



BLG
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Tax Topics for Tough Times

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Executive Summary

Economic uncertainty produces various challenges for businesses, some of which are more obvious and urgent than others. Whether or not arising as part of a court-based process under the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*, tax pitfalls arising from situations of financial distress (e.g., debt restructuring, cancelling contracts, reducing headcount) are not always easy to spot, and as with most things, to be forewarned is to be forearmed. This paper identifies the most important issues businesses face under the *Income Tax Act (Canada)* ("ITA") in the context of a challenging economic environment.

To begin with, it is important to note that times of depressed asset values may offer opportunities. One of the principal impediments to transferring assets is the potential taxation of accrued gains on them. A reduction or even elimination of such accrued gains due to adverse economic circumstances may allow an asset transfer that would not otherwise be possible, which can be helpful in various different scenarios. Moreover, one form of tax-advantaged financing ("distress preferred shares") is actually restricted to cases of debtor financial distress and so may be an opportunity not previously considered.

The financially troubled business may find it necessary to reduce its workforce or seek to amend or cancel contracts. Not all termination-related payments by employers are treated the same. Payments to secure the consent of creditors or for non-performance of contracts must also be considered in terms of deductibility to the payer and taxation to the recipient.

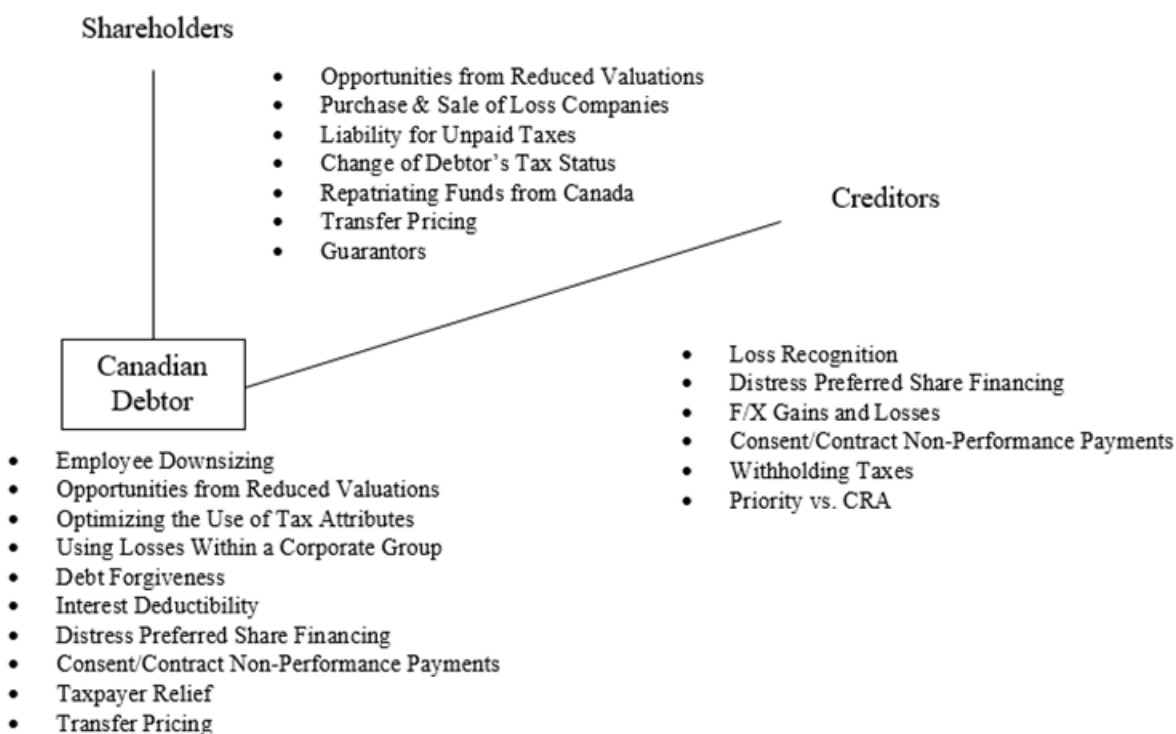
A business in a difficult economic situation can make the best possible use of its tax attributes (deductions, losses, credits, etc.) as a form of self-help, minimizing its tax burdens and potentially generating refunds of tax previously paid. Where the debtor is part of a corporate group, planning opportunities exist for optimizing the use of losses and deductions amongst the group members. Under certain circumstances, a corporation with significant losses can be sold to an arm's-length purchaser such that the purchaser can use the losses, but there are very significant limitations on such transactions and careful planning is necessary to achieve the desired result.

Debt restructurings generate various tax issues for both the debtor and its creditors. Debtors will be primarily concerned with managing the rules on "debt forgiveness," which create various adverse tax consequences for a debtor that settles (or is deemed to settle) a liability for less than 100 cents on the dollar. In most cases, any discount (the "forgiven amount") will reduce the debtor's favourable tax attributes or possibly even create an income inclusion for tax purposes, and careful planning is required to manage these complex rules. Debtors should also consider issues such as seeking relief from the Canada Revenue Agency (CRA) for interest and penalties, director liability for the corporate debtor's taxes, and the reversal of deductions taken for expenses accrued but not paid.

Creditors are primarily interested in ensuring that any losses arising in a financial distress scenario are crystallized, properly classified and not denied recognition for tax purposes. Separate rules apply to creditors that acquire a debtor's property on a debt default (i.e., realizing on security). Other creditor tax issues include the tax treatment of payments received for contract non-performance, foreign exchange gains and losses, and priority relative to the CRA's claims for tax debts.

Shareholders of a corporate debtor face tax issues of their own. They may be guarantors of the debtor's obligations or recipients of dividends that the CRA seeks to reclaim if the debtor cannot pay its tax debts. The tax status of a Canadian corporation may change due to it being in financial difficulty, often in a way that affects both it and its shareholders. Non-resident parent corporations and their Canadian subsidiaries should review the Canadian subsidiary's transfer pricing obligations on intra-group transactions and interest deductibility on cross-border debt. Further Canadian tax issues arise where the foreign parent seeks access to the Canadian subsidiary's cash.

Overview of Potential Tax Issues



1. Opportunities from Reduced Valuations

Reduced property values create various opportunities for tax planning. The presence of accrued but unrealized gains on assets is an impediment to moving them, since a disposition will cause those gains to be realized (and in the case of depreciable property potentially a recapture of depreciation previously claimed for tax purposes). Diminished asset values that eliminate gains (or create sheltering losses on other property that can be utilized to absorb gains) create opportunities to move property that are advantageous in any number of tax scenarios.

Corporate Restructurings and Extractions: a corporate restructuring that may not be possible to implement on a tax-deferred basis could become viable as a taxable transaction if gains have been reduced sufficiently. For example, a spinout of a subsidiary or the extraction of corporate assets to shareholders may now be possible at minimal or no tax cost. Intellectual property and other intangibles in particular should be considered with a view to whether now is the right time to transfer them (perhaps outside of Canada) at a reduced valuation. A depressed business environment may also facilitate a change in the business activities of the Canadian subsidiary of a multinational group, such as moving functions and risks out of Canada without an adverse transfer pricing result.

QSBC Purification: a Canadian-resident individual (other than a trust) can claim an exemption on capital gains from the sale of “qualified small business corporation” (QSBC) shares.¹ In order for a corporation to be a QSBC, it must meet certain tests that look to whether substantially all of its assets (by value) are being used for qualifying purposes. An economic downturn may reduce the value of qualifying assets, and where excess non-qualifying assets exist, a period of reduced valuation may reduce the tax cost of removing them from the corporation. It may also be desirable to actually crystallize and claim the QSBC exemption (thereby increasing the shareholder’s cost basis of the QSBC shares) to eliminate the risk of this exemption being repealed or an increase in the capital gains inclusion rate.

Estate Freeze/Re-Freeze: business owners wishing to convey the benefit of future growth to family members will often “freeze” their ownership of the existing value of the business, so that future increases accrue to other family members (potentially sheltered by their QSBC exemptions). This is achieved by having the current owner exchange his common shares of the corporation for fixed-value preferred shares equal to the current business value, with family members acquiring new common shares (with little current value) to which future gains will accrue. This can be done on a tax-deferred basis, with the result that future value is transferred away from the existing owner and the tax ultimately payable on the owner’s death (which triggers a deemed disposition of their property) is reduced. A negative business climate provides an opportunity to “freeze” the existing value at a lower amount. Where a “freeze” has already occurred and the redemption amount of the resulting fixed value preferred shares exceeds the current value of the business, a “re-freeze” into preferred shares with a lower redemption amount should be considered.

¹ The lifetime maximum amount of the QSBC capital gains exemption for each person is \$883,384 for 2020 (the lifetime limit is indexed to inflation).

Emigration: residents of Canada are subject to Canadian tax on their worldwide income, while non-residents are taxed in Canada only on Canadian-source income. Ceasing to be resident in Canada for tax purposes (“emigration”) is a taxable event, such that accrued gains and losses on most or all of the Canadian resident’s property are deemed to be realized. If diminished valuations have reduced the net accrued gains of a corporation or individual to the point where severing Canadian tax residence would not create an unacceptable tax liability, now may an opportune time to emigrate. A corporate emigration in particular is an oft-overlooked restructuring option that may be much simpler than transferring assets.²

Stock Option Repricing: where employee stock options are “underwater” because of economic conditions, the issuer may wish to reprice them downward through an exchange of old options for new ones with a lower exercise price. In such cases, the issuer should ensure that the exercise price of the new options does not exceed the current fair market value of the underlying shares, in order for the exchange to be tax-deferred and the new options to be eligible for favourable tax treatment on exercise.

Interest Rates: interest expense deductibility is limited to a “reasonable” rate of interest, based on commercial factors such as the debtor’s creditworthiness, the value of security offered and similar matters. Where a Canadian subsidiary of a multinational group is a higher lending risk because of economic circumstances, the rate of interest on intra-group loans to it should be reviewed to see if a higher rate is appropriate.

2. Employee Downsizing

Times of financial crisis often require businesses to reduce the size of their workforce. The CRA accepts that amounts paid by an employer to an employee as employment income will be deductible under general principles.³ Similarly, payments to dismissed employees as damages for wrongful dismissal will normally constitute a deductible expense to an employer.⁴

In terms of timing, an expense will be deductible to the employer in the year in which the obligation to pay the specific amount becomes absolute and unconditional (even if actual payment is not immediate). However, an expense for employee-related compensation that has been deducted and which remains unpaid 180 days after the end of the taxation year in which the expense was incurred is added back to the employer’s income, and will be deductible only when paid (s. 78(4)).

The tax treatment to an employee of termination-related amounts is more involved, as such a payment could be (1) employment income, (2) a “retiring allowance” or (3) damages. While the categorization of a particular payment is primarily of importance to the employee, it also matters to the employer because different employer withholding obligations may apply.

Employment income (for example, pay in lieu of statutory notice and salary continuation pay) is included in the employee’s income and taxed in the normal manner, subject to employer withholding and remittance as usual. Such amounts will count towards the employee’s earned income for purposes of computing her RRSP deduction limit.

² An emigrating corporation is also subject to a tax on its net corporate surplus (net asset value exceeding paid-up capital), the rate of which can be as little as 5%.

³ See for example CRA document 2009-0329441E5, May 7, 2010.

⁴ Interpretation Bulletin IT-467R2, paragraph 13 (archived).

A retiring allowance is an amount received by a person:

- on or after retirement of the individual from employment in recognition of the individual's long service; or
- in respect of loss of employment of the individual, whether or not received as, on account of or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal.

As a general rule the courts have interpreted this term as including payments which would not have been received but for, and are intended to compensate the employee for, the loss of employment. This includes early retirement incentive payments and damage awards relating to the loss of employment (e.g., mental anguish, etc.). A retiring allowance is included in the employee's income as received and does not generate RRSP contribution room. In some cases, an employee may find it attractive to defer payment of a portion of the amount to a later year in order to defer taxation.⁵ Withholding on retiring allowances is computed separately from employment income (and is usually lower), and employees with years of service before 1996 may be able to transfer all or part of a retiring allowance to their RRSP on a tax-deferred basis without regard to unused contribution room. Even if a retiring allowance relates to post-1995 years of service, an employee may wish to direct the employer to transfer a portion of his retiring allowance directly to his RRSP (up to available contribution room) to forego the normal employer withholding.

