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by Steve Suarez and Stephanie Wong

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PRACTITIONERS' CORNER

Canadian Year-End Tax Planning Deadlines for 2012

by Steve Suarez and Stephanie Wong

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As the end of 2012 approaches, taxpayers should be aware of some important tax planning deadlines in Canada. Some of these are recurring issues that arise every year, while others are specific to the end of 2012. In either case, it is useful to review some of the most important of these pending deadlines in order to ensure that opportunities for reducing or eliminating Canadian taxes are not missed. These deadlines are discussed below in relation to a corporation that is resident in Canada for Canadian tax purposes (Canco).

Table 1 summarizes the special year-end tax deadlines for 2012 discussed below.

I. Deadlines Unique to the End of 2012

A. Changes to Thin Cap Rules for Cancos

The thin capitalization rules in the Income Tax Act (Canada) limit the amount of debt owing to related nonresidents that a Canco can deduct interest expense on for tax purposes. The debt covered by these rules is debt owing by Canco to ''specified nonresidents'' — nonresidents who either are 25 percent-plus shareholders (by votes or value) of Canco or do not deal at arm's length with such 25 percent-plus Canco shareholders. Under current rules, Canco cannot deduct interest on any such debt to the extent that it exceeds two times Canco's ''equity'' (essentially the sum of Canco's unconsolidated retained earnings and the paid-up capital of Canco shares held by nonresident group members).

As a result of 2012 federal budget changes,[1] the 2-1 debt-to-equity limit will be reduced to 1.5 to 1, effective January 1, 2013. For example, starting in 2013, a Canco that owes $100 million to its foreign parent (or another foreign group member) and has only $50 million of equity will only be able to deduct interest expense relating to $75 million of that debt. (See Figure 1.) Interest on the remaining $25 million of debt will be nondeductible for Canadian tax purposes and, under a further 2012 budget change, will be recharacterized as a dividend to which Canadian nonresident dividend withholding tax will apply. U.S. lenders to Canadian group members will be particularly affected by this recharacterization: While *interest* is generally received by most U.S. recipients free of Canadian withholding tax under the Canada-U.S. tax treaty, interest recharacterized as a *dividend* for Canadian tax purposes under this rule will be subject to Canadian dividend withholding tax at a 25 percent rate (which may be reduced under an applicable tax treaty).[2]

Canadian subsidiaries of multinational groups should review amounts owing to foreign group members and, if necessary, reduce the amount of such debt (for example, by replacing it with debt owing to a Canadian or arm's-length lender) or increase the amount of the Canadian subsidiary's ''equity'' for thin capitalization purposes by the end of 2012, in order to ensure compliance with the new 1.5-1 debt-to-equity limit. It is very expensive to incur interest that is both nondeductible in Canada and subject to Canadian dividend withholding tax due to noncompliance with the thin capitalization rules (and likely taxable in the recipient's home country as well).

[1] *See* Steve Suarez, ''Canadian 2012 Federal Budget: Tightening the Screws,'' *Tax Notes Int'l*, Apr. 16, 2012, p. 247, *Doc 2012-6875*, or *2012 WTD 73-17*.

[2] The 2012 federal budget also extends the thin capitalization rules to debt owing to specified nonresidents by a partnership of which Canco is a member.

