

Tax Summit Week 2021

# TAX

IN MOTION

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# With you today



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## Learning objectives

By the end of this session, participants will be able to:

- Articulate the tax issues associated with investing in Canada and Mexico
- Describe what we might see next in terms of tax reform within the Americas





# UNITED STATES

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Outbound M&A structuring considerations



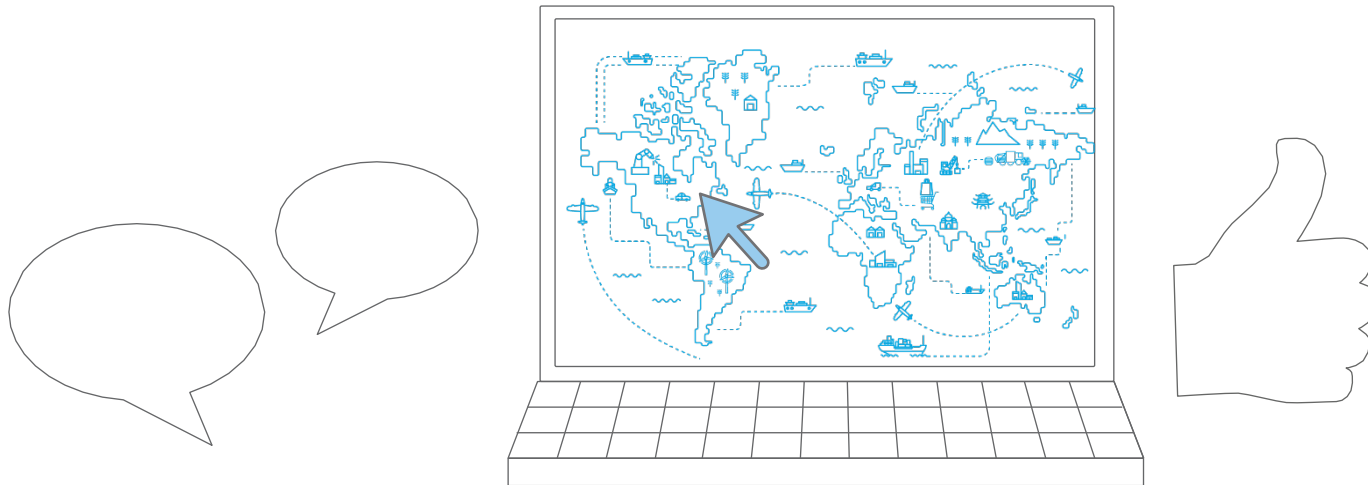
# U.S. debt pushdown considerations

- When financing U.S. operations, the limitations on deductibility of business interest need to be considered.
- IRC section 163(j) generally limits interest deductibility each year to the sum of interest income and a percentage of adjusted taxable income.
- The limit is generally 30% of adjusted taxable income (the Cares Act increased the limit to **50%** for tax years beginning in 2019 or 2020).
- Adjusted taxable income is derived from taxable income with addbacks for depreciation, depletion and amortization for years beginning **before** Jan. 1, 2022.
- For years beginning **after** Jan. 1, 2022, the limitation will be based on taxable income before interest.



# U.S. debt pushdown considerations (cont.)

- Structuring considerations:
  - The current U.S. debt limitations coupled with the increased limitations for years beginning **after** Jan. 1, 2022, are causing U.S. multinational corporations as well as private equity funds to reconsider their financing options when acquiring non-U.S. operations and entities.
  - In order to separately allocate debt to overseas entities and operations, a U.S. acquirer generally needs to separately acquire the non-U.S. assets or entity(s).
  - Structuring and tax modeling (including the projected tax deductibility of acquisition debt) is often undertaken at the start of the acquisition process.



# U.S. anti-deferral provisions for U.S. corporations

- Implications for U.S. multinational corporations of owning controlled foreign corporations (CFCs) under current law:
  - Subpart F income is recognized before GILTI (global intangible low-taxed income), but a high-tax exception is available.
  - GILTI is reduced by a 10% return on active business income (QBAI).
  - Foreign tax credits or a high-tax exception is available to reduce or eliminate the residual U.S. tax on GILTI income.
  - GILTI income is aggregated, and GILTI losses can offset GILTI income.
  - A deduction is available for U.S. corporations that generally result in only 50% of GILTI income being recognized.
  - U.S. corporate taxpayers can pledge non-U.S. assets or stock because they enjoy a dividend received deduction on investment in U.S. property inclusions.