Damages received for causes of action separate and distinct from the actual loss of employment are generally received free of tax. Examples might be harassment during employment, damages for defamation after dismissal or damages for a human rights violation. The CRA's position is that to be non-taxable, damages received upon loss of employment must be for personal injuries and unrelated to the loss of employment, *i.e.*, the damages must relate to events or actions separate from the loss of employment.⁶ Note that counselling services provided by an employer to terminated employees (e.g., for re-employment or mental health) are a non-taxable benefit, as are educational benefits in some circumstances.

Where the employee is participating in an equity-based incentive plan (e.g., stock options, deferred share units, restricted share units, performance share units) or trust-based compensation program (e.g., employee benefit plan, retirement compensation arrangement, supplementary unemployment benefit plan, etc.), the considerations are more complex. It is important to carefully review the terms of the relevant plan to determine the parties' respective rights and obligations.

⁵ The CRA insists this must generally be agreed to before the termination of employment: see Income Tax Folio S2-F1-C2, Retiring Allowances, para. 2.26.

⁶ *Ibid.*, para. 2.17.

3. Optimizing the Use of Tax Attributes

Canadian corporations need to make the best use of their available tax attributes in challenging times. Various self-help strategies exist, some of which are described below.

Realize Latent Losses

A Canadian corporation with accrued but unrealized losses should explore crystallizing them for use against other taxable income or gains. This planning is especially useful when the Canadian corporation has latent capital losses that, if recognized, could be offset against realized capital gains that otherwise create tax payable or use up non-capital (*i.e.*, operating) losses.⁷

The ITA contains a variety of rules (so-called stop-loss rules) designed to prevent losses from being recognized when they are not perceived as constituting true economic losses. In broad terms, these rules deny or suspend the recognition of losses on sales to members within the affiliated group, and they deny recognition of a loss on property sold outside the group if the seller or an affiliated person acquires the property (or an identical property) within 30 days before or after the sale.⁸ Careful planning may be necessary to trigger losses in a way that will be recognized for tax purposes to achieve the desired effect.⁹

Carry Back Losses to Prior Years

The Canadian tax system allows losses from a particular year (either net capital losses or non-capital (*i.e.*, operating) losses) to be carried back up to three tax years and used in those earlier years (capital losses against capital gains only; non-capital losses against all forms of income). If one or more of the corporation's three most recent tax years have positive taxable income (including capital gains), it will generally make sense to carry back current-year losses and apply them to those earlier years to generate a refund to the extent possible.

Discretionary Deductions

Various deductions from taxable income are voluntary on the part of the taxpayer, such as claiming reserves and capital cost allowance (CCA, the tax version of depreciation) and interest expense that could otherwise be capitalized. In some cases, claiming these to the maximum extent possible is desirable: for example, if seeking to maximize a current-year loss in order to carry it back to an earlier profitable year and recover taxes paid, as described above.

⁷ Using non-capital losses (which are more versatile and hence more valuable) to shelter capital gains is generally suboptimal.

⁸ See below under 9., Creditor Issues.

⁹ A "private corporation" in particular must carefully consider the impact and timing of realizing losses on various other tax attributes, such as its capital dividend account and its refundable dividend tax on hand.

Conversely, there can be situations in which it makes sense not to claim deductions as quickly as possible. While the carryforward limitation period for non-capital losses is quite generous (20 years), in some cases having the loss in latent form (for example, as the undepreciated capital cost of depreciable property) rather than as a realized loss may offer more flexibility in terms of how and when to use it. It is also possible to refile for earlier taxation years to amend claims for CCA and similar discretionary deductions taken in prior years in certain circumstances.¹⁰

4. Using Losses within a Corporate Group

The Canadian tax system does not include a group consolidation concept whereby an affiliated group of corporations can apply losses of one group member against income and gains of another simply by filing a consolidated tax return. Rather, under Canadian rules, each entity computes its own income and deductions and is responsible for its own tax payable. This notwithstanding, it is often possible with careful planning to achieve results similar to those that would occur under a group taxation system.

Although the general scheme of the ITA prevents a taxpayer's losses and deductions from being used by or transferred to *unaffiliated* persons (with some exceptions), Canadian tax authorities generally accept planning designed to allow Canadian members of an *affiliated* group to match income and losses realized within the group. If one Canadian corporation (Shelterco) has loss carryforwards, accrued losses or latent deductions (for example, excess future depreciation expense) and an affiliated Canadian corporation (Profitco) is taxable, it may be possible to effect a loss utilization transaction between the two entities.

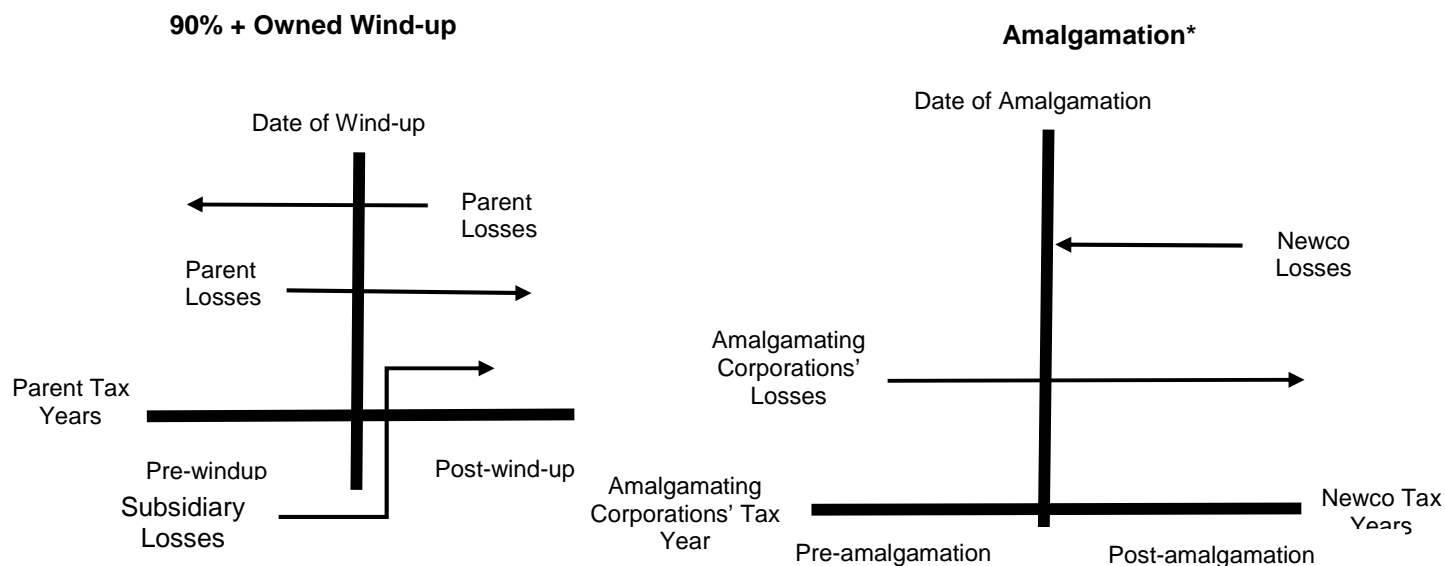
There are a variety of methods for achieving such a loss consolidation. In its simplest form, Shelterco can amalgamate or wind up into Profitco. If one Canadian corporation owns all of the shares of another, the subsidiary can wind up into the parent on a tax-deferred basis and allow the parent to use the subsidiary's loss carryforwards in future years.¹¹ Amalgamating two Canadian corporations within an affiliated group similarly allows the amalgamated corporation to carry forward the losses and other tax attributes of its predecessors and use them against income generated in the post-amalgamation period.¹² (See Figure 1.)

¹⁰ The CRA's administrative policy is set out in Information Circular IC 84-1 and CRA document 2014-0550381C6, dated November 18, 2014.

¹¹ Note that the subsidiary's losses cannot be carried back to *pre-wind-up* parent tax years. The parent can carry its own losses back and forth between the pre-windup and post-wind-up period.

¹² The corporation resulting from the amalgamation cannot carry post-amalgamation losses back against the pre-amalgamation income of its predecessors, unless one predecessor owned all the shares of the other at the time of the amalgamation (in which case the rule is similar to that for 90%+ owned wind-ups).

Figure 1. Permitted Use of Losses on Windups and Amalgamations

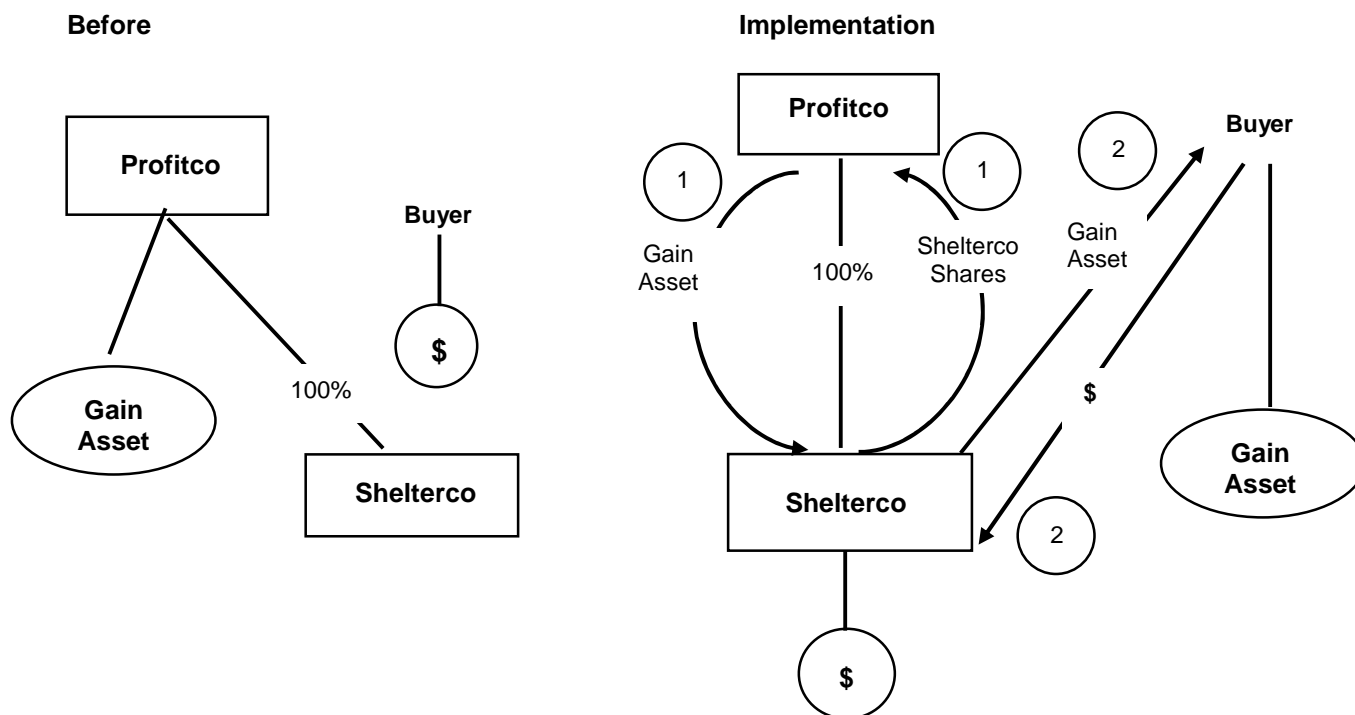


* Other than when one amalgamating corporation owns all of the shares of the other.

