanent establishment in occurrence. The political policy providing the fiscal base is justified by the sovereignty of countries to tax income attributable to fixed establishment through which business is carried on arising therein. Therefore, a foreign corporation engaged in trade or business within the United States shall be taxable on its taxable income which is effectively connected with the conduct of a trade or business within the United States.[11] Business profits are usually taxed under the corporate rate represented in the order of 30%, which is analogous among countries. However, several countries implemented a progressive taxation system and preferential tax rates for small businesses. For instance, in the United States the federal corporate tax bracketed is based on income level, with eight corporate tax brackets ranging from a low of 15% for earnings under 50,000 USD to a high of 35% for earnings in exceeding 10,000,000 USD.[12]

1.1.4.2 Branch level tax

A branch level tax (BLT) is granted by most tax convention. The Can-U.S. Convention provides for the possibility for contracting states to tax the earnings of a

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[10] Can-U.S. Convention*, supra* note 2, art. 7(1); OECD Model, *supra note* 3, art. 7(1)
[11] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter N, Part II, Subpart B, sec 882
[12] IRC, *supra note* 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 11 (b)

company attributable to permanent establishments in that State, in addition to the tax, which would be chargeable on the earnings of a company which is a resident of that State, as long as it does not exceed 5%.[13] A BLT is similar to a dividend withholding mechanism and has a double purpose. The BLT protects national economy from the repatriation of profits and it harmonizes the branch and the subsidiary's taxation regimes creating a presumption of a dividend equivalent amount (DEA). The DEA is the result branch's earnings and profits (E&P) minus the reinvested profits (RP) in the host country. [14] This prescription is self explanatory as profits that are reinvested in the host contracting state will not fall in the scope of the BLT. The DEA should be, *ceteris paribus*, equal to the increase of the equity of the parent corporation that is attributable to the branch.[15] Subsequently, the BLT rate is applied to the DEA which provides the BLT.[16] Most tax treaty provides that a BLT shall not be superior then the dividend withholding tax. Accordingly, the BLT rate is usually in the same range of the dividend withholding tax. The Can-U.S. Convention reduces the 30% withholding tax to 5%.[17] Moreover, the contracting states in occurrence, eager to attract foreign investments, have agreed upon a bilateral BLT exoneration on the first 500 000 CND of DEA.[18]

1.1.5 Tax planning

The initial years of the establishment of a business abroad may be deficient in proceeds. Therefore, it is not peripheral to focus on cost effectiveness. As a branch structure does not necessitate the complexity and the legal cost related to the registration of a corporation, this structure might be preferred in the initial years of operation. Furthermore, the possibility to offset the entity's worldwide profits with the deficits that may occur at the branch level in the initial years is not to underestimate. Consequently, when structural fees are an issue, this uncomplicated method of operating shall be recommended to corporations desiring to expand in a new market while predicting initial deficits.

[13] OECD Model, *supra note* 3, art. 10 (6)
[14] E&P - RP = DEA
[15] ↑EQ = DEA
[16] DEA x BLT% = BLT
[17] Can-U.S. Convention, *supra* note 2, art.10(6)
[18] Can-U.S. Convention, *supra* note 2, art.10(6) d)

1.2 Subsidiary

In contrast with a branch, a subsidiary has a distinct patrimony from the parent corporation. Thus, it will require a heftier legal framework regarding its establishment. The following sections will stress the relevant legal and fiscal aspects concerning subsidiaries. From an American standpoint, several different types of corporations are available for foreign investors. The main types of US federal corporate structures are the S Corporation (S-Corp), the C Corporation (C-Corp) and the Limited Liability Company (LLC).

1.2.1 Characterizing elements

The characterizing elements of a subsidiary will be addressed in the first part of this section. The elements regarding a subsidiary that cannot be overlooked are its distinct legal entity (1.2.1.1), its fiscal opacity (1.2.1.2) and its fiscal residence in the place of incorporation (1.2.1.3).

1.2.1.1 Distinct legal entity

One of the main features characterizing a subsidiary is its autonomous legal entity. Therefore, a subsidiary is a corporation and its legal personality is distinct from its shareholders. The creation of a distinctive legal vehicle involves the formation of a corporate group.

1.2.1.2 Fiscally opaque entity

In contrast with the fiscal transparency of a branch, a subsidiary is a fiscally opaque entity. The shareholders do not have the legal title of the income generated by a subsidiary since it is a distinct legal vehicle. Consequently, a subsidiary shall bare the annual burden of filing a distinct tax return from its equitable owners. Nevertheless, the IRC provides the S-Corp with a hybrid entity. In consequence, there is no taxation at the entity level for S-Corp structures and the income may flow though to the shareholders.[19] Also, if the U.S. subsidiary becomes members of a group of U.S. corporations affiliated by 80% or more of direct ownership may elect to join in the filing of a consolidated U.S. income tax return. Generally, it is

[19] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter S, Part I, Sec 1363

advantageous to file a consolidated return in order to combine losses of some members with income of other members[20]

1.2.1.3 Fiscal residence

National fiscal policies of host countries provide that the worldwide business profits of a resident corporation of a contracting state will be taxable therein, herein after: Residency Taxation (RT). In the provisions of bilateral tax treaties, the term "resident" means any person that, under the laws of a contracting state, is liable to tax therein by reason of that person's domicile, place of management or place of incorporation.[21] Accordingly, a subsidiary is resident and liable on its worldwide proceeds in the country of its incorporation. A resident corporation is taxed by the United States on its worldwide income, including capital gains, without regard to the source of such income.

