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TAX LAW BULLETIN

Borden Ladner Gervais

AUGUST 14 DRAFT LEGISLATION TARGETS FOREIGN-OWNED CANADIAN COMPANIES

The Canadian federal budget of March 29, 2012 (“2012 Budget”) contained a variety of provisions directed at Canadian subsidiaries of foreign companies (see **here** for prior commentary). On August 14, 2012, the Department of Finance released draft legislation that would enact many of these proposals and which contain some variations from the initial announcements in the 2012 Budget. This bulletin identifies who is affected by these proposals and how (summarized in the table below).

SUMMARY OF AUGUST 14 FOREIGN MULTINATIONAL DRAFT LEGISLATION

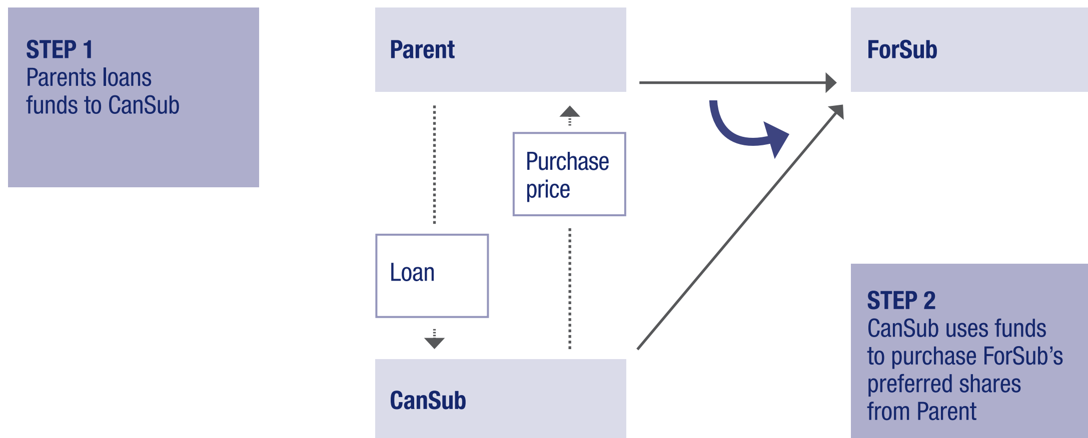
Development	Who is Affected	What’s Happening
“Foreign Affiliate Dumping” Rules	Canadian-resident corporation (Canco) that is (or as part of the relevant series of transactions becomes) controlled by a non-resident corporation, and who • acquires shares or debt of a foreign corporation in which it has (or acquires as part of the relevant series of transactions) a 10%+ equity interest (a “foreign affiliate”); or • acquires shares of another Canadian corporation >50% of the value of whose property is shares of foreign affiliates	Subject to limited exceptions, such transactions will • deem Canco to have paid a dividend to its non-resident parent, triggering non-resident dividend withholding tax; and/or • suppress any increase in the paid-up capital of Canco’s shares that would otherwise result These sweeping rules contain numerous traps and technical uncertainties, and may result in double taxation in some circumstances

Development	Who is Affected	What's Happening
Thin Capitalization Changes: Debt Owing by Canco to Non-Resident	Canadian-resident corporation (Canco) that owes money to a non-resident who is either • a 25%+ shareholder; or • dealing non-arm's length with a 25%+ shareholder. Canco is limited as to the amount of such debt it may deduct the interest on for tax purposes	The permissible amount of such debt is being reduced, from 2x Canco's equity (paid-up capital + start-of-year unconsolidated retained earnings) to 1.5x Canco's equity, effective 2013 Effective taxation years ending after March 28, 2012: • disallowed interest is treated as a dividend (not interest) for purposes of applying non-resident withholding tax; and • debt caught by these rules is expanded to include debt incurred by a partnership of which Canco is a member
Shareholder Loan Rules: Debt Owing to Canco from Non-Resident	Canadian-resident corporation (Canco) to whom an amount becomes owing after March 28, 2012 by a non-resident corporation that • controls Canco; or • does not deal at arm's length with another non-resident corporation that controls Canco	Instead of applying the usual rule deeming such loans (subject to certain exceptions) to be a dividend paid by Canco triggering non-resident withholding tax, Canco and its foreign parent can elect to have all such debt come within a new deemed-interest regime, which requires Canco to include income at least equal to a prescribed rate (currently 5%) on the debt each year it remains outstanding