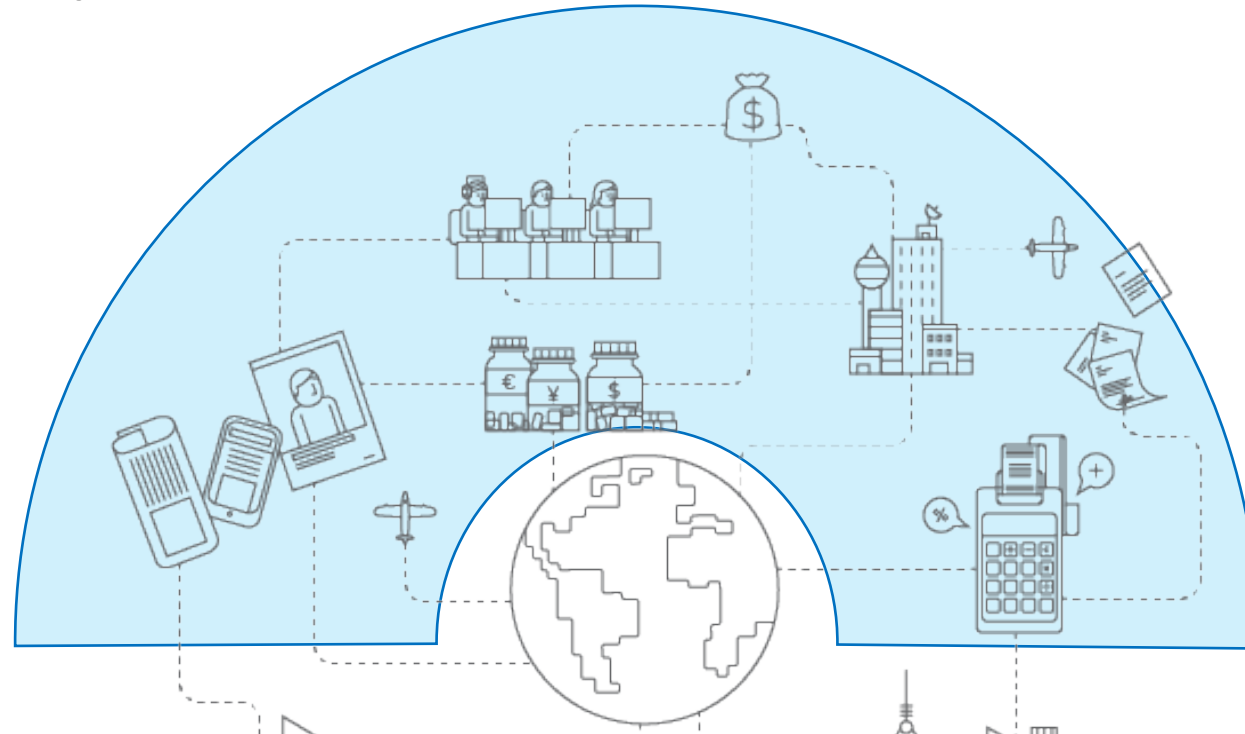
# U.S. anti-deferral provisions for private equity funds

- Implications for U.S. private equity funds owning CFCs under current law:
  - The Subpart F and GILTI inclusion only applies to 10% of U.S. partners.
  - A high-tax exception is available to reduce or eliminate the residual U.S. tax on GILTI income.
  - U.S. individuals do not receive benefit for foreign taxes paid within a foreign corporation.
  - U.S. partnerships that pledge non-U.S. assets or CFC stock have an income inclusion at the partnership level under the U.S. investment in U.S. property.
  - The inclusion related to pledging can be avoided if no non-U.S. assets are pledged, and less than two-thirds of CFC stock is pledged to support U.S. financing.



# Possible GILTI changes in U.S. taxation of non-U.S. operations

- Per country foreign tax credit limitation on GILTI inclusions.
- Possible reduction or elimination of 10% return on QBAI.
- Potential loss of ability to offset CFC losses with income for GILTI purposes.
- The GILTI tax rate may increase.



# Implications on structuring non-U.S. operations

- There is no “one-size-fits-all” in terms of structuring.
- Stepped up basis of U.S. and non-U.S. assets (for U.S. tax purposes) generally provides significant tax benefits.
- Enhanced focus on purchasing intangible assets in the United States to maximize the potential tax benefit of future amortization deductions.