1.2.2 Benefits

The attracting benefits of incorporating a subsidiary in a foreign country shall be defined as the ability of carrying over loss in the host country (1.2.2.1), the asset protection offered (1.2.2.2) and the simplicity related to the production of autonomous financial statements.

1.2.2.1 Ability of carryover

Usually, one may carryover losses to precedent and subsequent fiscal years on income return forms. This aspect is a significant benefit where deficits are foreseen. The first years of a new business are often devoted to product and market development. Therefore, the first years of a new business may engender valuable accounting deficits allowable against other proceeds. U.S. tax laws distinguish between net operating losses (NOL) and capital losses. An NOL is the excess of tax deductions over the company's gross income. Subject to limitation, an NOL may be carried back two years and forward 20 years until fully utilized. Capital losses will arise on the disposition of capital assets and may only offset capital gains. To the extent not used in the current taxable year, capital losses may be carried back three

[20] Pannell Kerr Foster, Doing Business in the United States, 2006, on line: Pannell Kerr Foster: http://www.pkftexas.com/default/pkf/Documents/DoingBusinessintheUS2006.pdf

[21] Can-U.S. Convention*, supra* note 2, art. 4(1); OECD Model, *supra note* 3, art.4(1)

years and forward five years.[22] These losses will be beneficial save as otherwise provided by the change of ownership rules, which limit the amount of allowable deductions attributable to carryover losses acquired by way of M&A.[23] Consequently, many M&A are attributable to fiscal deficit acquisitions.

1.2.2.2 Asset protection

The asset protection increases in importance in correlation with the enhancement of one's contractual obligations. Therefore, the relevance of asset protection will raise with the growth of the corporation. In a subsidiary structure, only the assets belonging to a subsidiary shall be available to its creditors in the occurrence of an insolvency. Nevertheless, most creditors will require that the parent corporation acts as a guarantor for the subsidiaries undertakings.

1.2.2.3 Distinct financial statements

The distinct entity characteristic of a subsidiary implies the production of autonomous financial statements. The absence of establishment of corporate ratios regarding the foreign subsidiary's expenses simplifies the task of the corporation accountants.

1.2.3 Disadvantages

The inconveniences related to operating a business in a foreign country through a subsidiary are confined in the legal framework required for its incorporation (1.2.3.1), the absence of offset since its losses are unallowable against entity's profits (1.2.3.2) and the absence of corporate synergy (1.2.3.3).

1.2.3.1 Legal framework

The creation of a subsidiary in a foreign country will frequently imply complex legal frame work. As registration compliance requisites may differ from one county to another and from state to state, investors shall consult legal practitioners to fulfil the different requirements. Consequently, the cost related to the legal fees will negatively affect the return on investment (ROI).

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[22] Pannell Kerr Foster, *supra note* 20

[23] Change of ownership rules apply when initiator of M&A had less then 50% of EQ before transaction. The application of this rule is also subject to a change of ownership to the extent of 50% of EQ or more in 3 years. Annual limit = RMV (of corporation acquired) x prescribed rate (4%).

1.2.3.2 Absence of offset

The main disadvantage of the implantation of a subsidiary is the absence of offset possibilities. Consequently, when creating a subsidiary, it is crucial to expect profits in a close future. As mentioned previously, many M&A are attributable to accounting deficit acquisitions and may mitigate this disadvantage. Save as otherwise provided by the control acquisition rules which limit the amount of deductions attributable to carryover losses acquired by way of M&A, this remedial alternative, may be suitable in various situations.

1.2.3.3 Absence of corporate synergy

As a subsidiary shall most probably have its own administration, the support an additional head office will cause a lack of financial effectiveness for the corporate group. Furthermore, the cost related to the framework attributable to the incorporation of a subsidiary may comprise the ROI.

1.2.4 Tax considerations

As a branch, a subsidiary will be responsible for paying taxes at two levels. First, the earnings and profits shall be taxed in compliance with the corporate taxation regime (1.2.4.1). Second, a withholding tax will apply on dividend payments made to shareholders residing abroad (1.2.4.2).

1.2.4.1 Corporation tax

As mentioned previously, fiscal legislation of host countries provide that the worldwide business profits of a resident corporation will be taxable therein, herein. A corporation has only one fiscal residence and is taxed on her worldwide profits by the county hosting her residence. Corporate tax rate are usually analogue from one country to another and are approximately represented by a 30% rate. Nonetheless, it is frequent that countries implement a progressive corporation tax regime.

1.2.4.2 Dividend withholding tax

Dividend withholding taxes are provided by most tax treaties and are also provided by the OEDC Model.[24] The Can-U.S. Convention provides for a 5% rate if the beneficial owner is a company which owns at least 10% of the voting stock of the paying company[25] and 15% in cases where the beneficial ownership criteria is not complied with.[26]

1.2.5 Tax planning

A subsidiary structure should be considered when profits are foreseen in a near future. In opposition, if losses are foreseen, save as otherwise provided by the control acquisition rules which limit this remedial alternative may be suitable in various situations.