Other planning strategies may produce a more desirable commercial result than a simple amalgamation or windup, including:

- Profitco transferring a profitable business to Shelterco on a tax-deferred basis so that future income earned is absorbed by Shelterco's losses and deductions (in some cases this can be done using a partnership rather than a direct sale);
- Shelterco selling assets (for example, shares of a subsidiary) to Profitco in exchange for interest-bearing debt, the interest from which will reduce Profitco's income and be absorbed by Shelterco's deductions;
- moving assets or personnel within the group to create deductible charges (for example, lease expenses or management fees) that will reduce Profitco's income while utilizing Shelterco's deductions (e.g., Profitco transfers property to Shelterco on a tax-deferred basis that is then leased back to Profitco);
- Profitco borrowing money from a bank (creating deductible interest expense) and using the funds to subscribe for shares of Shelterco, which it can use to repay its own bank debt; and
- where assets with accrued gains are being disposed of to a third party, first transferring the assets to Shelterco via a tax-deferred transfer in exchange for shares so that Shelterco can then sell the asset to the buyer and recognize the gain (see Figure 2).

Figure 2. Asset Drop-Down and Sale



In all cases, it is important to consider the provincial tax aspects of shifting income and deductions from one entity to another.

Finally, affiliated Canadian corporations frequently achieve self-help loss consolidations via the use of specific methods that the CRA has provided advance tax rulings on many times, subject to compliance with its basic constraints on intra-group loss consolidations:

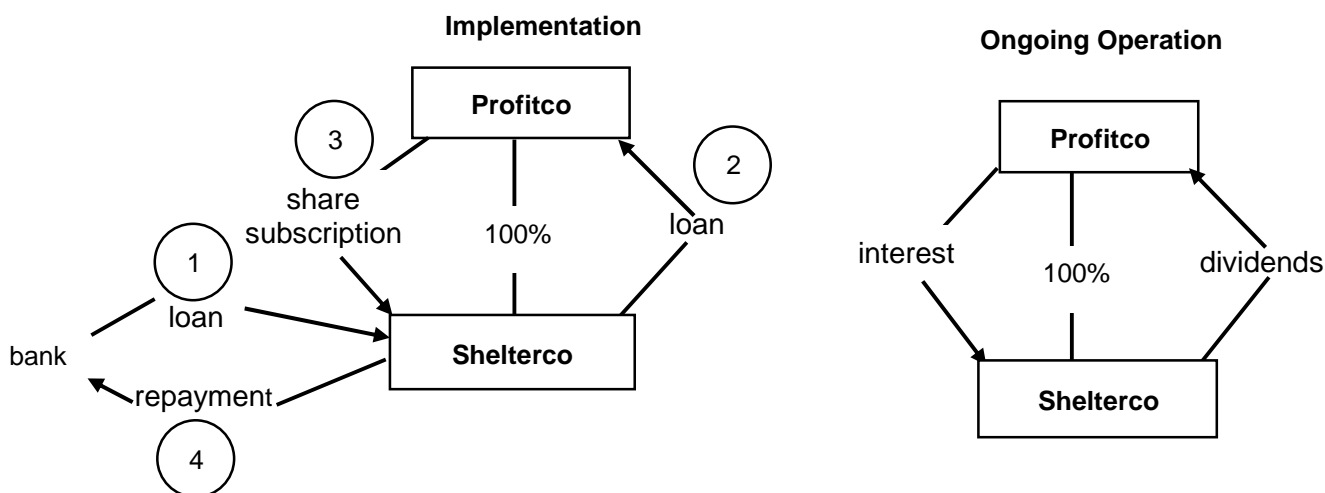
- the transactions must be legally effective under relevant corporate/commercial law;
- transactions designed to import into Canada foreign losses from outside the Canadian tax system will likely be challenged;
- planning that results in a circumvention of the ordinary time limits for using accumulated losses (loss refreshing) is typically viewed as offensive;
- the loss transaction should not be seeking to access losses or similar tax attributes that arose before the relevant entity became part of the affiliated group; and
- provincial tax authorities may be concerned if they perceive transactions as reducing the amount of tax owing to one province or another if the relevant entities do not have similar interprovincial income allocations.

The most common form of intra-group loss utilization transaction creates an interest expense deduction in Profitco and a corresponding income inclusion in Shelterco that is offset by its losses. Briefly, a simple form of this transaction would comprise the following steps (see Figure 3):

- Step 1: Shelterco obtains a daylight loan from a financial institution.
- Step 2: Shelterco uses the proceeds to make an interest-bearing loan to Profitco.
- Step 3: Profitco uses the borrowed funds to subscribe for shares of Shelterco.
- Step 4: Shelterco uses the share subscription proceeds to repay its daylight loan.

The result is that Profitco incurs deductible interest expense on the funds borrowed from Shelterco (reducing Profitco’s taxable income), and Shelterco’s interest income on the loan is absorbed by its losses. Shelterco will pay dividends to Profitco, which Profitco should generally receive tax-free due to a 100 per cent dividends-received deduction for Canadian-source intercorporate dividends. Note that the interest rate on Shelterco’s loan to Profitco must be commercially reasonable, and the amounts borrowed and invested must be within the parties’ arm’s-length borrowing capacity.¹³

Figure 3. Basic Loss Consolidation



¹³ During the 2008 financial crisis, the CRA relaxed this constraint to some extent to reflect temporary abnormal capital market conditions.

5. Purchase and Sale of Loss Companies

Significant limitations exist on the ability to monetize the losses of a corporation possessing substantial loss carry-forwards or accrued but unrealized losses via a sale of the corporation to an arm's-length party. The scheme of the Canadian tax system generally prevents losses from being used by or transferred to unaffiliated persons other than in limited circumstances.

When an acquisition of control of a corporation occurs (directly or indirectly),¹⁴ a number of tax implications arise:

- 1) a deemed year-end for the corporation;
- 2) the deemed realization of any accrued but unrealized losses on its property immediately before such year-end;¹⁵ and
- 3) the application of loss restriction rules that prohibit or restrict the corporation's ability to use pre-acquisition of control losses (including those from 2, above) in the post-acquisition period and *vice versa*.

Essentially, both non-capital losses from an investment (as opposed to those from a business) and net capital losses from the pre-acquisition of control period cannot be carried forward and used in post-acquisition of control tax years (and *vice versa*); they effectively become worthless if they cannot be used in the pre-acquisition period.¹⁶ However, non-capital losses from a business may be carried forward and used against post-acquisition of control income if the following conditions are met:

- the corporation must carry on the business that generated the loss (the loss business) with a reasonable expectation of profit throughout the later year in which it seeks to use the loss; and
- the income against which the loss is used must arise from carrying on either the loss business or another business substantially all of the income from which is derived from selling similar properties or rendering similar services that were sold or rendered in the loss business.

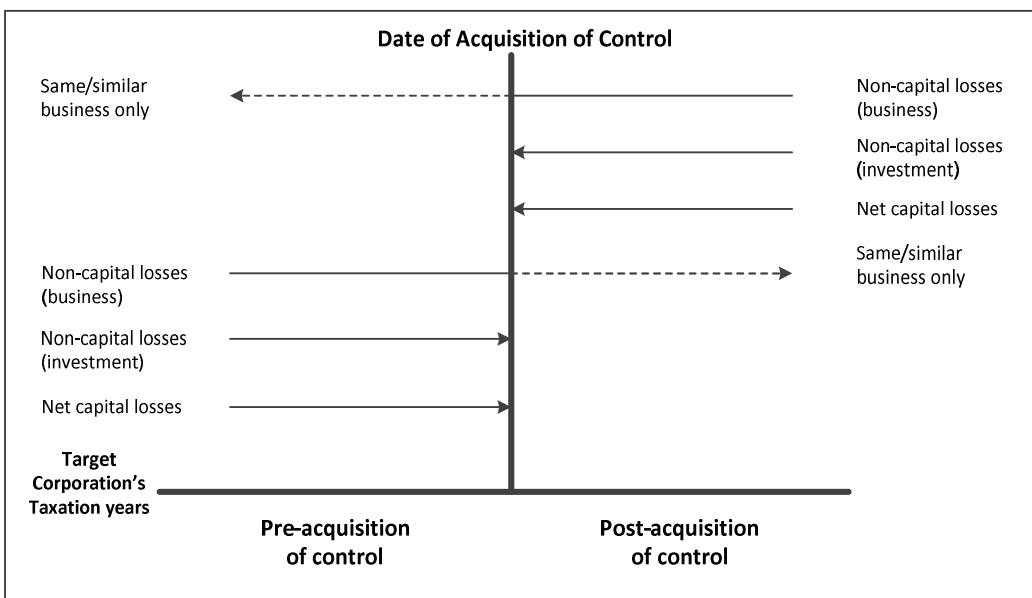
Thus, business losses are streamed to be usable only against income from the same or similar business, and only if the loss business itself continues to be carried on. When the corporation's business is in a sector with several profitable competitors, its losses are therefore much more likely to have value to a third party than a situation in which the industry as a whole is unprofitable.

¹⁴ That is, a change in the shareholdings of the corporation (or of another entity that directly or indirectly controls the corporation) such that a different person or group of persons has the ability (directly or indirectly) to elect the majority of the corporation's board of directors. In general, no acquisition of control occurs if the new controller is related to the previous controller (if any) or was already related to the target corporation (that is, intragroup transfers generally should not matter). An acquisition of control may be deemed to arise in other circumstances (e.g., acquisition of more than 75% (by value) of the equity of a corporation by a person or group of persons: s. 256.1).

¹⁵ The deemed realization of losses before the deemed tax year-end requires them to be either used in the tax year ending immediately before the acquisition of control or made subject to the rules described below governing the carryover of losses on acquisitions of control.

¹⁶ The potentially harsh effects of this rule are somewhat alleviated by a one-time election the corporation can make to effectively use any otherwise unusable pre-acquisition-of-control capital losses against any accrued but unrealized capital gains on its property that exist immediately before the acquisition of control. Doing so increases the tax cost of the gain property, reducing the accrued gain realized on an eventual disposition.

Figure 4. AOC Loss Utilization Restrictions



6. Distress Preferred Shares

Where a Canadian-resident borrower corporation is in financial difficulty, distress preferred share financing should be considered. As a general rule, interest is deductible to the payer and fully taxable to the recipient under the ITA. Conversely, dividends are non-deductible to the payer, and in the case of dividends paid by one Canadian corporation to another are generally received tax free by virtue of a 100% dividends-received deduction for intercorporate dividends. This means that dividends have a higher after-tax cost to corporate payers, and interest income produces a lower after-tax return for corporate recipients.

The ITA contains a variety of complex rules (often called the preferred share rules) designed to prevent equity investments that have the security of debt but that generate dividend income that a corporate investor can receive on a tax-free basis. Essentially, these complex rules deny the recipient the dividends-received deduction (that is, making the dividend taxable) and/or impose special taxes on the dividend payer and the recipient.

A distress preferred share (DPS) is a share that has many debt-like features designed to provide the holder with a more secure investment than regular equity - for example, it allows the holder to exchange the DPS for higher-ranking debt of the issuer in various circumstances. However, by virtue of a specific exception in the preferred share rules, dividends on DPS will still be eligible for the 100% dividends-received deduction. This means that the investor can accept a lower pre-tax rate of return on its investment than would otherwise be the case if the dividends were taxable to it. For example, an investor who wants debt-like security will prefer a DPS with a 5% dividend rate that is non-taxable compared to a 6% interest rate on "regular" debt that is taxable. This 5% non-deductible DPS is also less onerous for an issuer than a 6% interest rate on "regular" debt if the issuer has excess deductions and cannot use an interest expense deduction from issuing debt.