## **In light of the possible changes to the U.S. anti-deferral provisions:**

- ✓ Consider reducing functions and risks in non-U.S. operations and the corresponding tax leakage overseas
- ✓ Conducting non-U.S. operations in entities treated as transparent for U.S. tax purposes may provide an enhanced benefit (especially for S corps and PE funds)
- ✓ Tax modeling has increased significance





# CANADA

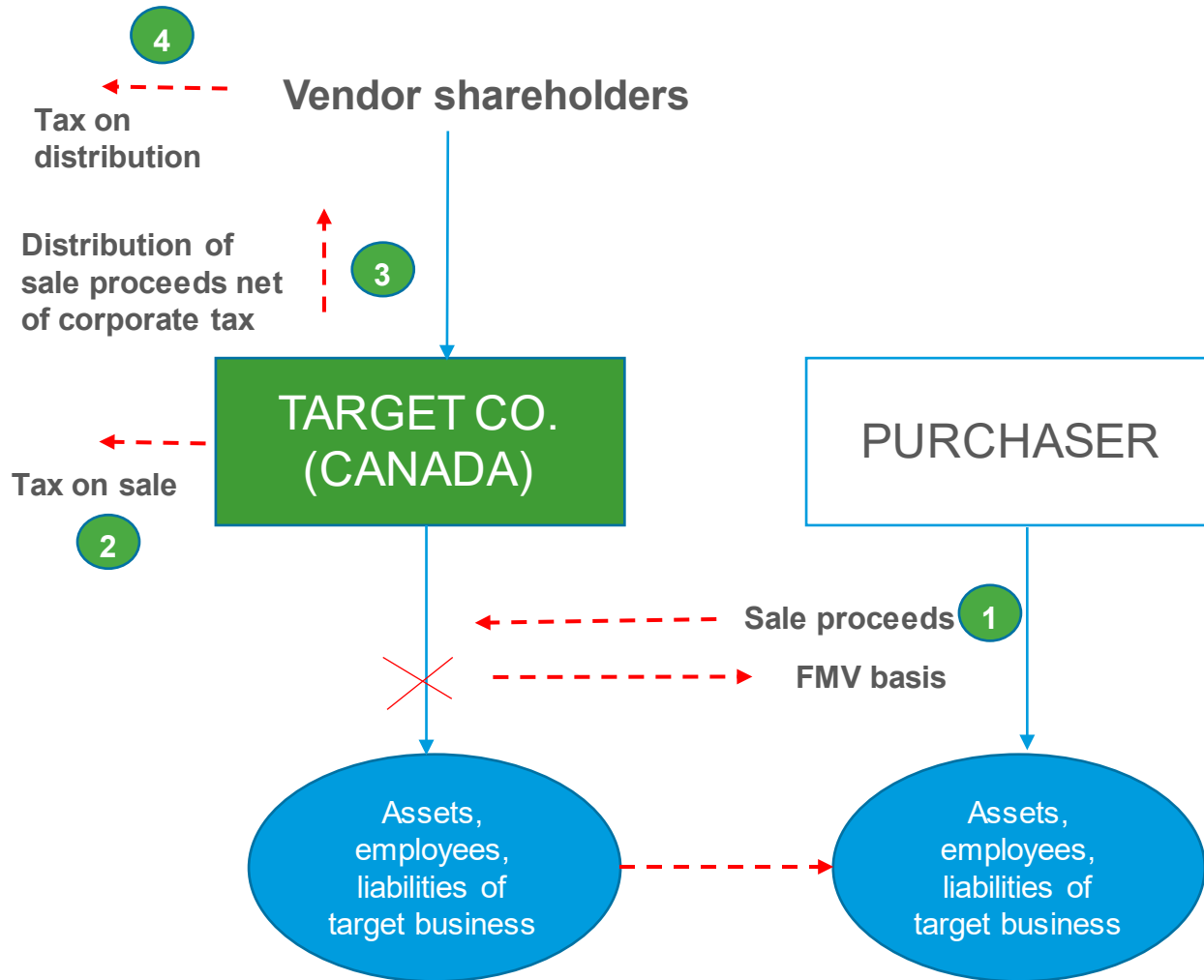
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Common M&A tax considerations