[24] OECD Model, *supra note* 3, art. 10(2)
[25] Can-U.S. Convention, *supra* note 2, art.10(2) a)
[26] Can-U.S. Convention, *supra* note 2, art.10(2) b)

2. THE RIGHT CAPITALISATION

Among fiscal planners, it is unequivocal acknowledgement that debt is a tax effective method for investing in a corporation. Debt is the investment instrument of choice in regards with tax efficiency, due to the deductibility of interest expenditures. In accordance, this analysis will emphasise on debt instruments and planning techniques to avoid the reclassification of shareholder debt as equity.

Caused by the tax advantages that make debt more attractive to corporate taxpayers, shareholder advances are often reported as debt, when they more closely bear a resemblance to equity. The concern frequently arises when a taxpayer clams interest deduction on a debatable shareholder capital advance, or when a shareholder claims a deduction for an irrecoverable business debt, rather than a capital loss for rubbish stock. The numerous court cases addressing the debt-equity question provide evidence of the ambiguity that surrounds it.[27]

Tax authorities are always extremely careful when determining whether the interest payment is due to an effective loan and not to equity investment. This determination is crucial for revenue agencies because the interest deduction reduces the tax bases of countries by reducing corporate taxable income. For the corporation, this qualification is also critical since if the given amount is considered an investment in the equity of the subsidiary instead of a loan, the sum paid by a subsidiary to the head corporation will be requalified as a dividend. Therefore, payments shall not be deductible for a subsidiary. Furthermore, a dividend withholding tax shall apply to the paid sum. If the sum is qualified as interest payments there will often be an absence of withholding liabilities since to promote foreign investments, most tax treaties reduce to 0% the withholding on interest payments.

[27] Numerous factors have been used by the courts to evaluate debt-equity cases. The IRS, Field Service Advisory, 200205031, February 2002, describes 12 factors that the Tax Court has relied on ever since to decide whether a debtor-creditor relationship exists. These factors have mainly been incorporated in IRC sec 385.

2.1 Debt

Dept may be defined as money or services owed to a third party. Furthermore, it is a legal obligation of the business arising either from written or oral agreement. Debt Instruments may provide for, short-term, medium-term or long-term of reimbursement. As for its economical substance, debt is established by subtracting the entity's assets from its equity.[28]

2.1.1 Characterizing elements

Courts and tax authorities have determinate many elements that are acknowledgeable while characterizing a debt instrument.[29] In most cases, the parties' intent (2.1.1.1) and the instrument's label (2.1.1.2) are addressed initially. Afterwards, considerations such as the relationship between parties (2.1.1.3); similar loan alternative (2.1.1.4); the presence of a principal and interest rate (2.1.1.5); a fixed term of refund (2.1.1.6); the right to enforce payment (2.1.1.7); and the prior claim criteria (2.1.1.8) are analyzed while qualifying investments.

2.1.1.1 Parties intent

A starting point for determining whether an investment in a corporation is debt or equity is the intent of the contracting parties. This intent may be reflected by the balance sheet classification of the contribution by the corporation. The instrument's label has also been a decisive factor in determining the parties intent.[30]

2.1.1.2 Instrument label

The title of the instruments underlying the investment contract is not always sufficient evidence of substance, but has been a decisive factor in proving the parties intent. Nevertheless, authorities are not bound by the parties contractual undertaking. In the characterisation of investment instruments, courts and authorities always favour substance over form.[31]

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[28] Assets – Equity = Debt

[29] *Estate of Travis Mixon, Jr.* v. *Commissioner, (1972) FCA,464 F.2d 394 (5th Cir.); Laidlaw Transportation, Inc. v. Commissioner* (1998) United States Tax Court, T.C. Memo 1998-*232; CRA interpretation bulletin IT-533, "Interest Deductibility and Related Issues " (October 31st 2003) and IRS Field Service Advisory 200205031 (2) (FSA 2002)*

[30] *Joseph Nachman* v. *Commissioner*, (1996), *United States Tax Court*, TC Memo 1996-288

[31] *Supra* note 29

[31] *Stubart Investments Ltd. v. R.*, *[*1984*]* 1 R.C.S. 536; Gloucester Ice & Cold Storage Co. v. Commissioner, (1962), FCA, 298 F.2d 183 (1st Cir.)

2.1.1.3 Relationship between parties

Authorities may analyze particular factual situations to see if a debtor-creditor relationship exists or if a corporation-shareholder relationship has been established. The shareholders relationship with the corporation tends to be fiduciary while the creditor's relationship with the corporation is an arm's length transaction. Whereas investors are third parties and do not hold equity positions in the corporation, there is a rebuttable presumption providing that the investment is debt.[32]

2.1.1.4 Similar loan alternative

The likelihood for the corporation to obtain a similar financing loan from an outside lender with the arm length principle with the same terms and conditions will create a presumption in favour of a debt.[33] This factor shall be particularly relevant in situations of leveraged buyouts where a corporation is facing financial distress and has difficulties to obtain an arm's length loan.