Table 1. Summary of Special Year-End Tax Deadlines for 2012

Legislative or Policy Change	Action/Deadline
Debt-to-equity limit under the thin capitalization rules will be reduced from 2 to 1 to 1.5 to 1, effective January 1, 2013; interest on excess debt nondeductible and subject to dividend withholding tax.	Review amounts owing by Canco to ''specified non-residents'' and either reduce the amount of such debt or increase Canco's ''equity'' for thin capitalization purposes before January 1, 2013.
Transitional relief from new ''foreign affiliate dumping'' rules available for transactions that arm's-length parties are legally obligated to complete under a written agreement made before March 29, 2012, but only if the transactions are completed by the end of 2012.	Ensure that any transactions that could benefit from this transitional relief are actually completed before January 1, 2013.
Exemption from foreign affiliate dumping rules available for debts owing to Canco by a foreign affiliate that arise after March 28, 2012, in the ordinary course of Canco's business (trade debt), but only if repaid within 180 days (and not part of a series of loans and repayments).	Ensure that debts that can benefit from this trade debt exclusion are repaid within the required 180-day period.
Election to opt into new section 17.1 ITA regime in respect of a particular qualifying debt must be made on or before Canco's tax return filing due date for the year in which such debt became owing (or in which the maturity date of pre-March 29, 2012, debt was extended) after March 28, 2012.	Ensure that Canco and its foreign parent corporation file a joint election in respect of each particular qualifying debt to be made subject to the section 17.1 ITA regime by the required due date to avoid paying a late-filing penalty.
Canada-Colombia income tax treaty will take effect on January 1, 2013.	Consider delaying payments of interest, dividends, and royalties between Canadian and Colombian residents until 2013 to take advantage of treaty-reduced rates of nonresident withholding tax.
Transition period for CRA's current policy regarding treaty-reduced nonresident withholding expires at the end of 2012.	Ensure that relevant information form NR301, NR302, or NR303 is obtained from nonresident payees prior to making payments after December 31, 2012, at treaty-reduced withholding tax rates.
Investment tax credit (ITC) inclusion rate will be reduced for certain qualifying SR&ED expenditures incurred in 2013. ITC inclusion rate will be reduced for mining preproduction exploration expenditures incurred in 2013.	Consider potential for making such expenditures before January 1, 2013, in order to maximize tax benefits.
On dispositions of shares of corporations, transitional relief from CRA policy change requiring use of gross asset valuation method to determine (1) taxable Canadian property (TCP) status and (2) applicability of treaty gains exemption, which expires at the end of 2012.	Nonresidents owning shares of a corporation that may be TCP and that were owned at any time in 2011 should consider whether they could benefit from using the net asset valuation method, which is permitted if they dispose of the shares before January 1, 2013.
Transitional relief from partnership interest bump denial rules available for a taxable Canadian parent corporation that satisfies certain conditions, but only if the parent amalgamates with, or begins to wind up, its subsidiary by the end of 2012.	Ensure that any taxable Canadian parent corporation entitled to this transitional relief amalgamates with, or begins to wind up, its subsidiary before January 1, 2013.
Less generous capital gains exemption under the Barbados-Canada tax treaty will take effect on January 1, 2013, if the November 2011 protocol to the treaty comes into force by the end of 2012.	Residents of Barbados holding shares that derive their value principally from Canadian real property should consider whether they could benefit by disposing of such shares before the end of 2012.

B. New Foreign Affiliate Dumping Rules

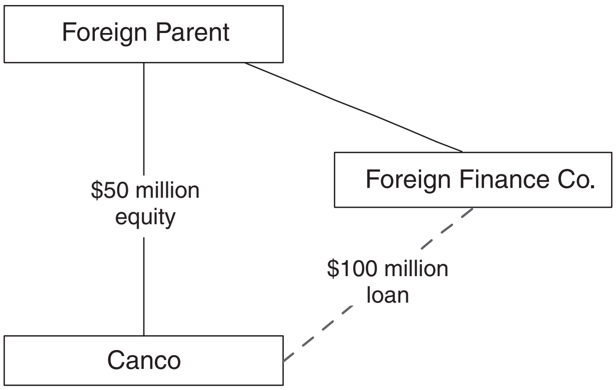
In the 2012 federal budget, the government introduced sweeping new rules to combat ''foreign affiliate dumping.'' These complex rules are overbroad and encompass a number of transactions that should not be caught from a tax policy perspective.[3]

In general terms, the rules apply whenever a Canco that is controlled by a foreign corporation (Parent) makes an ''investment'' in a non-Canadian corporation (Foreignco) in which Canco has a 10 percent-plus direct or indirect equity interest. When applicable, they will either:

- reduce Canco's tax attributes (which adversely affects Canco, including the calculation of its ''equity'' for purposes of the thin capitalization rules described in Section I.A of this article); or
- deem Canco to have paid a dividend to Parent (triggering Canadian dividend withholding tax).

[3]For a detailed review of these rules, see Steve Suarez, ''New 'Dumping' Rules Constitute Major Canadian Tax Policy Change,'' *Tax Notes Int'l* (forthcoming), *Doc 2012-20364*.

Figure 1. Reduced Thin Cap Limit



Starting in 2013, Canco can only deduct interest on $75 million of the debt owing to Foreign Finance Co.

No deduction for interest on the remaining $25 million, which is treated as a dividend and subject to dividend withholding tax.