# Tax structuring for asset sale

## Typical structure



## Vendors

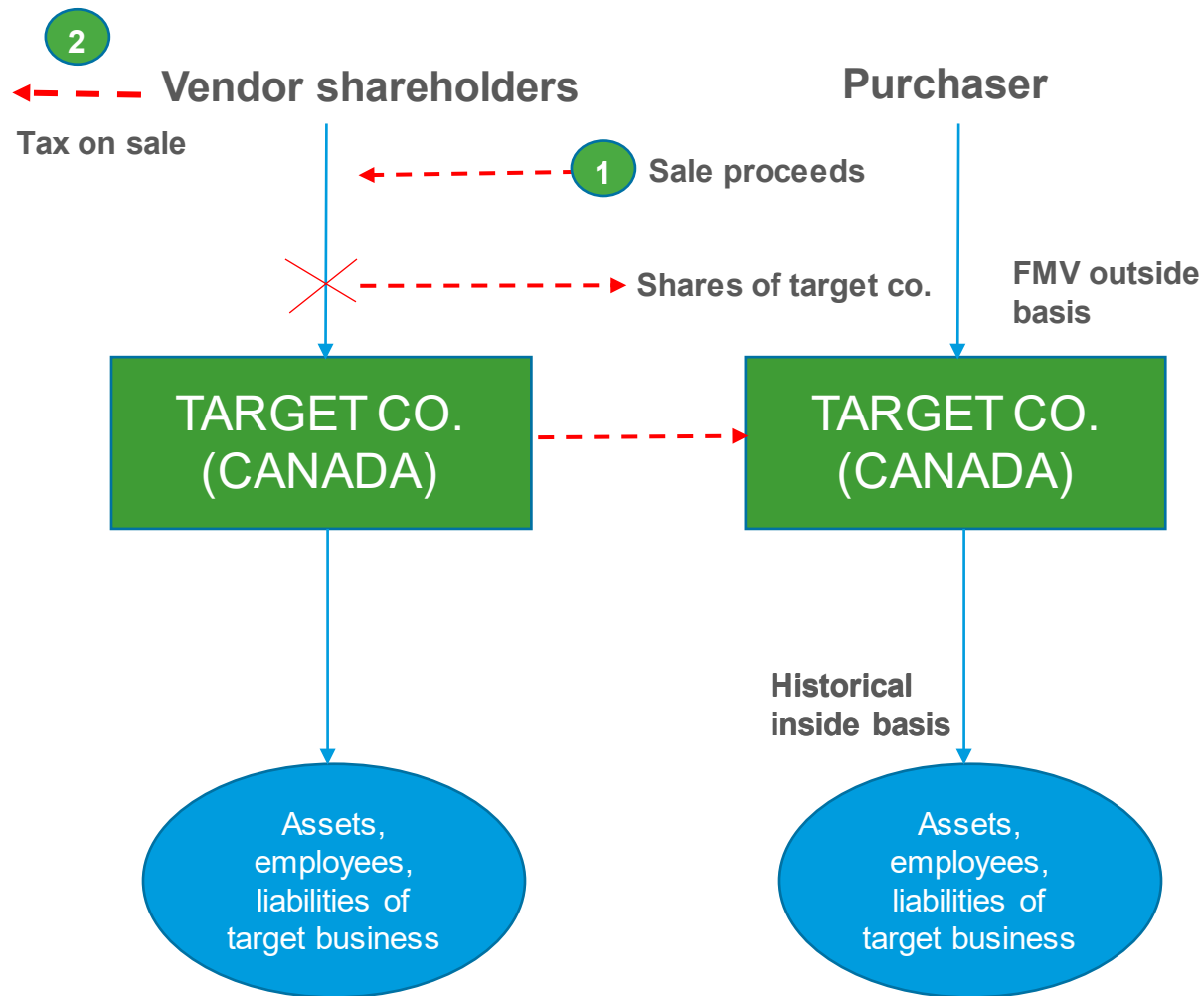
- Corporate tax on recaptured depreciation and capital gains with an additional layer of tax on distribution of proceeds to individual shareholders
- Cannot claim Canadian Lifetime Capital Gains Exemption(s) (LCGE) – approx. C\$240,000 of cash tax savings per exemption available
- Responsible for any historic exposure in Target
- Upfront tax rates of anywhere between 25%-49% depending on personal and Target tax attributes
- Tax a principal driver for preference for share sale from vendors' perspective
- Additional transfer tax and administrative costs regarding consents, transfer of employees, contracts, licenses, etc.

## Purchaser

- Full fair market value (FMV) step-up in tax basis of acquired assets
- Can choose assets to buy/liabilities to assume
- Do not inherit any legacy exposure of Target
- Additional transfer tax and administrative costs regarding consents, transfer of employees, contracts, licenses, etc.