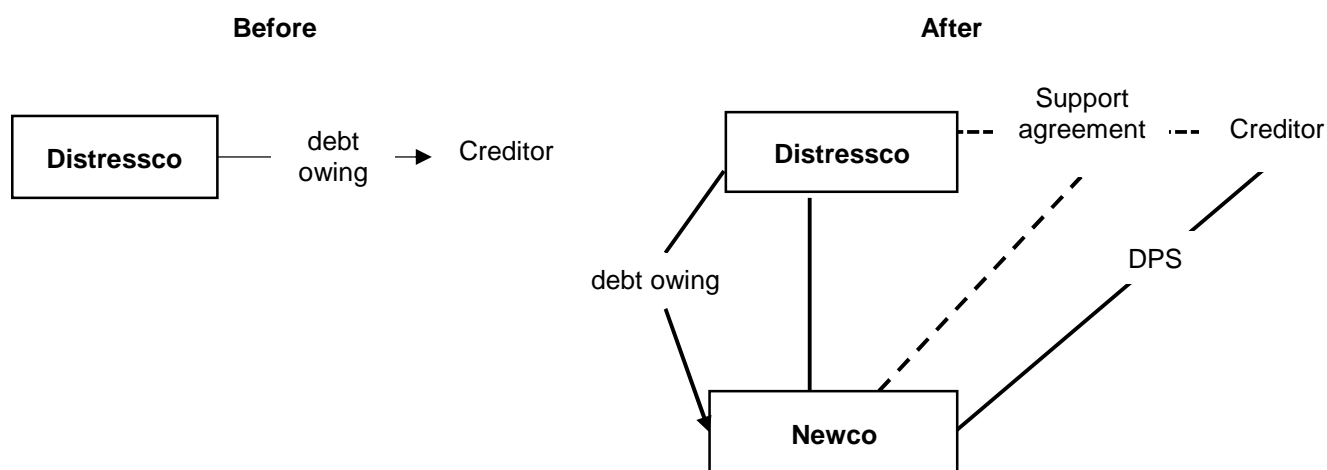
A DPS is a share issued by a corporation resident in Canada:

- as part of a proposal or arrangement with its creditors that had been approved by a court under the *Bankruptcy and Insolvency Act*;
- when all or substantially all of its assets were under the control of a receiver or trustee in bankruptcy; or
- when, by reason of financial difficulty, the issuing corporation or a non-arm’s-length Canadian corporation was in default (or could reasonably be expected to default) on a debt obligation held by an arm’s-length creditor, and the share was issued either wholly or in substantial part and either directly or indirectly in exchange or substitution for all or a part of that obligation.¹⁷

Figure 5 illustrates a typical DPS transaction, which can be summarized as follows:

1. The financially distressed corporation (Distressco) creates a new single-purpose subsidiary (Newco).
2. Newco receives a demand loan from the creditor equal to the face amount of the Distressco loan owing to the creditor and uses it to purchase the loan from the creditor.
3. The creditor then subscribes for DPS of Newco, which uses the funds to repay the demand loan owing to the creditor. The terms of the DPS generally provide that the holder can retract them (that is, force a redemption) at any time if an event of default occurs, and that the holder is entitled to an annual cumulative preferred share dividend. The DPS is often redeemable after five years, or earlier if Distressco generates excess cash flow. The DPS therefore contains many of the features of a debt.
4. Various agreements are entered into among Distressco, Newco, and the creditor, providing that (1) Newco will not receive any interest on the Distressco debt, (2) Distressco will make capital contributions to Newco sufficient to fund its DPS obligations, and (3) the creditor can put its DPS to Distressco and reacquire the Distressco debt (that is, revert to its original position as a Distressco creditor).

Figure 5. Distress Preferred Shares



¹⁷ See paragraph (e) of the definition of “term preferred share” in s. 248(1) and archived Interpretation Bulletin IT-527, which contains the CRA’s views on what constitutes a debtor being in “financial difficulty”.

Essentially, the DPS structure puts the creditor in the position of being a preferred shareholder that is able to receive tax-advantaged dividends. At the same time, however, the creditor is able to switch back into holding a debt security if necessary. Thus, a DPS effectively maintains the holder's priority against other claimants. The CRA has issued numerous DPS rulings to confirm the favourable tax treatment of these structures, and creditors usually insist on an advance tax ruling. DPS financing is most useful when the creditor does not have other tax shelter available to absorb taxable interest income and is (or can be made to be) a Canadian resident corporation that can take advantage of the dividends-received deduction. When subsequently redeemed (which must occur within 5 years), a DPS is effectively treated as if it were debt, and so may come within the debt forgiveness rules in s. 80 described below.

7. Debt Forgiveness

A corporation in more serious financial difficulty may need some degree of debt relief from its creditors (either external or within the group). The ITA contains many complex rules dealing with what happens to the debtor when a debt is repaid at less than 100 cents on the dollar (a debt forgiveness). The debt forgiveness rules may apply in a variety of circumstances, such as on a debt restructuring or even on some purchases and sales of debt. Determining when and how these complex rules apply often requires considerable analysis, and the implications for debtors can be significant. These rules can have non-intuitive results; for example, in some circumstances, they deem a debt to have been settled for tax purposes even though it remains legally outstanding. As such, these rules must be considered whenever debt is paid, transferred, amended, or restructured.

A. General Policy on Debt Forgiveness

When a debtor is able to avoid repaying the full amount of a debt, it is treated as having received a benefit that could result in more income for tax purposes or a reduction in favourable tax attributes (such as tax losses or the cost of property for tax purposes). Thus, the settlement of a debt by less than full payment has negative income tax consequences for the debtor. The impact of these tax consequences depends on what the debtor's tax attributes are and which statutory provisions apply to it.

The ITA has various rules that apply to debts in different situations. Relatively narrow specific rules apply in particular circumstances, such as:

- debts owing to non-arm's-length persons that remain unpaid by the end of the second taxation year following the year the expense was incurred (these are added back to the debtor's income in the third following taxation year under s. 78(1));
- debt owing by an employee to her employer (the forgiven amount is treated as employment income to the debtor);
- debt owing to a corporation by a shareholder (the forgiven amount is included in the shareholder's income);
- trade payables (the forgiven amount reduces the debtor's deductible expense); and

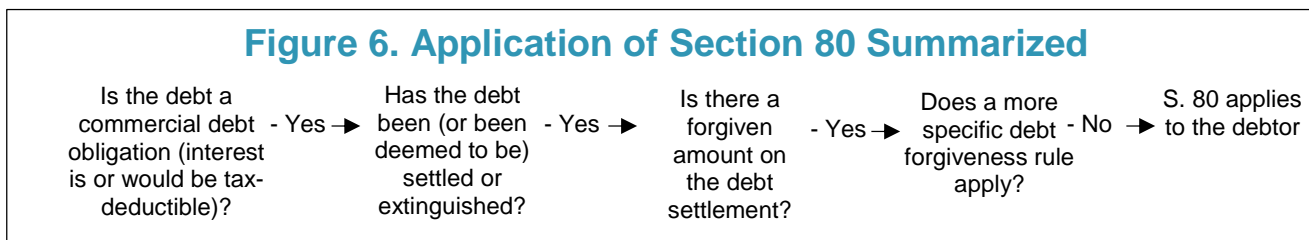
- debt under which the creditor has foreclosed on the debtor's property (that is, the debtor has surrendered property to the creditor due to non-payment by the debtor).¹⁸

If none of these special rules applies, the residual rule in s. 80 typically governs the settlement of a debt at a discount. There are three basic preconditions to the application of s. 80:

- *Commercial debt obligations.* s 80 applies only to debts the interest on which is (or would be, if interest were charged) tax-deductible. This limits the scope of the rule to debts incurred as part of a business or investment, not debts of a personal nature (compound interest is also excluded, as it is deductible only when paid, not when accruing);
- *Settlement.* The debt must be (or must be deemed to be) settled or extinguished; and
- *Forgiven amount.* There must be a forgiven amount regarding the debt (that is, payment of less than the full amount owing under the debt).

For this purpose, interest on a debt is treated as a distinct debt separate from the underlying principal of the debt, meaning s. 80 has to be applied separately to the principal and the interest.

Figure 6. Application of Section 80 Summarized



B. 'Settled or Extinguished'

S. 80 applies only when the debt has been "settled or extinguished." Generally, a debt is settled when the debtor is no longer liable to pay it. If the creditor accepts new debt or shares of the debtor in satisfaction of the old debt, the old debt will be considered to have been settled (the rules described below apply to deem what the forgiven amount is). Moreover, if a debt owing to an unrelated creditor ceases to be enforceable by the creditor because of the passage of time and a statutory limitation period for collecting it, it is deemed to have been settled.

A debt may also be settled if it is modified or restructured to the point that the changes are so extensive that they cause the existing debt to be considered to have been settled and a new debt created in its place for tax purposes. The Federal Court of Appeal held in *General Electric Capital Equipment Finance v. The Queen*¹⁹ that if substantial changes were made to the fundamental terms of an obligation that materially

¹⁸ In general terms ss. 79/79.1 ITA result in (1) the creditor not realizing any gain or loss on the receivable and acquiring the seized property at a cost equal to its cost of the relevant debt (plus fees and costs incurred), and (2) the debtor disposing of the property for sale proceeds equal to the amount of the creditor's debt (and any other debt extinguished as a result of the seizure or any other debt that was secured by the seized property). This rule would apply in a foreclosure scenario where the creditor acquires actual ownership of the debtor's property, but not in a power of sale where the property is sold by the debtor to a buyer and the proceeds applied to repay the debt.

¹⁹ 2002 DTC 6734 (FCA).

alter the terms, a new obligation would be created.²⁰ The court found that the fundamental terms of the debt obligations before it were:

- the identity of the debtor;
- the principal amount of the note;
- the amount of interest due under the note; and
- the maturity date of the note.

Since three of these four fundamental terms had been changed on the facts of the case (only the identity of the debtor had not changed), the court held that a new obligation had been created. The court further concluded that a debt could be modified so significantly as to constitute the creation of a new debt without a novation of the debt occurring under the relevant commercial law.²¹ In that case, the original obligation will be viewed as having been disposed of for tax purposes and a new obligation created.

Finally, a debt may be deemed to have been settled under the “debt parking” rules described below even though it remains legally outstanding. While the debt parking rules are complex, essentially they can apply when a person who doesn’t deal at arm’s length with the debtor acquires the debt from an arm’s-length creditor at a significant discount from the debt’s principal amount. This could occur if a related party acquires the corporation’s external debt from its lenders, or if an arm’s-length party acquires both the shares and intragroup debt of the corporation.

C. Forgiven Amount

Finally, there must be a forgiven amount (that is, extinguished principal or interest in excess of the amount paid by the debtor) for s. 80 to apply. The forgiven amount is the principal amount of the debt less any amounts paid or deemed to have been paid on its settlement. The forgiven amount is reduced by any amounts paid by the debtor to another person to assume the debt. A taxpayer that is bankrupt under the *Bankruptcy and Insolvency Act* is deemed to have no forgiven amount.

When the debtor issues a new debt in payment of existing debt, the principal amount of the new debt is deemed to have been paid in satisfaction of the principal amount of the new debt. Differences in the value of the new debt and the old debt are irrelevant in and of themselves, as are extensions of the maturity date. It is therefore possible to accomplish a debt-for-debt exchange without producing a forgiven amount simply by maintaining the same principal amount.

When the debtor issues shares of itself in payment of existing debt, it is considered to have paid an amount on the debt equal to the fair market value of the shares issued.²² The debt forgiveness rules may therefore apply when the value of shares received by a creditor to settle the debt is less than the debt’s principal amount. Moreover, if a creditor is also a shareholder of the debtor and the value of its existing shares of

²⁰ The issue in the case was whether a new obligation had been created for purposes of determining whether the obligation was exempt from withholding tax under former subparagraph 212(1)(b)(vii).

²¹ The CRA’s administrative position is largely similar, holding that a debt instrument will be considered to have been rescinded when the parties have effected such an alteration of its terms as to substitute a new obligation in its place that is entirely inconsistent with the original debt or, if not entirely inconsistent with it, is inconsistent to such an extent that goes to the very root of it. See *Income Tax Technical News*, No. 14, Dec. 9, 1998. The CRA has stated that *GE Capital* is consistent with this view (*Income Tax Technical News*, No. 30, May 21, 2004).

²² This rule does not apply if the shares being issued are distress preferred shares: see s. 80.02(3).

the debtor increases as a result of the debt settlement, that increase in value is treated as a payment toward the debt and reduction of the forgiven amount.