2.1.1.5 Principal and interest rate

A principal sum and a fixed market rate of interest are required for the qualification of a debt. The rate shall be reasonable and can be determined by comparing the rates offered by third party creditors. Parties implicated in loan transactions must be aware that a high rate of interest may be interpreted as a constructive dividend.[34]

2.1.1.6 Fixed term of refund

One of the major characteristic of debt is the expectation of definite repayment by creditors. On the other hand, the contributions of capital investors are open-ended commitments. In general, external creditors would not agree to the absence of a maturity date or demand feature when advancing funds. Thus, the presence of a fixed maturity date has been held to presume debt.[35]

[32] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 385 (b)
[33] *IRS Field Service Advisory 200205031 (2) (FSA 2002), # 10*
[34] *Indmar Products Co., Inc.* v. Commissioner (2006), FCA, 444 F3d 771 (6th Cir.)
[35] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 385 (b) 1) and *supra* note 33, # 12

2.1.1.7 Right to enforce payment

A debt instrument must give the right to enforce payment without contingencies. An unconditional promise to pay on demand or on a specific date is a quintessential characteristic of a debt transaction.[36] Therefore, an instrument failing to create binding obligations will not be recognized as debt.[37]

2.1.1.8 Prior claim criteria

If the investment redemption does provide a prior claim or subordination, there will be a presumption of debt.[38] Subordination to or preference over other financial liabilities of the corporation identifies arm's-length transactions. If the terms subordinate a shareholder's debt to that of outside creditors, the transaction may be qualified as equity.[39]

2.1.2 Benefits

Several considerable benefits are obtained by using debt as an investment instruments. Among others: Interest deduction (2.1.2.1); the maintenance of powers (2.1.2.2); the profit of financial leverage (2.1.2.3); and the maximisation of earnings per share (2.1.2.4) are of significant benefits.

2.1.2.1 Interest deduction

Amid all benefits pertaining to financing thought debt instrument, the possibility of deducting the interest expenditures from the issuer's taxable income is the most noteworthy. In accordance, most countries allow corporations to deduct from their taxable income the interest expense incurred in the course of the operation of their business.[40] This allowable is by far the cornerstone of most corporate tax pacifications.

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[36] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 385 (b) 1) and *supra* note 33

[37] *Benjamin D. Gilbert* v. Commissioner *(1957) FCA,* 248 F2d 399 (2d Cir.);

[38] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 385 (b) 2); Supra note 33, # 6

[39] Universal Racquetball Rockville Centre Corp. v. *Commissioner*, (1986), *United States Tax Court*, TC Memo 1986-363

[40] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 163;
Income Tax Act, RSC, 1985, c 1 (5th Supp), 8(1)(g) 20 (1) (c); *Stubart Investments Ltd. v. R.*, *[*1984*]* 1 R.C.S. 536; *Ludco Enterprises Ltd. v. R., [2001] 2 R.C.S. 1082*

2.1.2.2 Powers maintained

By definition, a dept instrument does not attribute voting rights to the owner of the instrument. Thus, the issuing of a dept instrument has no impact on the ratio of detention of voting rights. This method of raising capital has no incidence on the internal management and maintains third party investors out of the policy making processes.

2.1.2.3 Financial leverage

Exploitation and usage of third parties assets shall permit a corporation to maximize the return on its own resources. Financial leverage has the purpose of increasing internal return on investment results. Consequently, this mechanism may have a harmful impact on the corporation if the outcome of the return of leveraged investments is negative. In accordance, the present financial crisis was substantially caused by the treacherous claws of leveraged investment instruments.

2.1.2.4 Maximisation of earnings per share

Return on investment is the corner stone of all shareholders requirements. Accordingly, maximization of earnings per share is quintessential for corporation willing to attract investors. As mentioned above, the issuing of dept instruments is absent of any impact on the detention of shareholding and the market capitalization of the corporation. In consequence, financing via loans maximizes earnings per share.

2.1.3 Disadvantages

The corporation's respective situation shall unequivocally determinate to which extent some disadvantages will affect it. The main disadvantages of a dept instrument are the solvency requirement (2.1.3.1); and the interest expenditures (2.1.3.2).

2.1.3.1 Solvency requirement

In contrast with equity, in manners of obtaining a loan, solvency requirements shall frequently be met. Thus, banks and investors usually establish specific dept ratios for different industries. Therefore, if a corporation is unable to fulfil the established ratio

standards it will not be able to obtain financing from third parties through dept instruments.

2.1.3.2 Interest expenditures

Although interest expenditures are allowable against taxable income, the corporation will incur interest expenses negatively affecting its statement of income. In accordance, financial analysis and assessments shall be carried out in order to determinate if the benefits outweigh the disadvantages of the interest expenditures.

2.1.4 Tax considerations

Many factors are relevant to tax while considering dept instruments. For matters of concision, the present will assess the two main aspects. Accordingly, tax considerations acknowledged in this section will be: the interest deductions (2.1.4.1); and the relevant legal requirements (2.1.4.2).

2.1.4.1 Interest deductions

As mentioned previously, most countries allow corporations to deduct from their taxable income the interest expense incurred in the course of the operation of their business.[41] Therefore, it is crucial for tax planners to make sure that the instruments they create comply with the legal requirements.

2.1.4.2 Legal requirements

In general, interest paid by the company on borrowed money used for the purpose of earning income will be tax deductible.[42] In accordance, the expense must be made in a reasonable optic of an economical benefit for the corporation.[43] As for the usage of the moneys, form overrides economical substance.[44] All countries have the same legal requirement but the applications may differ depending on national courts.