Although the foreign affiliate dumping rules generally apply to transactions that occur after March 28, 2012, they do not apply to transactions that arm's-length parties are legally obligated to complete under the terms of a written agreement made before March 29, 2012, *but only if* those transactions are completed by the end of 2012. Foreign multinational groups should therefore ensure that any transactions that could benefit from this limited grandfathering protection are in fact completed before January 1, 2013.

For transactions that do not benefit from such grandfathering and that come within the charging provision of these rules, there are a few limited exemptions. One such exemption is for debts owing by Foreignco to Canco that arise after March 28, 2012, in the ordinary course of Canco's business (for example, trade debt), if such debts are paid by Foreignco within 180 days (other than as part of a series of loans and repayments). It is therefore important to ensure that debts that could benefit from this ''trade debt'' exclusion are repaid within the required 180-day period.

Another specific exception from these rules is provided for Canco ''investments'' that are debt of Foreignco (for example, Canco making a loan to Foreignco) that arise after March 28, 2012.[4] In general terms, Canco and Parent can file an election to cause such a debt to not be subject to these rules. The election must be filed on or before the due date of Canco's tax return for the tax year in which such debt became owing.[5] The result of making this election is that the new interest imputation regime in section 17.1 of the ITA will apply instead. Under that regime, Canco generally will be required to include in its income at least a minimum amount of interest of the debt for each tax year that such debt remains unpaid. (See Section II.B of this article for a description of these rules.) Because the election must be made on a debt-by-debt basis, Canco should ensure that it files an election for each particular debt that it wishes to exclude from the foreign affiliate dumping rules and make subject to section 17.1 of the ITA by the filing deadline. (Late filing of the election is permitted on payment of a penalty.)

The complexity and breadth of the foreign affiliate dumping rules require that Canco management be very proactive in identifying transactions that could constitute ''investments'' and trigger adverse tax consequences. Guaranteeing debts, providing management, legal/accounting, and related services, and doing other things of value for the benefit of a foreign affiliate are effectively treated as distributions to Canco shareholders under these rules (notwithstanding the presence of transfer pricing and other rules to regulate the taxation of these activities).

C. New Tax Treaties

The Canada-Colombia tax treaty (signed in November 2008) takes effect on January 1, 2013. As a result, treaty-reduced rates of nonresident withholding tax on interest, dividends, and royalties will apply to amounts paid or credited by residents of Canada to Colombian residents (and vice versa) on or after January 1, 2013. This means that it will generally be advantageous to delay payments of such amounts until after the end of 2012.

D. Treaty-Reduced Nonresident Withholding

Canadian resident persons making payments of dividends, rents, management fees, pension benefits, and some forms of royalties, trust income, and interest to a nonresident are required to withhold and remit to the Canada Revenue Agency 25 percent of the amount of the payment (Part XIII withholding). Purchasers of taxable Canadian property from a nonresident are also required to withhold and remit part of the purchase price for the property unless the vendor has obtained a section 116 certificate of compliance from the CRA. In either case, the payer can be liable for any deficiency in the amount withheld, plus interest and penalties.

A recipient of such a payment resident in a country with which Canada has a tax treaty may be entitled under the treaty to a reduction or elimination of Canadian tax on amounts subject to such withholding. Historically the CRA has allowed payers to generally rely on the recipient's name and address to determine whether the recipient was a resident of a treaty country and thereby entitled to a reduced rate of withholding. Unless aware that this information might not reflect the fiscal residence of the beneficial owner of the payment, payers had no obligation to look further to determine whether the recipient was in fact entitled to a

[4]Or a debt owing by Foreignco before March 29, 2012, the maturity date of which was extended after March 28, 2012.

[5]Cancos are generally required to file their tax return for a particular tax year within six months of their year-end.

treaty-reduced rate. Owing partly to the limitation on benefits provision that was added to the Canada-U.S. tax treaty a few years ago, the CRA now wants payers to more closely scrutinize the identity of nonresident payees that may be entitled to treaty benefits. New information forms introduced by the CRA for this purpose (Forms NR301 for corporations or individuals, NR302 for partnerships, and NR303 for hybrid entities) were originally intended to apply after December 31, 2011. However, the CRA extended the transition period for another year and continued to apply its previous (more generous) administrative policy with some modifications.[6]

The transition period maintaining the CRA's previous policy expires on December 31, 2012. As a result, the CRA will thereafter expect payers who reduce the amount withheld on payments to nonresidents in reliance on a treaty-based exemption to obtain completed versions of the new forms from nonresident recipients.[7] While obtaining the completed forms does not guarantee that the CRA will refrain from assessing the payer in the event that the treaty-based exemption or reduction does not in fact apply, being able to demonstrate such due diligence makes it more likely that administrative discretion will be exercised in the payer's favor (particularly regarding interest and penalties). Nonresident recipients of payments from Canadians to which withholding tax applies should be prepared to complete these forms on the Canadian payer's request.