An obvious alternative to issuing shares in direct repayment of an intragroup debt is to have a related party inject cash into the corporate debtor as a share subscription or capital contribution, which the debtor then uses to repay the debt in full. When a foreign parent holding debt of a Canadian subsidiary subscribes for shares of the debtor with cash that is used to repay the debt, the CRA has stated that this transaction could be challenged as an abuse or misuse under the general anti-avoidance rule in the ITA.²³ While the soundness of this administrative position is open to debate, foreign parents holding debt of their Canadian subsidiaries should be aware of it.

D. Consequences of Forgiveness

When s. 80 applies, it applies the forgiven amount of the debt to reduce various favorable tax attributes of the debtor, such as accumulated and unused losses from earlier years (loss carryforwards) and the cost of property for tax purposes (tax cost). This will typically result in higher taxable income in later years due to, for example, prior years' loss carryforwards being unavailable to shelter future income. For property whose tax cost has been reduced under s. 80, there will be smaller future depreciation deductions each year for depreciable property (since tax depreciation is computed as a percentage of a property's cost) and higher gains realized when the property is sold.

The order in which the debtor's attributes will be ground down by a forgiven amount is generally as follows (the debtor has some ability to choose certain grind-downs):

- i) non-capital (that is, operating) loss carry-forwards from prior years;
- ii) capital loss carryforwards (losses usable only against capital gains) from prior years;
- iii) the tax cost of depreciable properties;
- iv) accumulated expenditures on some natural-resource-sector properties;
- v) the tax cost of capital properties other than depreciable property and the properties in vi) and vii) below;
- vi) the tax cost of shares and debt of corporations in which the debtor is a specified shareholder²⁴ (other than those in viii) below);
- vii) the tax cost of shares and debt of corporations that are related to the debtor and interests in partnerships that are related to the debtor²⁵; and
- viii) current-year capital losses.

To the extent that the forgiven amount exceeds these reductions in the debtor's tax attributes, 50% of the excess (100% for partnerships) is added to the debtor's income for tax purposes, potentially increasing its taxes payable.

²³ *E.g.*, see CRA document 2003-0022357, dated Sept. 25, 2003.

²⁴ In general, a specified shareholder is a shareholder who, together with non-arm's-length persons, owns at least 10 per cent of any class of shares of the corporation.

²⁵ A debtor corporation may be able to elect under s. 80.04 to transfer a portion of the remaining forgiven amount to certain eligible transferees, including related taxable Canadian corporations, instead of reducing the adjusted cost bases of shares and debt of related corporations.

For example, assume that a debtor settles a \$10,000 debt for \$7,000 (that is, a \$3,000 forgiven amount), and that the debtor has a \$1,500 loss carryforward from a previous year and a property with a cost for tax purposes of \$1,000. S. 80 could apply the \$3,000 forgiven amount to eliminate the loss carryforward (\$1,500) and reduce the tax cost of the debtor's property down to zero (\$1,000). Fifty per cent of the remaining unapplied \$500 of the debt forgiveness is added to the debtor's income for the year of the debt settlement (subject to an optional reserve of up to 5 years), which depending on the debtor's circumstances could result in taxes owing.²⁶

The example above is only a general description of the sequence in which a forgiven amount is applied. For example, some tax attributes are reduced only if the taxpayer so chooses, and others can be used to absorb the forgiven amount only if other tax attributes have been reduced to the full extent possible. There are also provisions effectively transferring the forgiven amount to related parties, such that their tax attributes are reduced instead of the debtors. These rules are generally intended to prevent a taxpayer from largely negating the effect of s. 80 by reducing less favorable tax attributes first.

However, with careful planning there is considerable scope for managing the application of s. 80. For example, it is often desirable to:

- apply the forgiven amount against the undepreciated capital cost of classes of property that yield lower rates of tax depreciation (capital cost allowance);
- convert non-capital losses from prior years into other tax attributes, so that s. 80 can apply first to less desirable tax attributes;²⁷
- where s. 80 will produce a residual 50% income inclusion, ensure the debtor's current year operating loss is big enough to absorb the income inclusion;
- transfer property with attractive tax attributes to a newly-formed subsidiary on a tax-deferred basis in exchange for shares;
- crystallize capital losses (particularly on shares of related entities), either through actual transfers or deemed loss recognition events, to absorb the forgiven amount; and
- in situations in which an acquisition of control of the debtor (which impacts tax attributes) is imminent, carefully time the ordering of that event with the debt forgiveness to ensure that the least desirable tax attributes are those reduced (e.g., losses that would not survive an acquisition of control in any event).

E. Planning Within a Canadian Group

When more than one Canadian group member exists, there may be additional opportunities for managing the application of the debt forgiveness rules. For example, one way a debtor can convert loss carryforwards into undepreciated capital cost (UCC) is by transferring depreciable property to a related party in order to realize latent recaptured CCA, reducing the debtor's loss carryforwards (used to absorb recapture) and

²⁶ For corporate debtors, s. 61.3 provides a deduction that essentially limits the incremental tax liability to the corporation's remaining net assets (if any), while s. 61.4 provides an optional reserve.

²⁷ For example, by foregoing discretionary deductions such as capital cost allowance and reserves, including refiling to "unclaim" CCA deductions in prior years to the extent permissible (see above under 3., Optimizing the Use of Tax Attributes, with reference to Information Circular IC 84-1).

increasing the transferee's UCC base.²⁸ Property transfers within a related group are often a key element of s. 80 planning.²⁹

Amalgamations and windups involving Canadian group members can often be very useful for dealing with debt forgiveness issues. For example, if a related party has tax attributes that are less desirable than the debtor's, a merger of the two prior to the debt forgiveness allows the forgiven amount to be applied directly against the less favourable tax attributes.

Amalgamations and windups can also be used to eliminate debt of one Canadian group member held by another. For example, when a debtor and creditor that are both Canadian corporations amalgamate, or when one is wound up into the other on a tax-deferred basis, no debt forgiveness will arise as long as the creditor's tax cost of the debt is not less than the principal amount. Essentially the creditor owning debt of a subsidiary (or *vice versa*) with a value less than its principal amount foregoes its loss on the debt to preserve the debtor's tax attributes by not creating a forgiven amount.

This principle is used in "ATR-66" transactions when the shares and debt of a subsidiary are to be sold to a purchaser wishing to use the subsidiary's preserved tax attributes.³⁰ Consider the case of a parent company (Holdco) owning all the shares of an operating company (Opco) and a promissory note owing by Opco with a principal amount of \$100 and a fair market value of \$70. A simple settlement of the note would produce a debt forgiveness that reduces Opco's tax attributes. If instead Holdco sells the note to a newly-formed subsidiary of Opco (Subco) for a new note equal to the fair market value of the Opco note, and Subco is then wound up or amalgamated into Opco,

- Holdco realizes no gain or loss on the sale of the Opco note, and Subco acquires the Opco note at Holdco's cost basis (*i.e.*, the \$100 originally loaned to Opco);
- the merger of Subco and Opco results in (1) Opco assuming the \$70 liability under the Subco note, and (2) the cancellation of the Opco note at a deemed settlement amount of \$100 such that Subco realizes no gain or loss and Opco has no debt forgiveness.³¹

The shares and debt of Opco can then be sold to a purchaser for fair value without risk of the debt parking rules described below applying to grind Opco's tax attributes due to the purchaser acquiring the Subco note for an amount significantly less than its principal amount.

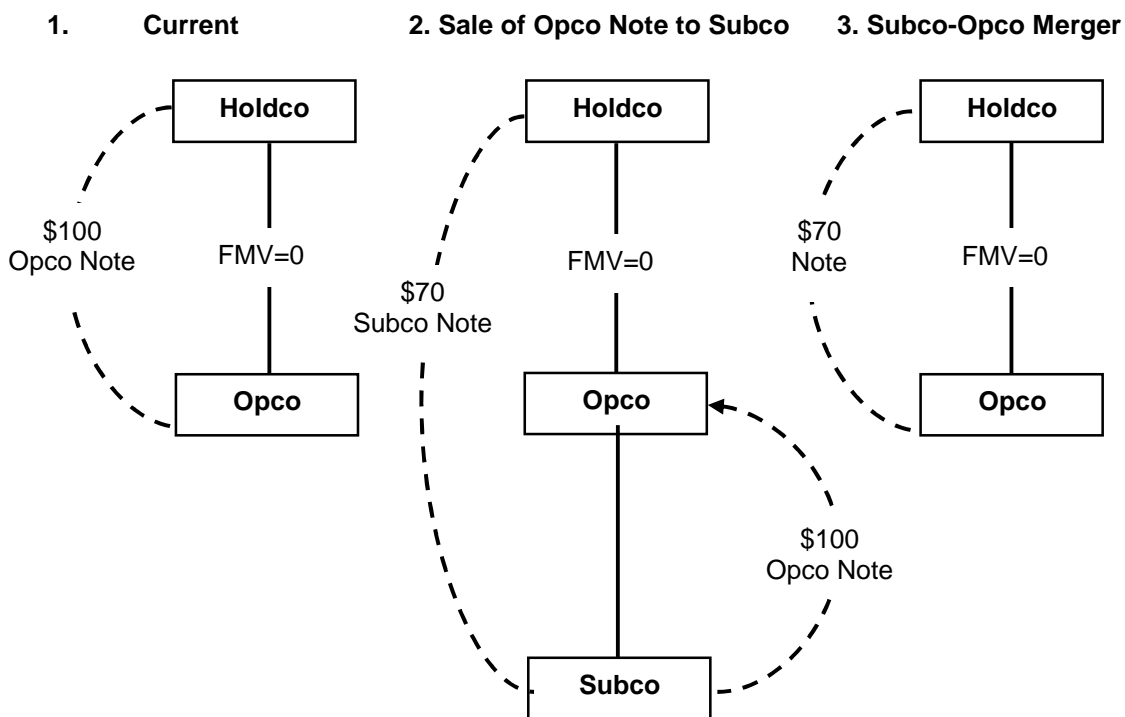
²⁸ This will require a taxation year-end between the property transfer and the debt forgiveness.

²⁹ For an example of these concepts, see CRA document 2008-0266441R3, dated July 16, 2008.

³⁰ ATR-66, "Non-arm's-Length Transfer of Debt Followed by a Winding-up and Sale of Shares," April 20, 1995 (cancelled), continues to reflect the CRA's administrative policy on such transactions: see CRA document 2014-0522501E5, dated April 4, 2014.

³¹ Ss. 40(2)(e.1), 53(1)(f.1) and 80.01(3) and (4).

Figure 7: ATR-66 Transaction



A merger of two corporations within a corporate group prior to a debt forgiveness may also allow the debtor's forgiven amount to be applied to less desirable tax attributes owned by the other merger participant, rather than the debtor's more favourable ones.

Finally, s. 80 includes a mechanism that in some circumstances allows any residual forgiven amount to be transferred to a related member of the Canadian group. This can offer some degree of choice as to which tax attributes are ground down by the forgiven amount. Applied with suitable creativity, this mechanism can be very useful, especially when there are reasons for maintaining the separate existence of different Canadian group members (for example, legal liability) that make a windup or amalgamation undesirable. In principle, this mechanism requires the debtor to make the maximum possible reductions in its most advantageous tax attributes before transferring any residual forgiven amount to eligible transferees, although again there are a number of planning opportunities for optimizing the results.

F. Debt 'Parking'

Under older versions of s. 80 debt could be by a related entity that simply let it remain outstanding indefinitely without ever enforcing repayment. Specific rules in s. 80 now target such "debt parking" by deeming the debt to have been settled in some circumstances. However, these rules catch situations beyond the simple strategy described above.

While the debt parking rules are complex, when the following conditions apply they deem a debt to have been settled for tax purposes even though it remains legally outstanding:

- the debt was previously either:

- owned by a creditor who dealt at arm's length with the debtor and did not have a significant interest in the debtor;³² or
- acquired by the holder from a person unrelated to it;³³ and
- the current holder does not deal at arm's length with the debtor or has a significant interest in the debtor, and its cost of the debt is less than 80 per cent of its principal amount.