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[41] ibid
[42] Supra note 40
[43] *Ludco Enterprises Ltd. v. R., [2001] 2 R.C.S. 1082*
[44] *Shell Canada Ltée v. R. [1999] 3 R.C.S. 616; Stewart v. R. [2002] 2 R.C.S. 645*

2.1.5 Tax planning

Tax planners shall structure investment transaction in manners increasing the efficiency of financial resources. In accordance, it is beneficial for corporate groups to benefit of two interest deductions for the identical loan. Thus, it is mandatory for fiscalists to try to incorporate a double dip structure[45] or a tower structure[46] to achieve optimal tax efficiency.

2.2 Equity

In opposition with a debt instrument which is a liability owed by the corporation to a third party, equity in a corporation is a right in the residual value of the business. The value of the equity of a corporation is the difference between the assets and liabilities of the corporation.[47]

2.2.1 Characterizing elements

Essentially, the considerations in characterizing equity[48] are: the power criteria (2.2.1.1); the convertibility (2.2.1.2); the effective usage (2.2.1.3); the thin capitalisation rule (2.2.1.4); the Bond/Share detention pro-rata (2.2.1.5); the current assets criteria (2.2.1.6) and finally the Earnings & profits criteria (2.2.1.7).

2.2.1.1 Powers criteria

An adverse effect on any argument favoring debt shall be implied where the obligations terms grants increased authority to the holder. Consequently, equity shall be presumed where a loan gives management authority and/or voting rights regarding the corporation to the holder as it is an equity criteria.

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[45] In Double dip structures the initial interest deduction offsets the parents' source income, while another deduction, claimed in the country in which a subsidiary being financed is located. Therefore, the group enjoys two deductions for what is economically the same expense.

[46] Tower financing structures are chains of holding entities that are used to reduce or eliminate tax on investments from one country into another. The distinctive aspect of a tower structure is its exploitation of hybrid entities. A hybrid entity is one that is treated differently under the tax systems of two or more countries.

[47] Assets – liabilities = equity; *Neuman v. R. [1998] 1 R.C.S. 770*

[48] Estate of Travis Mixon, Jr. *v. Commissioner*, (1972) FCA,464 F.2d 394 (5th Cir.) and *Laidlaw Transportation, Inc. v. Commissioner (1998) United States Tax Court, T.C. Memo 1998-232*

2.2.1.2 Convertibility

A convertible debt instrument is usually a bond that is convertible to equity of the corporation upon the holders will. Where an instrument is convertible into the corporation's stock it is more likely to be classified as equity. The convertibility may be at the discretion of the holder or the issuer and the option may be explicit in the instrument's terms or may be implied when the issuer has the discretion to repay a debt instrument by the use of its own stock. [49]

2.2.1.3 Effective usage

One of the key elements in characterizing a financial instrument is to identify the effective usage of resources by the issuer. Consequently, if the moneys are invested by the issuer on durable and amortizable capital assets, there is a presumption of a debt instrument. In contrast, if the usage is to pay current obligations or inventory the presumption will be in favour of equity.[50]

2.2.1.4 Thin capitalisation rule

Many fiscal authorities and financial institutions have established specific thin capitalisation rules. In the main, evidence supporting that the financial condition of the issuer relies on less than one third of equity will create the presumption that every subsequent investment raising the debt/equity ratio will be considered as capital investment.[51]

2.2.1.5 Bond/Share detention pro rata

Provided that creditors are shareholders, the occurrence of correlation between the percentage of investment and percentage of shares detention may create a presumption. Where a correlation may be identified between the pro-rata of stock holding and the percentage of detention of the corporation's bonds, a there will be a rebuttable presumption favoring equity.[52]

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[49] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 385(b)(4);
in Canada the situation shall be analyzed on a case by case following ITA art. 20(1) f) and Imperial Oil Ltd. And Inco Ltd. V. R, 2006 DTC 6660 (CSC)

[50] *American Offshore, Inc. v. Commissioner (1991) United States Tax Court, T.C. Memo*, 97 TC 579

[51] IRC, *supra* note 1, sec 385-6(f)(3); *Brazoria Cty. Stewart Food Markets, Inc. v. Commissioner,(2001),United States Tax Court, T.C. Memo* 2001-220; *John Kelley Co. v. Commissioner,(1946),United States Tax Court, T.C. Memo*, 326 US 521

[52] *Supra* note 37

2.2.1.6 Current assets criteria

The current asset doctrine evaluates if the corporation has sufficient current assets to reimburse the investment. Where repayment depends solely on the corporation's earnings and profits (E&P), the transaction has the appearance of equity. Oppositely, when repayments are not contingent on E&P and may be reimbursed with the corporation's current assets the investment will be considered as a loan. In accordance, specific ratios have been established as evidence that the company has sufficient liquidity to satisfy issued instrument.[53]

2.2.1.7 Earnings & profits criteria

In contrast with the prior doctrine related to the current assets of the corporation, this doctrine evaluates sufficiency instead of contingency. Consequently, if the corporation does not have sufficient E&P to reimburse the investment the instrument will be acknowledged a capital investment. The evaluation is based on past income statements and future prospects speculations. It is often not problematic if debt is repaid from E&P. The problem arises when repayment is contingent on said E&P.[54]

2.2.2 Benefits

The main benefits prevalent to raising capital through equity may be resumes as followed: The autonomy of issuing dividends (2.2.2.1); the absence of solvency requirements (2.2.2.2); and the investment does not affect ratios (2.2.2.3).