"FOREIGN AFFILIATE DUMPING" RULES

For some years the Department of Finance has been concerned with certain transactions that, in their simplest form, involve a foreign-controlled Canadian subsidiary purchasing shares of a foreign member of the group and deducting interest accruing from the balance-of-sale purchase price against its income for Canadian tax purposes (see Figure 1). Such "dumping" of the foreign affiliate into the Canadian subsidiary was perceived as inappropriately taking advantage of the fact that in many cases, Canada will not tax dividends (if any) that are paid to the Canadian subsidiary on the shares of the foreign affiliate it purchased.

FIGURE 1



The 2012 Budget addressed this issue by proposing a sweeping new rule that went far beyond this original (and in some cases justified) concern. While the August 14 draft legislation responds to some of the many problems identified by the tax community with the original proposal, the revised "foreign affiliate dumping" rules remain a serious concern for any foreign-controlled Canadian corporation that has equity interests in foreign corporations. These new rules apply to transactions occurring after March 28, 2012, with very limited transitional relief for transactions between arm's-length parties that were agreed to in writing on or before that date and that are completed by the end of 2012.

These rules cast an overly broad net, as they can apply in a number of situations where no Canadian tax advantage is being sought or achieved. Those caught within the net are left to rely on a few specific exceptions of very limited scope or certain provisions that mitigate the effect of these rules in some circumstances but not others. The danger presented by the broad reach of these rules is compounded by the use of various concepts whose scope is imprecise (e.g., "series of transactions", "confer a benefit"), and by the fact that it is quite possible for double taxation to result.

Scope of New Rules

In its simplest form, the new rule applies whenever a corporation resident in Canada ("Canco") that is controlled by a non-resident corporation ("Parent") acquires shares or debt of a non-Canadian corporation ("Foreignco") in which Canco has (or acquires) a 10%+ equity interest so that Foreignco is (or becomes) a "foreign affiliate" of Canco. The net is then broadened in a number of ways:

- *Relevant Series of Transactions:* it extends to situations in which, not at the time of the Canco's investment but at some other time during the series of transactions that includes Canco's investment (the "Relevant Series"), Foreignco becomes a "foreign affiliate" of Canco or Canco becomes controlled by Parent;
- *Maturity/Redemption Date Extensions:* if Canco extends the maturity date of a debt owing by Foreignco or the redemption date of Foreignco shares that it owns, the extension is treated as an acquisition of the debt or shares;
- *Benefit Conferred on Foreignco:* a contribution by Canco to the capital of Foreignco is caught, which for this purpose is deemed to include any "benefit" conferred by Canco on Foreignco;
- *Acquisitions of Other Cancos:* if Canco acquires shares of another Canadian corporation the value of whose assets is primarily attributable to its "foreign affiliates," this too is caught (a further rule extends the net to cases where property of the acquired corporation is later sold as part of the Relevant Series and this results in the "primarily attributable" threshold being met); and
- *Acquisitions by Partnerships:* look-through rules attribute acquisitions made by a partnership to its partners.

A few narrowly-drafted exceptions are carved out of the charging provision. In the case of an acquisition of Foreignco debt by Canco, there are exclusions for (1) debt incurred in the ordinary course of business (e.g., trade debt) and repaid within 180 days, and (2) debt arising after March 28, 2012 that Canco elects to make subject to a new rule requiring the inclusion in its income of at least a minimum amount of interest (see below under **Upstream Loans from Canco**). An exception is also provided for Canco acquisitions of Foreignco shares as part of some (but not all) intra-group corporate reorganizations. A further exception meant to allow for "strategic business expansion" of Canco's business by investments in foreign affiliates is so narrowly drafted and unclear in scope as to be of little practical use in most cases.