These rules might apply when a subsidiary or parent of the debtor purchases the debt from a bank or other arm's-length creditor at a substantial discount. It can also apply when an arm's-length acquirer purchases both the shares of the debtor and its debt owing to the shareholders. For example, when the value of the debtor's assets is less than its outstanding debt, an acquirer will typically purchase the debtor's shares at a nominal amount and the debtor's debts at an amount less than the principal amount. If the amount the acquirer pays for the debt is less than 80 per cent of its principal amount, the debt parking rules will deem the debt to have been settled immediately after the shares and debt are acquired since at that point the acquirer and debtor will not deal at arm's length. The ATR-66 transaction described above can prevent this if the issue is identified in time; however, the debt parking rules constitute a trap for the unwary.

When a debt is deemed to have been settled under the debt parking rules, the debtor is deemed to have paid an amount equal to the current holder's cost of the debt in satisfaction of the principal. Because the creditor must have a cost of the debt that is less than 80 per cent of the principal amount for this rule to apply, a forgiven amount will result, causing a reduction in the favorable tax attributes of the debtor and/or extra taxable income for the debtor.

8. Other Debtor Issues

A. Interest Deductibility

Where a debtor is the subject of a stay order under insolvency legislation such as the *Companies' Creditors Arrangement Act*, the CRA takes the position that it is not under a legal obligation to pay interest and therefore cannot deduct the related expense.³⁴ Interest or other deductible expenses incurred by the taxpayer owing to a non-arm's-length person in one tax year must be paid by the end of the payer's second following tax year. If it remains unpaid by that time, the amount is added back into the payer's income in the immediately following tax year, effectively reversing any deduction previously taken.

Canada's thin capitalization rules restrict the amount of interest-deductible debt that a Canadian-resident corporation³⁵ can incur in connection with debts owed to related non-residents, limiting the potential for cross-border intragroup interest stripping. Essentially, these rules prevent the corporation from deducting

³² For the purposes of the debt parking rules, a shareholder of the debtor who holds 25 per cent or more of the votes or value of the debtor's shares (including shares held by non-arm's-length persons) is deemed not to deal at arm's length with the debtor. A person has a "significant interest" in the debtor if that person or someone not dealing arm's length with that person owns 25 per cent or more (by votes or value) of the debtor's shares.

³³ Generally, two parties will be related when one has legal control of the other or when both are under common legal control. Some elective bad debt write-downs can also trigger the debt parking rules.

³⁴ CRA documents 2008-030484117, dated May 14, 2005, and 2009-031464117, dated October 15, 2009. This position appears to be supported by the Ontario Court of Appeal's judgment in *Re Nortel Networks Corporation*, 2015 ONCA 681 supporting the application of the "interest stops rule" in CCAA proceedings.

³⁵ The thin capitalization rules apply not only to Canadian-resident corporations, but also to Canadian-resident trusts and to non-resident corporations and trusts that either carry on business in Canada or elect to be taxed as Canadian residents. These rules also generally apply to partnerships in which any of those entities are members.

interest on outstanding debt owed to "specified non-residents"³⁶ to the extent that such debt exceeds 150% of its "equity." The debtor corporation's start-of-year retained earnings form part of its "equity" for this purpose. Therefore, if a debtor's retained earnings are diminished due to financial distress (or otherwise), its capacity to support deductible interest expense on cross-border intra-group debt will also shrink. In such cases either the Canadian debtor's equity must be increased or its debts owing to specified non-residents decreased (e.g., replaced with equity or arm's-length debt) to stay inside the 1.5:1 limit.

B. Foreign Exchange

A Canadian corporation that repays or restructures debt that is not denominated in Canadian dollars may recognize a foreign exchange gain or loss because of a difference in the value (expressed in Canadian dollars) of the amount borrowed and the amount subsequently repaid.³⁷ In general, the characterization of a foreign exchange gain or loss on either income account or capital account is determined by reference to the character of the underlying transaction, asset, or liability to which the foreign exchange gain or loss relates.³⁸ Characterizing foreign exchange gains and losses on debt depends on the characterization of the underlying debt, which in turn generally depends on the use of borrowed funds.

Debt-related foreign exchange gains and losses on capital account are generally recognized when the underlying debt is settled.³⁹ This may occur on the repayment of the debt, including on a debt-for-debt or debt-for-equity exchange, or if the debt terms are modified to the point that the old debt is considered to have been disposed of and replaced by a new debt. A foreign exchange gain or loss on the settlement of debt is generally computed as the difference between:

- the amount paid on the settlement, multiplied by the exchange rate in effect on the date of settlement; and
- the original amount of the debt, multiplied by the exchange rate in effect on the date the liability arose.

Under the s. 80 debt forgiveness rules, currency fluctuations are generally ignored for purposes of determining whether a debtor has realized a forgiven amount on the settlement of debt. In other words, a forgiven amount should not arise under the debt forgiveness rules of s. 80 solely by virtue of fluctuations in the value of the currency in which the debt was denominated, even if the debtor realizes a foreign exchange gain or loss on a debt exchange. In practice, however, there are circumstances in which foreign exchange issues can arise under s. 80 on the restructuring of foreign-denominated debt, and it is important to carefully work through all the elements of these complex rules before acting.

D. Contract Consent or Non-Performance Payments

A debtor in financial difficulty may be unable to meet its obligations under business contracts or need to secure the agreement of lenders or others to amend business terms. Such payments must be classified as

³⁶ A specified non-resident as regards a Canadian-resident corporation is defined as a non-resident person who either (1) owns at least 25 per cent of its shares (by votes or value, and including any shares held by non-arm's-length persons) or (2) does not deal at arm's length with shareholders holding at least 25 per cent of its shares.

³⁷ The general rule is that Canadian tax results must be reported in Canadian dollars. However, some corporations resident in Canada may elect under s. 261 to report their tax results in a qualifying currency that is the primary currency in which they keep their books and records for financial reporting purposes.

³⁸ For example, an F/X gain or loss on money borrowed and used to purchase a capital asset will generally be a capital gain or loss. For a detailed discussion of this issue, see Steve Suarez and Byron Beswick, "Canadian Taxation of Foreign Exchange Gains and Losses," *Tax Notes Int'l*, Jan. 12, 2009, p. 157.

³⁹ S. 39(2).

income or capital in nature in accordance with general principles, to determine whether and in what form tax recognition is given to them.⁴⁰ Expenses incurred as part of a debt restructuring must be similarly analyzed.

E. Change of Status

A restructuring or change in share ownership of a Canadian-resident corporation may cause its tax status to change, with various potential tax consequences. Shareholders should review whether a corporation's financial circumstances and actions taken to address it have changed its tax status.

There are essentially three types of Canadian-resident corporations for income tax purposes:

- a “public corporation,” being a Canadian-resident corporation that has a class of shares listed on a designated stock exchange in Canada;⁴¹
- a “private corporation,” being a Canadian-resident corporation that is not (and is not controlled by) a “public corporation”; and
- a corporation that is neither a public corporation or a private corporation (e.g., a non-public corporation that is controlled by a public corporation).

As a general rule, private corporations receive advantageous tax treatment relative to non-private corporations as regards shareholders resident in Canada. This is primarily because only a private corporation can elect to designate a dividend as a “capital dividend” (up to the amount of its capital dividend account), which is received tax-free by Canadian-resident shareholders.⁴²

Canadian-controlled private corporations (CCPCs) are a subset of private corporations, being a private corporation that is incorporated in Canada and which is not controlled (directly or indirectly, in any manner whatever) by non-residents and/or public corporations. CCPCs are eligible for a number of potential tax advantages, including:

- a low rate of corporate income tax on their first \$500,000 of active business income;
- favourable treatment on employee stock options; and
- enhanced investment tax credits on qualifying scientific research and experimental expenditures.

In addition, only a CCPC can be a “small business corporation,” which is a CCPC that meets certain tests as to the composition of its assets (which may be affected by changes in the value of its assets). The shares of a “small business corporation” are potentially eligible for the qualified small business corporation lifetime capital gains exemption described above, and (as noted below under Creditor Issues) a loss on shares or debt of a “small business corporation” may entitle the holder to an allowable business investment loss.

⁴⁰ Interpretation Bulletin IT-467R2 contains the CRA's views on the income/capital treatment of damage payments to payers in respect of the non-performance of business contracts. In general, the CRA accepts that “the portion of [a contract termination] payment relating to the elimination of future obligations under the terminated agreement would probably be deductible where those future payments would have been deductible”: see CRA document 2003-004476117, dated January 27, 2004.

⁴¹ A Canadian-resident corporation which previously had a listed class of shares remains a “public corporation” unless it meets certain conditions and elects (or the CRA designates it) not to be. The Department of Finance website lists the stock exchanges that are designated stock exchanges, including those in Canada.

⁴² Essentially the corporation's capital dividend account reflects 50% of capital gains (net of capital losses) realized by the corporation over time.

F. Bankruptcy

When a corporation becomes bankrupt within the meaning of the *Bankruptcy & Insolvency Act*, it undergoes an immediate tax year-end. The trustee in bankruptcy administers the bankrupt corporation's assets and liabilities as its agent for ITA purposes. Where the corporation is a bankrupt at the time a debt has been settled, generally no "forgiven amount" will arise for purposes of the debt forgiveness rules in s. 80.

Once the bankrupt is granted an absolute order of discharge, its accumulated losses from prior years are not usable in the year of the discharge or any later year. Conversely, if the bankrupt is the subject of a proposal to creditors under the *Bankruptcy & Insolvency Act* that is accepted (*i.e.*, the bankruptcy is annulled), no such restriction applies on the use of its losses.⁴³ A corporation that undergoes an acquisition of control as part of the bankruptcy process will be subject to the normal loss restrictions applicable to any acquisition of control (see below under Purchase and Sale of Loss Companies).

9. **Creditor Issues**

A. Loss Realization

In most cases the creditor's primary tax issue in cases of a debtor's financial difficulty is realizing and optimizing the use of any economic loss incurred. Leaving aside special rules applicable to financial institutions and creditors whose ordinary business includes moneylending, the most relevant provisions are the following:

Doubtful Debts: a creditor that has included the amount in income (*e.g.*, interest, a trade receivable, etc.) can claim a reasonable reserve in respect of doubtful debts under s. 20(1)(l). The reserve is added back to the creditor's income in the following year. The factors to be considered in determining whether a debt is "doubtful" include "the time element, a history of the account, financial position of the customer and the general business condition in the locality where the debtor lives or operates, as well as general economic conditions."⁴⁴ The CRA generally expects the reserve to be computed based on the taxpayer's past collection history of doubtful debts (not all debts) and industry practice.⁴⁵

Bad Debts (Income): a creditor that has included the amount in income (*e.g.*, interest, a trade receivable, etc.) can claim a deduction under s. 20(1)(p) in respect of debts that are established to be bad debts in the year. The courts have held that factors such as the debt's history and age, the debtor's financial position, liquidity, current assets and liabilities, and general economic conditions are all relevant in determining whether a debt is "bad."⁴⁶ Any amount subsequently received by the creditor will be included in its income, effectively reversing the deduction to that extent.

Bad Debts (Shares & Debt): s. 50(1) provides for a capital loss to be claimed on debts owing to the creditor at year-end established to be "bad debts."⁴⁷ To realize the loss without actually disposing of the receivable, the creditor must elect for this provision to apply. The creditor is deemed to have disposed of the debt for

⁴³ See also CRA document 9924355, dated September 23, 1999.

⁴⁴ *The Queen v. Copley Noyes & Randall Limited*, 93 DTC 5508 (FCTD).

⁴⁵ See Interpretation Bulletin IT-442R, para. 24.

⁴⁶ *Rich v. The Queen*, 2003 FCA 38.