2.2.2.1 Autonomy of issuing dividends

Dividends payment is contingent to a dully adopted resolution by the board of administrators of the issuing corporation. The declaration of dividends must also comply with strict solvency requirement governed by the relevant corporate laws. Therefore, no obligation lies upon the corporation in regards of dividend payment, which is discretionary, save as otherwise provided by a guaranteed and cumulative

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[53] *Nestle Holdings Inc. v. Commissioner,(1995),United States Tax Court*, TC Memo 1995-441

[54] Burilovich, Linda "Planning techniques to avoid the reclassification of shareholder debt as equity" *The Tax Adviser*, December 1st, 2006 available on line at : The Free Library: http://www.thefreelibrary.com/Planning+techniques+to+avoid+the+reclassification+of+shareholder+debt...-a0155919006

dividend conferred by preferred stocks. In the opposite, interest payments are not a yield that is due upon the free will of a corporation, it is a mandatory payment.

2.2.2.2 Absence of solvency requirements

In contrast with the bond market, some capital investors may not require immediate solvency of corporations. Notwithstanding, that investors prefer holding equities of solvent corporations, capital investments are by definition a speculation on future prospects and future growth value albeit absence of solvency warranties.

2.2.2.3 Does not affect ratios

Equitable investments do not affect negatively debt/equity ratios (D/EQ). These ratios shall most likely be evaluated by investors prior to allocating loans to corporations. Moreover, favourable debt/equity ratios are relevant and beneficial for tax purposes in regards with expenditure limitation rules such as the earning stripping rule.[55] Therefore, it is primordial to bear in mind that an investment by way of equity increases the denominator in the D/EQ ratio.

2.2.3 Disadvantages

The most significant disadvantages relevant to equity investments are: The absence of dividend deductions (2.2.3.1); the dilution of voting powers (2.2.3.2); and the negative effect on earnings per share ratios (2.2.3.3).

2.2.3.1 Absence of dividend deductions

Following the Generally Accepted Accounting Principles[56] tax authorities do not allow dividend payments as expenditure for corporations. Thus, the cost of attracting investors for financing through equity will be less favourable from a fiscal efficiency stand point. In opposition with interests which are deductible from the income, dividends are issued from the corporation's net after tax earnings.

[55] See section 3.4.2;

[56] A.K.A GAAP, are accounting rules used to prepare, present, and report financial statements for a wide variety of entities. Generally GAAP includes local applicable Accounting Framework, related accounting law, rules and Accounting Standard. GAAP are imposed by markets and not by tax authorities.

2.2.3.2 Dilution of powers

Additional shareholders amount undeniably to less power for the previous stock owners. Nevertheless, this disadvantage may be dodged by issuing preferred shares, which do not attribute any voting powers. However, preferred shares often offer guaranteed, prior and cumulated dividends which can be an additional financial burden for the corporation and the original shareholders diluting the dividends.

2.2.3.3 Affects' earnings per share ratio

Earnings per share are usually considered as the most influential variable in determining a share's price which is a considerable incentive for investors. It is also a key component used to calculate the price-to-earnings valuation ratio.[57] By increasing the number of shares of a corporation, the earnings per share (E/S) will decrease accordingly. Therefore, if a corporation is willing to conserve a most favourable E/S ratio, the issuing of debt instruments will be preferred.

2.2.4 Tax considerations

Pertaining to tax considerations, it is mandatory to expose that there is no taxation of capital dividends (2.2.4.1). Furthermore, the subject regarding the development of preferred shares will be addressed (2.2.4.2).

2.2.4.1 No taxation of capital dividends

An established policy provides that the return of capital investment and dividends from the capital dividend account[58] shall not be taxed in accordance with the fact that these financial resources have previously been taxed. Therefore, it is relevant to specify that if the dividends issued by the corporations capital dividend account it will not be taxed. It is essential to stress that although return of capital investment is not taxed in the U.S., there is no U.S. counterpart of the Canadian concept of capital dividend account.

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[57] A valuation ratio of a company's current share price compared to its per-share earnings

[58] *Income Tax Act*, RSC, 1985, c 1 (5th Supp) art. 89(1)

2.2.4.2 Development of preferred shares

The financial markets and its solicitor's have developed preferred shares, which have many similar characteristics with debt instruments. Consequent of the development of preferred shares, financial investors may inject funds in a corporation without negatively affecting the D/EQ. As we will address subsequently, the D/EQ ratio is fundamental in matters of earnings stripping rules.