Consequences

Where Canco's acquisition of shares or debt comes within the new rules, they have two effects:

- to the extent that Canco has transferred any property (other than Canco shares) or incurred any debt in relation to its acquisition, the value thereof is treated as a dividend paid by Canco to Parent, triggering Canadian dividend withholding tax at a rate of 5%-25%. Thus, for example, Canco making a loan to Foreignco or paying the purchase price for Foreignco shares in cash or by giving a promissory note is treated as a dividend, even where Canco is acquiring property of equal value and even if the seller is an arm's-length party;

- to the extent Canco has issued any shares of itself in relation to the acquisition, no amount may be added to the paid-up capital ("PUC") of Canco's shares. This reduces the amount of distributions Canco can make to non-resident shareholders without those shareholders incurring non-resident dividend withholding tax, and limits its ability to deduct interest expense on intra-group debt owing to non-residents of Canada (see below under **Thin Capitalization Rules**).

In some cases an election is permitted to treat a deemed dividend as a reduction of existing Canco PUC instead, although this is not permitted in all cases. In a subset of these cases the PUC so reduced can be reinstated solely for the purpose of distributing out of Canco the Foreignco shares (or substituted property or sale proceeds from such property) that Canco acquired to trigger the application of the new rules.

Any foreign-controlled Canadian corporation that has an equity interest in a foreign corporation must be very careful not to trip over these rules, which apply in both arm's-length and non-arm's-length transactions. As drafted, the rules appear to apply in any number of innocuous situations, such as Canco performing services for, or paying expenses related to, a foreign affiliate without a full-value charge-back (i.e., "conferring a benefit"). Many multinationals are likely to avoid putting any foreign investment under their Canadian subsidiaries unless absolutely necessary, and indeed may actively consider taking steps to extract existing foreign investments out from under those Canadian subsidiaries. Foreign acquirors of a Canadian corporation that owns shares of foreign entities will also need to carefully consider these rules, as such acquisitions are generally made through the use of a Canco as the direct purchaser.

THIN CAPITALIZATION RULES: DEBT OWING BY CANCO

Most countries have rules that limit the extent to which interest expense can be used to reduce taxable income. Canada's "thin capitalization" rules apply to restrict the amount of interest-deductible debt that a Canadian-resident corporation (Canco) can incur to "specified non-residents" – non-residents of Canada who either are 25%+ shareholders of Canco (by votes or value) or do not deal at arm's length with such 25%+ shareholders. Currently these rules prevent Canco from deducting interest expense on debt owing to specified non-residents that exceeds twice the sum of (1) Canco's unconsolidated retained earnings at the start of the taxation year, and (2) PUC attributable to Canco shares owned by (and contributed surplus received from) a non-resident 25%+ shareholder of Canco.

Debt/Equity Ratio Tightened

Under the 2012 Budget, this 2:1 debt/equity limit is being reduced to 1.5:1, effective for taxation years beginning after 2012. For example, a Canadian subsidiary with $100 million of "equity" for thin capitalization purposes will only be able to deduct interest on $150 million of debt owing to specified non-residents starting in 2013. Canadian subsidiaries of multinational groups will need to review and in some cases reduce the amount of debt they owe to foreign group members (or increase the amount of equity) by the end of 2012, as paying interest

that is taxable in the creditor's home country but not deductible in the debtor's jurisdiction is generally a bad bargain.