E. Reductions in ITCs

The 2012 federal budget reduced the scope of certain investment tax credits, which are dollar-for-dollar reductions in taxes payable (not merely reductions in taxable income) provided for making qualified expenditures.[8] If making qualifying expenditures after 2012 would result in a reduced ITC entitlement compared with making such expenditures during 2012, affected taxpayers should consider accelerating the timing of such expenditures, if possible, to maximize the tax benefit.

1. SR&ED

The 2012 federal budget made a number of changes to the tax regime for scientific research and experimental development (SR&ED), some of which take effect in 2013. An ITC can be claimed for qualifying SR&ED expenditures incurred in a tax year, while an enhanced ITC may be claimed for a limited amount of qualifying expenditures incurred in a tax year by a Canadian-controlled private corporation. For taxpayers using the simplified proxy method to determine the amount of qualifying SR&ED expenditures eligible for an ITC, the current 65 percent inclusion allowance for overhead expenditures directly attributable to SR&ED activities will apply for 2012, but will be reduced to 60 percent for 2013. For taxpayers making payments under arm's-length SR&ED contracts, 100 percent of such expenditures incurred in 2012 will continue to be eligible for the ITC, but after 2012 the expenditure inclusion rate will drop to 80 percent (the reduction being meant as a way of excluding the profit element of such contracts).

2. Resource Sector

Taxable Canadian corporations that undertake certain mining sector activities relating to qualifying minerals in Canada are entitled to claim an ITC equal to 10 percent of the amount of qualifying expenditures incurred before the mine is producing in reasonable commercial quantities on ''grass roots'' exploration to determine the existence, location, extent, or quality of a mineral deposit in Canada, or activities undertaken in order to bring a new mine in Canada into production.

As a result of the 2012 federal budget, the preproduction mining expenditures ITC will be phased out. The current 10 percent ITC will continue to apply for preproduction *exploration* mining expenditures incurred in 2012, with the ITC rate dropping to 5 percent for expenditures incurred in 2013 (and eliminated for subsequent years).[9]

F. Nonresident Dispositions of Corporate Shares

Nonresidents of Canada who dispose of property that is ''taxable Canadian property'' (TCP) may be subject to Canadian tax on a gain resulting from the disposition (subject to potential treaty relief). Moreover, regardless of whether any gain arises or any Canadian tax is owed on the disposition of such property by the vendor, the vendor may be required to notify the CRA of the disposition and file a Canadian tax return, and the purchaser of the property may be required to withhold and remit a specified percentage of the property's purchase price to the CRA under Canada's section 116 system.[10]

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[6]For prior coverage, see Steve Suarez, ''Canada Extends Transition Period for Treaty-Reduced Nonresident Withholding,'' *Tax Notes Int'l*, Feb. 27, 2012, p. 687, *Doc 2012-1864*, or *2012 WTD 38-12*.

[7]In the case of nonresident vendors requesting a section 116 certificate of compliance from the CRA for the disposition of taxable Canadian property in reliance on a treaty exemption, the relevant information form would be sent with the request to the CRA starting in 2013. For a detailed review of Canada's section 116 system applicable to dispositions of taxable Canadian property, see Suarez and Gosselin, *infra* note 10.

[8]*See* Suarez, *supra* note 1.

[9]For preproduction *development* expenditures, the 10 percent rate continues to apply for qualifying expenditures made before 2014, with a phased-out reduction in later years, subject to limited grandfathering.

[10]This issue is discussed in depth in Steve Suarez and Marie-Eve Gosselin, ''Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property,'' *Tax Notes Int'l*, Apr. 9, 2012, p. 175, *Doc 2012-4308*, or *2012 WTD 68-13*.