⁴⁷ S. 50(1) also applies to shares of a corporation that is (1) a bankrupt within the meaning of the *Bankruptcy & Insolvency Act*, (2) the subject of a winding up order under the *Winding-up and Restructuring Act*, or (3) insolvent, where the shares have no value and it is reasonable to expect the corporation to be dissolved.

nil proceeds and required it at a cost base of nil. The CRA takes the position that the entire amount of the debt must be uncollectible in order for s. 50(1) to apply.⁴⁸

Foreclosures & Seizures (s. 79/79.1): as noted above (fn. 18), when a creditor acquires a debtor's property as a consequence of non-payment, the creditor is essentially deemed to have disposed of the debt to which the default relates without gain or loss, and to have acquired the seized property at a cost amount equal to the creditor's cost of the debt. As such, the creditor will realize a gain or loss when the seized property is disposed of.

Allowable Business Investment Losses: unlike a normal capital loss that may only be used against capital gain, an allowable business investment loss (ABIL) can be used against items of income. An ABIL arises upon a disposition to an arm's-length person of a share of a "small business corporation" or a debt owing by an arm's-length "small business corporation."⁴⁹ A "small business corporation" for this purpose is a "Canadian controlled private corporation" substantially all of the assets of which are used in an active business carried on primarily in Canada (or securities in other "small business corporations") any time in the preceding 12 months.

In cases where a debt restructuring involves a creditor receiving equity of the debtor in place of an existing receivable (*i.e.*, a recapitalization), this may or may not result in a disposition of the receivable for tax purposes such as would cause the creditor's accrued gain or loss on the receivable (and foreign exchange gains and losses on non-Cdn.\$-denominated debt) to be realized. For example, if the creditor acquires shares of the debtor in exchange for a receivable the terms of which give the creditor the right to make the exchange, this is deemed not to be a disposition of the receivable for tax purposes.⁵⁰ Where the terms of the existing debt do not have such a conversion right, the addition of such a right to the existing debt has been held not to amount to a replacement of the existing debt with a new debt (*i.e.*, a taxable disposition) in some circumstances but rather merely an amendment to the existing debt.⁵¹

B. Stop-Loss Rules

There are various rules in the ITA that deny recognition of a loss to a creditor. For example, in some circumstances a loss realized on the disposition of a share is reduced by the amount of particular dividends received on the share.⁵² A loss on property acquired primarily for personal enjoyment (personal-use property) is deemed to be nil, as is a loss incurred on a debt that was not made for an income-earning purpose or as consideration for the sale of property to an arm's-length person.⁵³ Interest-free debts are a common problem in this regard, since the creditor is not directly earning any income. The courts have held that a creditor who loans money to a corporation in which it is a shareholder may have a satisfactory indirect income-earning purpose via the expectation of increased dividend income on its shares of the debtor.⁵⁴

A general stop-loss concept that manifests itself in several places in the ITA is that losses on the disposition of property should generally not be recognized when the taxpayer or an affiliated person continues to own the property or an identical substituted property. The basic principle is that no true economic loss arises until the relevant property is no longer owned within the affiliated group. While there are separate such stop-loss rules dealing with different types of property, they generally operate along similar lines, and can

⁴⁸ See CRA document 2013-0495671C6, dated October 11, 2013.

⁴⁹ S.39(1)(c). An ABIL may also arise on a deemed disposition under s. 50(1) (see above).

⁵⁰ S. 51(1): to apply, the creditor must receive no consideration other than shares of the debtor.

⁵¹ See for example CRA document 2013-0514191R3, 2014.

⁵² S. 112(3) *et. seq.*: see Suarez, "The Capital Property Dividend Stop-Loss Rules", 53(1) *Canadian Tax Journal* 269-91 (2005).

⁵³ S. 40(2)(g)(ii).

⁵⁴ See for example *Bynum v. The Queen*, 99 DTC 5117 (FCA).

be illustrated by describing the stop-loss rules applicable to dispositions of non-depreciable capital property by a corporation, partnership, or trust. Briefly, a loss from the disposition of non-depreciable capital property (the disposed-of property) by a corporation, partnership, or trust (the transferor) is deemed to be nil when:

- the disposition of the disposed-of property is not an excepted disposition;
- the transferor or an affiliated person acquires a property (the acquired property) within the 61-day period that begins 30 days before and ends 30 days after the date of the disposition;
- the acquired property is either the disposed-of property itself or property identical to the disposed-of property; and
- at the end of the 61-day period, the transferor or an affiliated person owns the acquired property.

Thus, for example, simply transferring ownership to an affiliated person or disposing of property and buying it (or an identical property) back within 31 days will cause the loss to be suspended. The suspended loss will be recognized at the beginning of the first 30-day period following the disposition in which neither the transferor nor an affiliated person owns the acquired property (or an identical property that was acquired within the 30 days preceding the start of the 30-day period). Thus, the loss could be unsuspended because the acquired property has been sold outside the affiliated group or because the owner of the acquired property has ceased to be affiliated with the transferor.⁵⁵

C. Other Issues

Consent or Contract Non-Performance Payments: in situations where a creditor is receiving “consent” payments or other remuneration in consideration to agreeing to not exercise rights it may otherwise have or as breach-of-contract compensation, the tax treatment of those payments should be carefully considered. It is possible that rules dealing with “restrictive covenants” will deem such amounts to be income to the creditor (even if not deductible to the payer). This is undesirable if the payment is essentially capital in nature.⁵⁶

Non-Resident Creditors: various considerations apply when the creditor is a non-resident of Canada. Interest withholding tax does not apply in respect of interest paid to an arm’s-length non-resident creditor. However, issues may arise where a debt restructuring results in a non-resident creditor receiving a variable amount that may be characterized as “participating interest” (convertible debt is an area of particular uncertainty) or acquiring share ownership so as to potentially not deal at arm’s length with the debtor. The transfer by a non-resident of debt owing by a Canadian resident to another Canadian resident may also result in a deemed payment of interest for withholding tax purposes.⁵⁷ “Consent payments” described above may also yield withholding tax when made to a non-resident creditor.⁵⁸

Guarantors: guarantors who are required to perform under the terms of their guarantees generally acquire the underlying receivable owing from the debtor so as to have the same rights and claims against the debtor

⁵⁵ The stop-loss rules are described in more detail in Suarez, “Tax Planning With Losses in Canada,” *Tax Notes Int’l*, Aug. 1, 2005, p. 451.

⁵⁶ Interpretation Bulletin IT-365R2 contains the CRA’s views on the income/capital treatment of damage payments to recipients in respect of the non-performance of business contracts.

⁵⁷ Ss. 214(6)-(8).

⁵⁸ S. 212(1)(i). See *Pangaea One Acquisition Holdings XII SARL v. Canada*, 2020 FCA 21.

as the creditor had. As such, guarantors typically have similar issues faced by creditors under the debt being guaranteed. Specifically, an income-earning purpose is required to support:

- recognition of any loss incurred by the guarantor in honouring the guarantee (see above under Stop-Loss Rules); and
- interest deductibility if a guarantor of a debt has borrowed money to honour the guarantee.

An income-earning purpose exists where a guarantee fee was paid or where the guarantor charges interest to the defaulting debtor. An indirect income-earning purpose may also suffice, such as a parent corporation guaranteeing the debts of a subsidiary from which it expected to earn dividend or other income.⁵⁹

10. Liability for Unpaid Taxes

A. Directors' Liability

Directors of a corporation experiencing financial difficulty may become personally liable for some of the corporation's tax liabilities when the corporation has failed to deduct, withhold, or remit to the CRA in respect of certain amounts, including:

- salary, wages, certain employment benefits, and distributions out of various plans paid by the corporation to employees (including EI premiums and CPP contributions);
- amounts paid or credited by the corporation to non-residents and subject to withholding tax; and
- the federal goods and services tax and any harmonized provincial sales tax collected or collectible by the corporation.⁶⁰

An employer who fails to make source deductions from employee remuneration (as opposed to deducting but not remitting to the CRA) is liable for penalties and interest in respect of such failure to withhold⁶¹ and for CPP contributions and EI premiums⁶² but not for the income tax that should have been withheld from the employee's remuneration itself.⁶³ Where the corporation has deducted such amounts (or collected GST/HST) but failed to remit them to the CRA, the corporation is liable for such amounts plus interest and penalties.⁶⁴ In some cases the source of the potential liability may not be obvious. For example, the CRA may challenge whether payments made to people whom the corporation treated as independent contractors are in fact employees of the corporation, such that payroll-related withholding and remittance obligations are exigible (plus interest and penalties).

The amount for which directors may be liable is the amount that the corporation failed to deduct, withhold, or remit, as well as any interest or penalties. Generally, a director will become personally liable only if:

⁵⁹ See CRA Folio S3-F6-C1, paras. 176-180.

⁶⁰ S. 227.1 ITA, s. 21.1(1) *Canada Pension Plan*, s. 83(1) *Employment Insurance Act* and s. 323 of the *Excise Tax Act* (ETA).

⁶¹ Ss. 227(8), (8.3) and (10).

⁶² Ss. 21(1) and 22 *Canada Pension Plan* and 82(4) and 85(1) *Employment Insurance Act*.

⁶³ Unless the employee is a non-resident of Canada: see s. 227(8.4). Note that the CRA's time limit for re-assessing is different for all three statutes (unless the taxpayer has made a misrepresentation in filing, in which case no limit exists).

⁶⁴ Ss. 227(9)-(10.1) ITA, ss. 21(6), 21(7) and 23(2) *Canada Pension Plan*, ss. 82(8)-(9) *Employment Insurance Act* and 280(1) ETA: see also below under Crown Priorities with reference to deemed trusts for collected amounts

- the CRA has first pursued the corporation for amounts owing, which typically requires the CRA to register a certificate in the Federal Court of Canada and show that its execution of the writ against the corporation was returned unsatisfied;⁶⁵
- the CRA reassesses a director within two years after the director last ceased to be a director (including a *de facto* director)⁶⁶ of the corporation; and
- the director failed to exercise the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances (the due diligence defense).

Directors of a financially troubled corporation should demonstrate the appropriate diligence in making sure that the corporation is meeting its tax obligations. For example, regular inquiries should be made of management to the effect that the corporation is deducting and remitting to the CRA all legally-required tax and payroll-related amounts (including Employment Insurance and Canada Pension Plan premiums). There should also be suitable procedures in place to confirm that all required deductions and remittances have in fact occurred. A director concerned about potential liability can avail herself of the due diligence defense by acting appropriately (suitable directors' insurance should also be in place). Outside directors will generally be held to a lower standard than directors who are involved in the day-to-day management of a corporation and influence how its business is conducted, and a particular person's education and business experience are also relevant in considering whether they have met the due diligence standard.⁶⁷

The ITA also provides that every person who is a legal representative that administers, winds up, controls or otherwise deals with the property or business of a corporation is required to apply to the CRA for a clearance certificate before distributing any of the corporation's property.⁶⁸ The clearance certificate generally certifies that the corporation has paid certain taxes or posted security for such amounts. Failure to obtain a clearance certificate will render the representative personally liable for the payment of the corporation's taxes owing, up to the value of the property distributed. Although this provision most commonly arises in the case of executors, it may also apply to directors (for example, on the wind-up of a corporation). Finally, Canadian corporate law typically provides that if the directors of a corporation declare dividends when a corporation is unable to pay its liabilities (including taxes) or such a payment would result in the corporation becoming unable to pay its liabilities, the directors may become liable to the corporation for the amount of the improper payment.⁶⁹

B. Non-Arm's-Length Transfers

Where a tax debtor has transferred property to a non-arm's length person and received less than the property's fair market value in return, the transferee may be jointly and severally liable for amounts owed by the tax debtor to the CRA for the year of the transfer and previous years.⁷⁰ The amount of the transferee's liability is limited to the excess of the transferred property's fair market value over any consideration paid by the transferee, *viz.*, the amount by which the transferee was enriched by the transaction. The transferee need not be aware of the debtor's tax liabilities or have any intention to defeat creditors in order for this provision to apply.

⁶⁵ S. 227.1(2) ITA.

⁶⁶ See for example *Bremner v. The Queen*, 2009 FCA 146.