# Tax structuring for share sale

## Typical structure



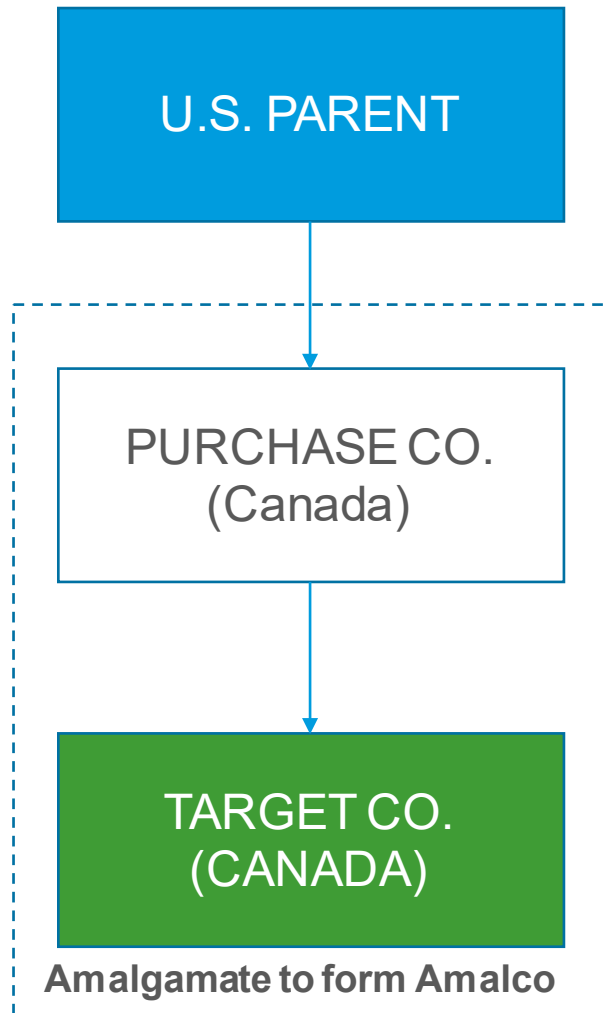
## Vendors

- Capital gains only 50% taxable in Canada
- Possibility of claiming LCGE(s)
- Elimination of joint holdings/economics on proceeds (particularly equity proceeds)
- No historic exposure—clean exit
- Limited transfer tax and administrative costs regarding consents, transfer of employees, contracts, licenses, etc.

## Purchaser

- No 338-style internal basis step-up in Canada
- Inherit tax attributes of Target shares
- Potential for a partial inside basis step-up to the extent of expiring tax attributes in target
- Inherit historic exposure
- No indemnity protection if PE/public vendors
- Limited transfer tax and administrative costs regarding consents, transfer of employees, contracts, licenses, etc.