2.2.5 Tax planning

Although the corporation benefiting the investment through the way of equity may not deduct dividends as financing expenditure because they are issued from its net after tax earnings, tax authorities allow the capital investors to reduce their taxable income to the extent of the amount of interests incurred pertaining to the purchase of the equity. Hence, investors should purchase their equity by means of debt as the cost of the loan will be tax deductible, and they will also benefit from financial leverage. Many leveraged buyout or bootstrap transactions are structured in accordance with these principles.[59]

[59] The acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

3. INVESTMENT STRATEGIES

While structuring the proper transactions, tax experts must focus on avoiding the reclassification of debt as equity by fiscal authorities. Thus, tax specialists shall draft financial instrument which correlates with the previously portrayed elements characterizing each form of capitalisation. Additionally, tax counsels shall provide corporations with the relevant documentation surrounding yield transactions and assure effective follow trough. Moreover, the rules regarding to the repatriation of foreign earnings shall be kept in mind. The key features of the foreign affiliate regime are the foreign active business income rule and the foreign accrual property income rule. Furthermore, as interest deduction is the rudiment of most corporate tax planning's, fiscalists ought to be aware of its legislative limitations. In a will of protecting their respective tax bases, most developed countries provide for rules limiting the interest deductions such as inclusion/deduction matching rules and earning stripping rules.

3.1 Avoiding the reclassification of debt as equity

Shareholder advances to corporations are often reported as debt, when they bear a resemblance to equity. The numerous factors previously stressed have been used by the courts to evaluate the debt-versus-equity status, and the volume of cases demonstrates the ambiguity often surrounding the relevant issue at stake. Consequently, tax authorities frequently challenge the classification of shareholder loans to a corporation as equity, rather than debt. The following sections will address different approaches that shall protect debt classification of shareholder advances.

3.1.1 Appropriate drafting

The drafting aspect of a financial transaction is delegated to the parties respective legal representatives. It is essential that the parties' effective intentions are translated in the instrument drafted by their counselors. As mentioned previously

mentioned, the substance of an instrument will outweigh its entitlement.[60] Thus, it is fundamental that the legal representatives draft the appropriate financial instrument to avoid the reclassification of dept as equity.

3.1.2 Documentation

Relevant documentation is constructed by the corporation's financial statements such as its balance sheets, income statements and treasury cash flows and with corporate records such as board resolutions, minute books and tax returns. All these documents reveal many in formations related to the classification of the respective instrument. Thus, it is essential that this documentation is upheld and consequential to avoid the reclassification of dept as equity.

3.1.3 Effective follow-through

Finely drafted documents, where the corporation recorded advances as loans in their accounting records, without proper executed debt instruments will most likely be interpreted by the tax authorities as an indication of capital contributions. The latter conclusion is provided by the doctrine supporting the fact that the transaction's economic substance and not its form will be the relevant indicator for classification.[61] Therefore, many cases requalified these instruments that were not representative of the reality. To assure the proper execution and follow-through of debt instruments the interests payments shall be made effectively. Although investors may be affiliated with the capitalized corporation, loan costs shall be made on a regular base and in a timely fashion to assure the presence of an arm's length transaction.

3.2 Repatriation of foreign earnings rules

The repatriation of foreign earnings earned by a Canadian taxpayer through a controlled foreign affiliate is taxed under a set of rules identified as the controlled foreign affiliate regime. The scope of the regime applies to Canadian taxpayer who detains more than10% interest in a foreign corporation.[62] A controlled foreign affiliate has three sources of income: property, a business other than an active business,

[60] *Supra* note 31

[61] *Supra* note 31

[62] ITA, *Supra* note 58, art. 95(1)

and an active business.[63] Income from an active business is taxed when paid to the shareholder as a dividend. Property income and income from a business other than an active business are taxed on a current basis as foreign accrual property income (FAPI). The following sections will stress the key features of the controlled foreign affiliate regime pertaining to the repatriation of foreign earnings.

3.2.1 Foreign active business income rule

Active business income[64] earned by a foreign affiliate of a Canadian corporation is taxable under the Income Tax Act when it is repatriated as a dividend to the parent corporation. Although dividends from a foreign affiliate are included in the Canadian corporation's income,[65] if they come out of exempt surplus,[66] they can be deducted.[67] Furthermore, dividends from taxable surplus[68] are also included in the Canadian corporation's income, but a deduction is allowed for underlying foreign tax paid by the foreign affiliate and for foreign withholding tax paid on the dividend.[69] The Canadian Income Tax Act provides presumptions regarding the order of distribution of dividends.[70]

3.2.2 Foreign accrual property income rule

The foreign accrual property income[71] rules seek to prevent Canadian resident taxpayers from avoiding tax by earning passive income. The rules provide that a Canadian resident shareholder is taxable on an accrual basis on amounts related to certain types of income earned by controlled foreign affiliates.[72] FAPI income include interest, dividends from other than foreign affiliates, royalties and 50 percent

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[63] ITA, *Supra* note 58, art. 95(2)
[64] ITA, *Supra* note 58, art. 95(1)
[65] ITA, *Supra* note 58, art. 90(1)
[66] Exempt surplus is active business income earned by a controlled foreign affiliate in treaty countries and certain capital gains. Income Tax Regulations, C.R.C., c. 945 (Herein after ITR.), art. 5907(1)
[67] ITA, *Supra* note 58, art. 113(1)(a)
[68] Taxable surplus is generally income earned in non-treaty countries, as well as passive income (FAPI) and certain capital gains. ITR art. 5907(1)
[69] ITA, *Supra* note 58, art. 113(1)(b), (c)
[70] Dividends are normally deemed to come first from exempt surplus, then from hybrid surplus (capital gains on the sale of shares in other foreign affiliates), then from taxable surplus, then pre-acquisition surplus (non-taxable return of capital that reduces adjusted cost base) ITR art. 5901
[71] ITA, *Supra* note 58, defined in art. 95(1)
[72] ITA, *Supra* note 58, art. 90(1)

of capital gains realized from the sale of property that is not excluded property[73] in foreign holding companies. FAPI also includes most real estate income unless the affiliate has more than 5 employees[74] and payments made by a Canadian resident to its controlled foreign affiliates for services.[75] Relief will be provided by any foreign tax paid on the included revenue. A foreign accrual property loss can be carried forward 20 years or back 3 years to apply against other FAPI.[76] The American Internal Revenue Code provides for analogous foreign accrual property income rules.[77]