Table 2. Summary of TCP Status

Property	TCP Status
Shares of corporations listed on a designated stock exchange; shares of mutual fund corporations; units of mutual fund trusts.	TCP if at any time during the preceding 60 months, both: • the nonresident holder owned more than 25 percent of any class of the corporation's shares or the trust's units (including any shares or units owned by non-arm's-length persons); and • more than 50 percent of the value of the shares or units was derived (directly or indirectly) from Canadian real property.
Unlisted shares of corporations (other than mutual fund corporations); interests in partnerships and most trusts.	TCP if at any time during the preceding 60 months more than 50 percent of the value of the share or interest was derived from Canadian real property directly or indirectly (otherwise than through a corporation, partnership, or trust, the shares or interests of which are not themselves TCP at that time).

If the property being sold is not TCP, generally no Canadian tax will arise and the parties will have no Canadian notification and withholding obligations under these rules. Table 2 summarizes the TCP status of interests in various entities. Unlisted shares of a corporation or interests in partnerships or certain trusts are considered to be TCP if more than 50 percent of the fair market value of the shares or interest was derived directly or indirectly[11] from Canadian real property at any time in the five years before the disposition of the shares or interest (the FMV test). Shares of corporations listed on a designated stock exchange are considered to be TCP if the FMV test is satisfied and the nonresident holder owned (alone or together with non-arm's-length persons) more than 25 percent of any class of the corporation's shares or the trust's units at the same time. The capital gains articles of most of Canada's tax treaties generally use a similar test when dealing with the taxation of shares (or partnership interests), based on whether the shares (or interests) derive their value principally from Canadian real property (directly or indirectly) at the time of disposition.

Historically, in applying the FMV test in tax treaties to shares of corporations, the CRA allowed taxpayers to determine what property those shares principally derived their value from on either a gross assets basis (without regard to the corporation's liabilities) or a net assets basis (deducting the corporation's liabilities from the value of assets to which they reasonably relate). However, late in 2011 the CRA announced that it was changing its policy to require taxpayers to use the gross asset valuation method exclusively in applying the FMV test under *both* the TCP definition and tax treaties. A transitional exception to this new policy was provided for property held by a taxpayer at any time in 2011 and disposed of before 2013.[12] Accordingly, nonresidents owning shares of a corporation that may be TCP should consider as soon as possible whether they would benefit from using the more flexible net assets approach in determining whether they would be taxable in Canada on any gain (or subject to the Canadian section 116 system) on a disposition of the shares, and take action before the end of 2012 if appropriate.

G. Cost Basis 'Bump' of Partnership Interests

The Canadian tax system provides a cost basis step-up or ''bump'' when one Canco (the subsidiary) is wound up or amalgamated into another Canco (the parent) that owns all of the subsidiary's shares. The rules are very complex, but in principle they allow the parent to push the cost basis in its shares of the subsidiary (which are cancelled on the wind-up or amalgamation) down to certain of the subsidiary's assets that the parent acquires on the wind-up or amalgamation.[13] This cost basis bump thereby reduces (or even eliminates) accrued but unrealized gains on the subsidiary's bump-eligible property. Figure 2 illustrates such a bump transaction, whereby CanAcquireCo purchases the shares of Canco for $100, winds up Canco on a tax-deferred basis, and uses the cost basis bump to increase the tax cost of the bump-eligible Canco property it acquires on the wind-up from $20 to $60 (its FMV).