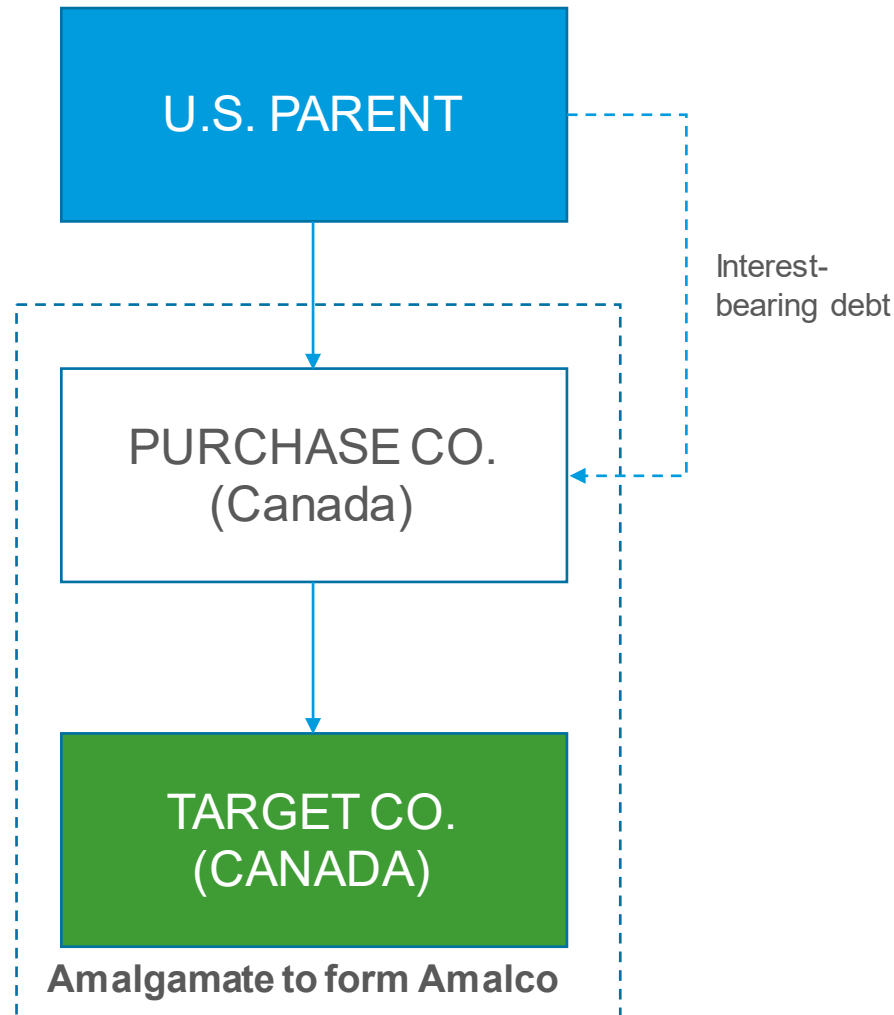
## Typical structure



## Common Canadian issues

- Equity capitalization: Paid-up capital (PUC)
  - No withholding tax on reduction of PUC
  - Can generally take steps to convert PUC to related-party debt (subject to thin capitalization rules)
  - Proceeds in excess of PUC are deemed dividends, subject to withholding tax (25% / 5%)
  - No requirement to distribute earnings and profits first as under U.S. rules
- Debt capitalization: Thin capitalization rules
  - Interest deductibility limited if debt-equity ratio is  $> 1.5:1$
  - Any excess interest is disallowed such that
    - It is nondeductible for Canadian income tax purposes; and
    - The denied interest is also treated as a deemed dividend, subject to Canadian withholding tax.
- Earnings stripping rules in 2021 federal budget
  - Limits net interest expense to 40% of 'Tax EBITDA' (2023); 30% of Tax EBITDA (2024 onwards)
  - No deemed dividend treatment
  - Expected to apply together with thin capitalization rules
  - No draft legislation released yet

## Typical structure

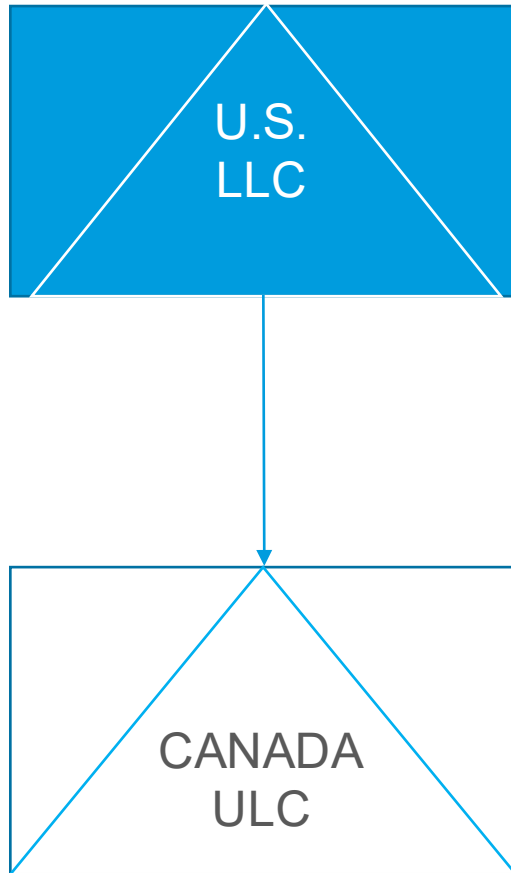


## Debt pushdown

- U.S. purchasers seeking to acquire the shares of a Canadian target generally prefer to form a Canadian acquisition company (i.e., Purchase Co.).
- The purpose is to obtain cross-border PUC equal to the FMV purchase price.
- U.S. parent could also consider funding Purchase Co. with a mix of equity (PUC) and interest-bearing debt.
  - This action would need to comply with the 1.5 to 1 debt to equity ratio under Canadian thin capitalization rules.
- After acquiring Canadian Target Co., Purchase Co. would then amalgamate with Target Co.
  - Unlike a U.S. style merger, an amalgamation does not result in a surviving entity; its more like “two rivers coming together to form a single stream.”
- As a result, the related-party debt is “pushed down” into Amalco and the interest expense is applied against future Canadian profits.