3.3 Interest deductions limitations

Interest paid by the company on borrowed money used in a reasonable expectation of an economical benefit for the corporation is tax deductible.[78] Nevertheless, tax authorities have established statutory limitation to circumscribe this tax benefit. Explaining the technical differences in the application of the referred rules in respect with each country would be dreadfully exhaustive. Consequently, to abridge the analysis, the terminology will solely refer to the vocabulary established by the IRC.

3.3.1 Matching rule

This rule prevents the debtor to deduct interest expenditure without effectively having wired the payment to the creditor. The relevancy of this statutory rule is justified by the fact that many dept instruments are issued to associated corporations violating the arm's length principle. This rule provides that the creditor's inclusion of the interest income is a prerequisite of the debtor's interest deduction.[79]

3.3.2 Earning stripping rule

The object of the earning stripping rule (ESR)[80] is to protect the fiscal base of the countries so that interest paid to non residents does not strip the entire profits of the corporation out of the country without being taxed. This limits the deductibility of

[73] Such as property used to earn active business income and shares of another foreign affiliate where all or substantially all of the fair market value of the property of that other foreign affiliate is attributable to excluded property.
[74] ITA, *Supra* note 58, art. 95(1); ITR 5900, 5907
[75] ITA, *Supra* note 58, art. 95(2)(b)
[76] ITR art. 5903
[77] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subpart F, sec. 951, 964
[78] *Supra* note 40
[79] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 267
[80] 1° NIE–(50%xATI)=NDI 2° IE–NDI=DI NIE = Net interest expense ATI = Adjusted taxable income NDI = Non deductible Interest DI = Deductible interest

interest paid with to a related party if such interest is not subject to U.S. withholding which is the case in occurrence provided by the Can-U.S. Convention.[81] Additionally the ESR applies if the D/EQ exceeds 1.5 to 1.[82] Even if, a debt-to-equity ratio exceeds 1.5 to 1, a U.S. corporation is allowed interest deductions as long as its cash flow is sufficient to service the existing debt level.[83] Therefore, a U.S. corporation is allowed to deduct all of its interest expense as long as the net interest expenses[84] does not exceed 50% of its adjusted taxable income. The non deductible amount can be carried forward indefinitely.

3.4 Tax planning

It is crucial to recognize that although tax efficiency is the leading aspect of financing for fiscalists, the structure shall primarily foster an effective use of resources. Furthermore, it is necessary to keep in mind that the assessment of the prevalent financing structure will vary following the respective tax and corporate legislations. Nevertheless, Tax planners should focus on interest expenditure deductibility in the creation of their financing structures as this aspect is the cornerstone of optimal tax planning. Hence, financing structures should always try to achieve tax efficiency by using mismatches between legal qualifications, hybrid entities and double dip financing structures.

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[81] Can-U.S. Convention, *supra* note 2, art. 11 (3)
[82] IRC, *supra* note 1, Title 26, Subtitle A, Chapter 1, Subchapter A, Part II, sec 163 (j)(2)(A)(ii): Debt Equity ratio safe harbor
[83] Cash flow safe harbor
[84] Interest expense minus interest income

CONCLUSION

As mentioned previously, in a world characterised by global exchanges and complex investment structures, the acknowledgement of international taxation fundamentals is an essential requirement for any legal practitioner who evolves in the environment therein.

Subsequent to the acknowledgment of the present, tax experts shall be proficient in addressing the different issues pertaining to the choice of entity surrounding a foreign investment. Consequently, is quintessential to bear in mind that the implantation of a corporate branch allows a group to offset taxable benefits. Alternatively, a subsidiary offers enhanced asset protection and provides ease regarding the production of autonomous financial statements.

As stressed in the second section of this essay, corporations ready to expand their market abroad shall opt for the mode of investment between dept and equity in the optic of increasing fiscal effectiveness. The cornerstone of this aspect relies on the deductibility of interest expenditure, which reduces the effective cost of corporate financing by way of dept. Alternatively, investors may be willing to enhance hard resources in their foreign investment providing an increase of the denominator in the dept/equity ratio while benefiting of the discretion provide by dividend payment.

Ultimately, subsequent to the choice of entity and the choice of investment, a favourable investment strategy must be established. Accordingly, tax planners shall analyse the possibility of structuring the financing in ways that enhances fiscal effectiveness. In constructing the relevant transactions, tax counsels shall focus on avoiding reclassification of the instrument by the tax authorities in presence. Moreover, fiscalists analyze possibilities of interest deductions structures respecting the statutory limitation established to confine this shelter.

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