⁶⁷ See Information Circular IC 89-2R3 and GST/HST Policy Statement P-237 for the CRA's administrative policies on this issue.

⁶⁸ S. 159(1).

⁶⁹ See, e.g., section 130(2) of the *Ontario Business Corporations Act*.

⁷⁰ S. 160(1).

This issue often arises in respect of significant shareholders of a corporation receiving dividends, loans or other benefits from the corporation. Where applicable, the shareholder may find itself liable under s. 160 for the corporation's tax debts even though the shareholder was already taxed on the actual transfer of property itself (e.g., a dividend included in the shareholder's income). The shareholder's payment under a s. 160 assessment does not reduce whatever tax was payable when the shareholder received the property from the corporation.⁷¹

C. Crown Priorities

The key questions on Crown claims for tax debts are generally (1) what actions the CRA can take to pursue taxes owing, and (2) where the CRA ranks relative to other creditors. These are often not straightforward, and the law in this area continues to evolve and change.

While in most insolvency situations the CRA ranks as an unsecured creditor in respect of the debtor's taxes owing, in certain cases it enjoys priorities for taxes relative to other creditors. For the most part, these are for amounts the debtor is required to withhold and remit to the CRA, such as source deductions on employee remuneration (e.g., taxes, CPP and EI) and non-resident withholding tax. A deemed trust in favour of the Crown exists over such amounts that have been collected or withheld by the debtor but not remitted to the CRA.⁷² An enhanced garnishment provision allows the CRA to demand payment of such amounts from third parties who would otherwise make a payment to a debtor (or its secured creditors).⁷³

If a tax debt has been "certified" in the Federal Court before proceedings have commenced under the *Bankruptcy & Insolvency Act* or the *Companies' Creditors Arrangement Act*, it is treated as a secured claim for these purposes. A stay of proceedings ordered under either of these statutes may prevent the CRA from taking immediate action to collect unpaid taxes and related amounts. The CRA is generally permitted to set off amounts owing to a debtor (e.g., refunds and credits) against the debtor's taxes and related amounts owing.⁷⁴

D. Taxpayer Relief

The CRA has discretion to provide various forms of administrative relief to taxpayers in certain circumstances, including waiving or cancelling interest and penalties otherwise payable.⁷⁵ An application for relief can be made in respect of interest accruing or penalties arising for the 10 years immediately prior to the taxpayer's request for relief.

A taxpayer's inability to pay or financial hardship is one of the circumstances which the CRA has identified as being eligible for relief under these provisions. In particular, the CRA is open to waiving interest in situations where the taxpayer's ability to pay the underlying tax debt is such that an extended payment period is necessary or interest would absorb a significant portion of any payments. Cancellation of penalties is less common, but will be considered in cases of financial difficulty so severe that penalty enforcement would jeopardize the continuity of the taxpayer's business operations, the jobs of the employees, and the

⁷¹ See for example *Parihar v. The Queen*, 2015 TCC 52.

⁷² Ss. 227(4) and (4.1). Comparable provisions exist for CPP contributions (s. 23(3) and (4), *Canada Pension Plan*), EI premiums (ss. 86(2) and (2.1) *Employment Insurance Act*) and GST/HST (ss. 222(1) and (3) *ETA*). The priority of the Crown's deemed trust for unremitted GST over secured lenders outside of a court-supervised BIA or CCAA restructuring was recently illustrated in *The Toronto-Dominion Bank v. The Queen*, 2020 FCA 80, which noted the difference between the ITA and ETA in this regard (para. 44).

⁷³ S. 224(1.2). Similar provisions exist for CPP contributions (s. 23(2) *Canada Pension Plan*), EI premiums (s. 99 *Employment Insurance Act*) and GST/HST (s. 317(3) *ETA*).

⁷⁴ The CRA's collections policies and procedures are described in Information Circular IC 98-1R7.

⁷⁵ S. 220(3.1).

welfare of the community as a whole.⁷⁶ Taxpayers in financial distress should fully explore the potential for administrative relief from amounts owing to the CRA.

11. Transfer Pricing

Canada's transfer pricing rules apply to transactions between a Canadian and a non-resident of Canada not dealing at arm's length with that Canadian (a non-arm's-length non-resident or NALNR), and ensure that the Canadian has not paid too much (or received too little) by testing those transactions against the arm's-length standard. Specifically, section 247(2) requires identification of a particular transaction or series of transactions (the tested transactions) that both the Canadian taxpayer and an NALNR participate in. The general transfer pricing rule (GTPR) in section 247(2)(a) applies when the terms and conditions of the tested transactions between the actual participants differ from those that would have been made between arm's-length persons in the same circumstances.⁷⁷ If the GTPR applies, the CRA is entitled to revise those terms and conditions (*i.e.*, prices) to whatever arm's-length parties would have agreed to.

In Canada, transfer pricing penalties may apply when the taxpayer's net transfer pricing adjustment for the year exceeds the lesser of \$5 million or 10 per cent of the taxpayer's gross revenue for the year. A taxpayer subject to transfer pricing adjustments (however large) can avoid penalties if it can show it made reasonable efforts to determine and use arm's-length prices and allocations. Whether the taxpayer has made such reasonable efforts for any particular transaction is a question of fact. However, when the taxpayer fails to meet the statutory requirements set out in section 247(4) to prepare and provide the CRA with satisfactory "contemporaneous documentation" outlining the underlying analysis, it is deemed not to have made reasonable efforts. This puts taxpayers who fail to prepare satisfactory contemporaneous documentation within 6 months of year-end at considerable risk (which is the intention of the penalty).⁷⁸

An adverse business environment may represent an opportunity to rethink where assets (especially IP), functions and risks are located, in terms of matching of deductions and income across a multinational group and potentially reducing the activities of subsidiaries in unfavourable jurisdictions. The fact that a taxpayer's transfer prices need only be within the range of prices that arm's-length persons would reasonably transact at allows considerable flexibility to revise transfer pricing methodologies and comparables within the arm's-length standard.

Moreover, changes in the business environment may be significant enough to require a full transfer pricing study to determine whether existing methodologies and comparables remain valid. Taxpayers should review the terms of existing inter-company agreements to see whether provisions dealing with business disruptions exist (or should be added), and deviations from normal business practices as a result of unusual market conditions should be documented and explained. Interest rates on related-party cross-border loans are likely to be scrutinized especially closely and should be supported by detailed analysis justifying the interest rates used.

Transfer pricing audits are generally quite intensive following significant economic changes, and will require both more upfront analysis to justify transfer pricing methodologies and prices, and more time spent with CRA personnel to explain any changes made (or why none were appropriate). The requirement that

⁷⁶ Information Circular IC 07-1R1, paragraphs 27-28.

⁷⁷ The more severe transfer pricing recharacterization rule in section 247(2)(b) applies when the tested transactions would not have been entered into between arm's-length persons at all (*i.e.*, they are commercially irrational), and can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

⁷⁸ See Suarez, "Transfer Pricing in Canada," *Tax Notes International*, December 2, 2019, p. 781 at p. 790.

contemporaneous documentation necessary to prevent the CRA from imposing transfer pricing penalties be prepared within 6 months after the taxpayer's year-end will be especially challenging to meet in 2020.

12. Repatriating Funds from Canada

A corporation having financial difficulties may seek to access a subsidiary's cash. There are three primary ways for a foreign shareholder to repatriate cash from a Canadian subsidiary:

- the payment of a dividend by the Canadian subsidiary;
- a distribution of paid-up capital (PUC) by the Canadian subsidiary; or
- a loan by the Canadian subsidiary to the foreign parent.

Each of these alternatives has different Canadian tax consequences. The primary considerations are typically (1) whether withholding tax applies, and (2) the effect on the Canadian subsidiary's "equity" for purposes of determining how much interest-deductible debt it can borrow from non-arm's-length non-residents under Canada's "thin capitalization" rules.⁷⁹ Canada's thin capitalization rules restrict the amount of interest-deductible debt that a Canadian subsidiary can incur on debts owed to non-arm's-length non-residents. Essentially, these rules prevent the Canadian subsidiary from deducting interest on outstanding debt owed to non-arm's-length non-residents to the extent that such debt exceeds 150% of its equity.

A. Dividends

A dividend paid by a Canadian subsidiary to a foreign parent will be subject to Canadian dividend withholding tax of 25 per cent, subject to potential reduction under an income tax treaty. For example, under the Canada-U.S. Income Tax Convention, dividends paid by a Canadian resident corporation to a U.S. company entitled to treaty benefits will generally be subject to a 5 per cent withholding tax rate if the U.S. company owns 10 per cent or more of the voting stock of the Canadian subsidiary. Otherwise, the general dividend withholding rate for U.S. residents entitled to treaty benefits on Canadian-source dividends is 15 per cent.

Because the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI) is now in force in Canada, an anti-avoidance "principal purpose test" will apply to restrict claims by non-residents for relief (including on dividend withholding tax) under many of Canada's tax treaties (excluding its treaty with the U.S.).⁸⁰ A dividend that reduces the Canadian subsidiary's retained earnings will diminish its "equity" for thin capitalization purposes in the subsidiary's taxation year after the year the dividend is paid.

B. PUC Distributions

PUC is essentially the tax version of the corporate law concept of stated capital or the accounting concept of share capital, subject to adjustments set out in the ITA. Under Canadian tax law, a corporation can generally choose to make distributions to shareholders as a return of share capital (to the extent of PUC) or as a distribution of profits (that is, dividends). There is no requirement to distribute profits as dividends

⁷⁹ A Canadian subsidiary borrowing the funds to be repatriated rather than using funds on hand must also consider whether interest will be deductible on the borrowed funds, separate and apart from thin capitalization constraints.

⁸⁰ See Suarez, "How the MLI Will Change Capital Gains Taxation in Canada," *Tax Notes International*, May 11, 2020, p. 657.

before returning PUC, unlike the U.S. tax rule in which any corporate distribution is treated as a dividend to the extent of the corporation's earnings and profits.

A distribution of PUC is not a dividend and therefore does not incur dividend withholding tax. Such distributions instead reduce the shareholder's cost for tax purposes (tax cost) of the shares on which the PUC distribution is made. Accordingly, a Canadian corporation generally can distribute PUC to shareholders tax free, since such amounts are essentially a return of invested capital rather than profits.⁸¹ A PUC distribution will reduce the Canadian subsidiary's "equity" for thin capitalization purposes in the year of the distribution.

C. Loans

There are several tax provisions that may apply if a Canadian subsidiary makes a loan to a foreign parent or related non-resident. They are intended to prevent a foreign parent from using a loan (or a series of loans and repayments) as a substitute for a dividend from the Canadian subsidiary. The basic premise of these rules is that such loans are *de facto* shareholder distributions and should be treated as such and included in the debtor's income unless falling within certain limited exceptions. The most important exception is a loan to a shareholder that is repaid by the end of the creditor's second taxation year after the debt was incurred (if not part of a series of debts and repayments).

Otherwise, a loan by a Canadian subsidiary to a foreign parent or sister company is treated as a dividend paid to the non-resident, such that dividend withholding tax applies as described above with reference to actual dividends.⁸² A subsequent repayment of the debt may entitle the foreign debtor to a refund of withholding tax paid. In certain circumstances, the parties may elect for an alternative regime to apply instead, which requires the Canadian subsidiary to include at least a minimum prescribed amount of interest on the loan in its income. A loan does not impact the Canadian subsidiary's "equity" for thin capitalization purposes.⁸³

⁸¹ If the amount of the PUC distribution received by the shareholder exceeds the shareholder's tax cost of the Canadian corporation's shares, a capital gain will result. Most Canadian tax treaties exempt residents of the other jurisdiction from Canadian tax on capital gains on shares of corporations that do not derive their value primarily from Canadian real property (directly or indirectly).

⁸² Ss. 15(2) and 214(3)(a).

⁸³ The subject of loans and other distributions from Canadian corporations to non-residents is complex, and discussed in Suarez, "The MNE's Abridged Tax Guide to Canada", *Tax Notes International*, June 2020.

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