## Typical problematic structure

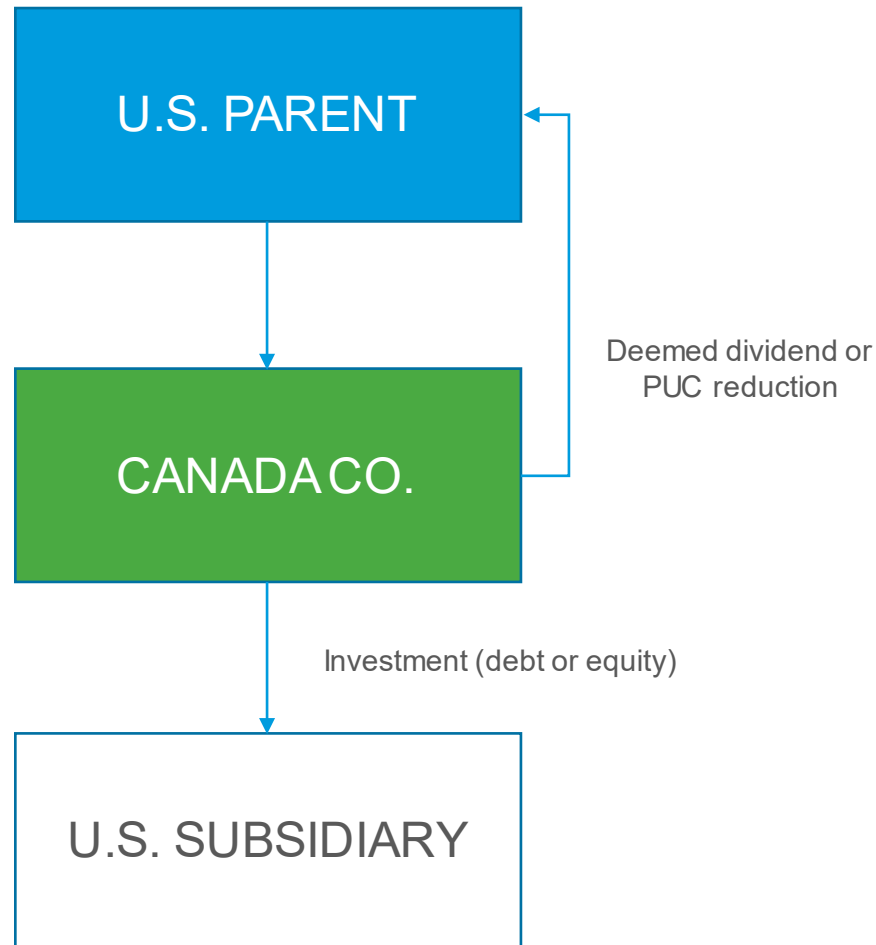


## Common Canadian issues

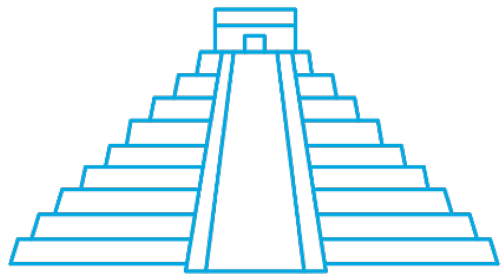
- Flow-through structures, such as using U.S. LLCs to invest into Canada, are commonly used to facilitate U.S. tax planning objectives
- Canadian treatment of LLCs
  - Incongruence with U.S. treatment
- Withholding tax at 25% on dividends / interest / royalty from disregarded Canadian ULCs to disregarded U.S. LLCs
  - Treaty reduced rate of 5% generally not available, due to the application of the anti-hybrid rule in Article IV(7)(b) of the Canada-U.S. tax treaty

# Foreign affiliate dumping (FAD) rules

## Typical sandwich structure



- Subject to certain exceptions, Canada does not generally tax foreign dividends received if attributable to active business income earned by a foreign subsidiary.
- The FAD rules can effectively penalize “sandwich structures” where Canada funds a foreign subsidiary while being foreign controlled.
- Often, U.S. buyers have their Canadian acquisition companies acquire shares in Canadian target entities, which also own a foreign target subsidiary.
- Planning is generally required/recommended to extract foreign subsidiaries out from under Canada post acquisition.
  - 88(1)(d) bump
  - 93(1) tax election
  - 111(4)(e) designation



# MEXICO

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M&A tax considerations



## Mexico financing considerations

- When financing Mexico's operations, the limitations on deductibility of business interest need to be considered.
- MITL Art. 28 XXXII: Limits interest deductibility each year on adjusted taxable profits.
  - Adjusted taxable profit is 30% of taxable profit with addbacks for interest and asset depreciation.
  - A 20 million pesos exception will apply.
  - Foreign exchange gain or loss is not considered interest.
  - There is a 10-year carryforward for nondeductible interest.