Disallowed Interest Treated as a Dividend

Currently Canada levies non-resident withholding tax from 10%-25% on payments of interest by a Canadian to foreign recipients not dealing at arm's length with the payer, unless they reside in the United States (the Canada-U.S. tax treaty has a zero withholding rate on non-arm's-length interest). Another 2012 Budget measure will change the withholding tax treatment of interest that has been denied deductibility under the thin capitalization rules, applicable to taxation years ending after March 28, 2012. Such disallowed interest will now be treated as a dividend for withholding tax purposes. This may result in a higher or lower rate of Canadian withholding tax, as many Canadian tax treaties have different rates for interest and dividends, and in some cases more than one rate for dividends. In the case of U.S. residents the result will typically be adverse, since the rate on Canadian-source interest for them is zero. This new rule can also change when the withholding tax is payable, as it deems disallowed interest (other than compound interest) that has accrued but is unpaid at year-end to have been paid, thereby triggering the withholding tax obligation.

Canadian subsidiaries of foreign groups will thus have an extra incentive to ensure that they remain on-side the thin capitalization debt/equity limit. Interest expense that yields no deduction for the borrower and creates a liability for Canadian withholding tax (as well as being taxable in the recipient's country) is very costly indeed.

Partnership-Level Debt Now Included

Finally, the 2012 Budget revisions to the thin capitalization rules expand the scope of debt that is subject to the debt/equity interest deductibility limitation, to include debt incurred by a partnership of which a Canco is a member. While the allocation mechanics set out in the August 14 draft legislation are somewhat complicated, in essence Canco is treated as if it owes its proportionate share of the partnership's debt to any non-resident creditor for the purpose of Canco's debt/equity calculation. To the extent that such additional debt causes the permitted debt threshold to be exceeded, Canco has a deemed income inclusion intended to offset its share of the interest deduction the partnership claimed on the debt. This rule is applicable to taxation years beginning after March 28, 2012.

UPSTREAM LOANS FROM CANCO: NEW ELECTIVE ALTERNATIVE

Subject to certain important exceptions (such as downstream loans to a foreign affiliate or loans that are repaid within 1-2 years), where a non-resident who is either a Canco shareholder or someone not dealing at arm's-length with a Canco shareholder (in either case, a "non-resident debtor") becomes indebted to

Canco, the loan is treated as a dividend paid by Canco to the non-resident debtor. This in turn triggers Canadian non-resident dividend withholding tax at a rate of between 5%-25%, depending on where the recipient is resident. In effect, the loan is treated as a permanent distribution by Canco rather than a debt that will eventually be repaid.

The August 14 draft legislation contains a new alternative to deemed dividend treatment, available on amounts that become owing to Canco after March 28, 2012 by a corporate non-resident debtor that either controls Canco or does not deal at arm's length with a non-resident corporation that controls Canco. If they choose, Canco and the non-resident corporation that controls it can file a joint election to have all debt owing to Canco by any particular non-resident debtor that would otherwise be subject to deemed dividend treatment instead come within an alternative set of rules. Under the alternative regime, Canco is required to include at least a minimum amount in its income for each particular year the debt is outstanding, reduced by any actual interest on the debt already included in Canco's income for the year. This alternative allows deemed dividend treatment to be avoided where Canco is willing to include in its income at least a minimum amount of combined actual and deemed interest on the debt.

The minimum income inclusion under the new regime is currently set at the amount of interest that would accrue on the debt for the portion of the year it remains outstanding if a 5% interest rate applied. However, where Canco (or a related Canadian resident) itself owes interest on a debt incurred to fund Canco's loan to the non-resident debtor, the minimum income inclusion under the new regime will be the actual interest payable by that Canadian borrower for the year, if that amount is higher than the amount produced by applying the 5% rate to Canco's receivable from the non-resident debtor for the year. The attractiveness of this new alternative will depend on a number of factors, including the applicable dividend withholding tax rate that would otherwise apply under the existing rules, Canco's effective taxation rate on any income inclusion, the rate of interest (if any) on the debt to Canco and the number of years the debt is likely to remain outstanding.

Please contact any member of the BLG Tax Group for more information on the rules discussed in this bulletin and how they may affect you.

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