## Mexico financing considerations (cont.)

- MITL Art. 28 XXVII: Limits interest deductibility based on a **3:1 debt/equity ratio**.
  - Interest is allowable under the lower of the 3:1 debt/equity limitation or the adjusted profit method.
  - All intercompany loans need to have arms-length terms and be supported by a transfer pricing study.
  - Mexico taxes inflationary adjustments.
  - Liabilities have an impact on inflationary adjustments.
  - In general, interest withholding tax ranges from 4.9% to 21%. If relief is available under either the U.S. or Canadian Double Tax Treaty, a 10% withholding rate would apply.

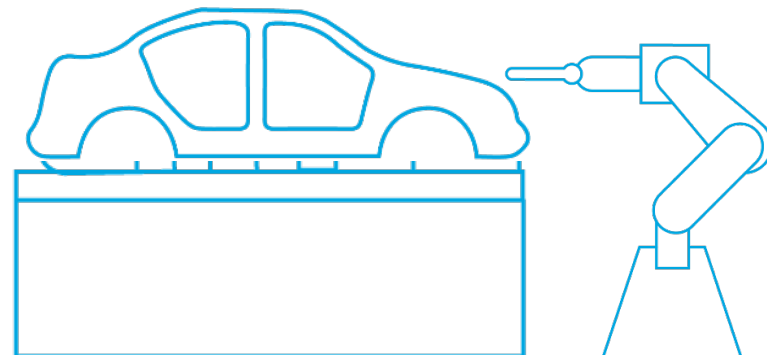
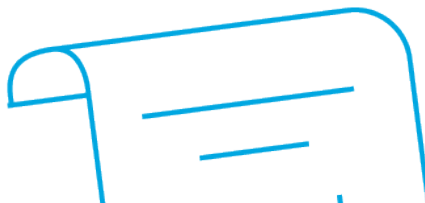


## Stock purchase

- Family-owned entities with no corporate governance could trigger considerable tax exposures.
- Issues often arise on intercompany service charges without proper support and/or tax substance.
- Joint liability on transactions without business purpose.
- Mexican law requires a Mexican legal entity to have two separate, distinct owners at all times.

## Asset purchase

- Ownership of assets needs to be supported through invoices, pedimentos, leasing agreements.
- Intangible assets are only amortizable in Mexico under certain circumstances.



# Acquisition of a Maquiladora

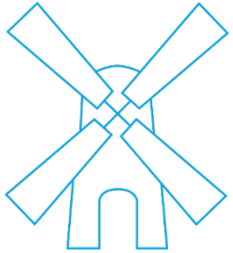
- Among the considerations are the following:
  - Maquiladoras are not allowed to distribute Maquila-produced products in Mexico (no domestic sales).
  - At least 30% of P&E must be property of the non-Mexican related party.
  - No intercompany charges are allowed for royalties, management fees, etc.
  - The Maquiladora regime is an arrangement; it is not akin to a U.S. check-the-box election.
  - If one of the previous conditions is unfulfilled, a permanent establishment liability for the foreign-related party will be triggered.
  - A change to the IMMEX Maquila regime from an IMMEX manufacturing arrangement could require considerable time and expense.
  - A Maquiladora's tax base is determined under a safe harbor computation; either 6.5% of costs or 6.9% of assets are utilized.



- Labor reform in force:
  - Increase of profit-sharing payments, capped to three months of salary or 10% of taxable profit.
  - Non-deductibility of expenses on subcontracting services to nonregistered entities.
  - Second payroll entity structure is no longer allowed.
- Highlights of 2022 initiative reforms:
  - Business reason will be required to obtain tax benefits related to a sale of shares at tax cost, tax deferred group restructuring, and tax-free mergers and spinoffs.
  - Financing operations without business reasons will be considered as a back-to-back loans.
  - Back-to-back loans are treated as deemed dividend income for tax purposes.
  - Maquiladoras are no longer allowed to determine tax profit under an APA.
  - Statutory tax report will be mandatory for entities with revenues higher than 1,600 million pesos.







## **M&A issues across Europe**

Jan. 27, 2022

*With Mitch Siegel, Frederik Bos (RSM Netherlands) and Christopher Knipp (RSM GmbH)*

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## **Recent developments in mergers and acquisitions: Asia Pacific**

March 29, 2022

*With Mitch Siegel, Eric Chen (RSM Hong Kong) and Dorothy Ng (RSM Hong Kong)*

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## **U.S.-U.K. deal structuring**

May 25, 2022

*With Mitch Siegel and Miranda Sharpe (RSM UK)*



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