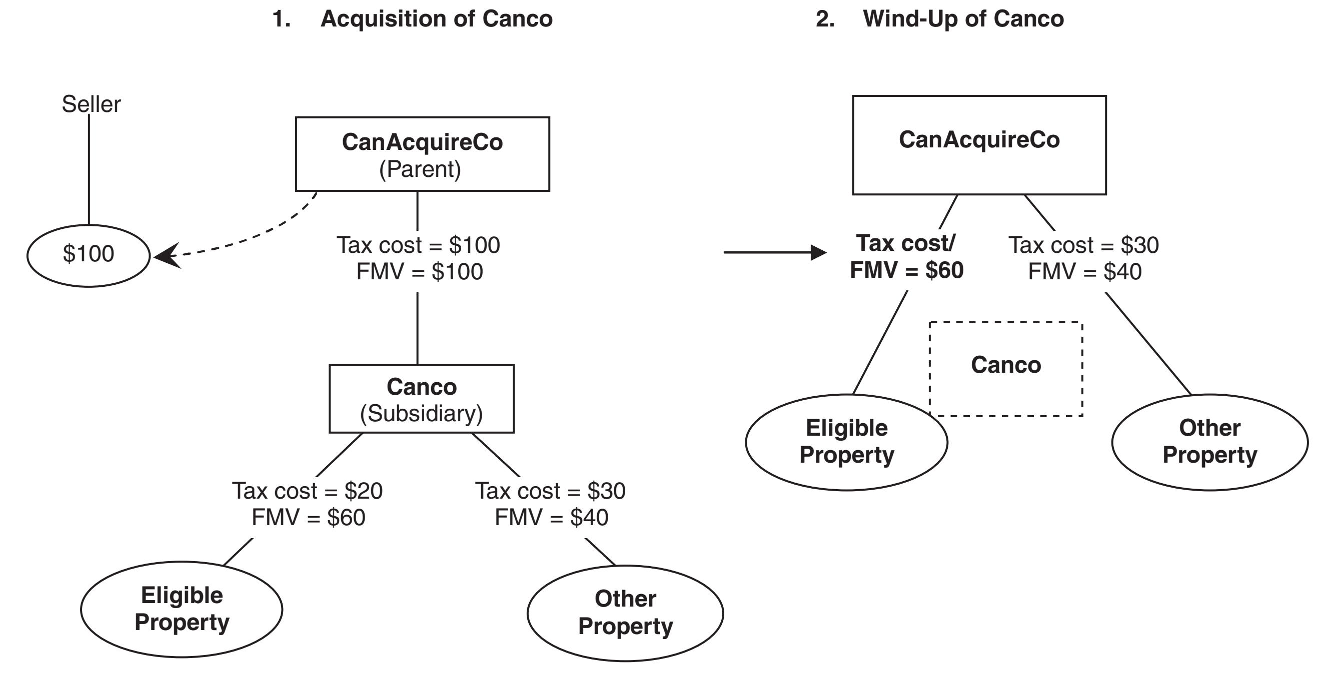
The 2012 federal budget introduced a new rule affecting partnership interests owned by the subsidiary. It reduces the amount of any bump in the cost basis of a partnership interest held by the subsidiary on the winding-up or amalgamation of the subsidiary with its

[11]Unless derived through a corporation, partnership, or trust the shares or interests of which are not themselves TCP at that time.

[12]CRA Round Table, Canadian Tax Foundation Annual Conference, Nov. 29, 2011.

[13]This topic is discussed at length in Steve Suarez, ''Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know,'' *Tax Notes Int'l*, Dec. 4, 2006, p. 779, *Doc 2006-21865*, or *2006 WTD 237-7*.

Figure 2. Basic Bump Transaction



parent, to the extent that the accrued gains on the partnership interest are attributable to property other than nondepreciable capital property. Since the tax cost of property that is not nondepreciable capital property cannot be bumped if the subsidiary owns that property directly, this new rule prevents indirect bumps in the cost basis of such property by owning such property through a partnership.

The new rule generally applies to amalgamations that occur (and windings-up that begin) after March 28, 2012. However, a transitional exception is provided for a parent corporation that acquired control of a subsidiary before March 29, 2012 (or that was legally obligated to acquire control of the subsidiary under a written agreement made before March 29, 2012), but only if the parent corporation intended to amalgamate with or wind up the subsidiary (as evidenced in writing before March 29, 2012). To fit within the transitional exception, the parent corporation must ensure that it in fact amalgamates with or begins to wind up the subsidiary before 2013.

H. Gains Under Barbados-Canada Tax Treaty

As noted earlier, many of Canada's tax treaties exempt a nonresident of Canada from Canadian tax on gains arising from the disposition of shares unless the shares derive their value principally from real property situated in Canada, directly or indirectly. The treaty language used to describe ''real property situated in Canada'' usually captures shares in other entities ''below'' the corporation whose shares are being disposed of, if those lower-tier shares themselves derive their value principally from real property situated in Canada.

However, the current capital gains exemption in the Barbados-Canada tax treaty is broader: It exempts gains from the disposition of shares of a corporation unless the property of the corporation ''consists'' principally of immovable property situated in Canada. The CRA has acknowledged that where the relevant treaty language uses the term ''consists'' without any reference to ''directly or indirectly,'' the determination is based solely on the assets held *directly* by the corporation, without applying a look-through or consolidation approach.[14] Thus, under the current Barbados-Canada tax treaty, if a Barbados resident owns shares of a holding company, and that company holds shares of a subsidiary and the subsidiary holds Canadian real property interests, the Barbados resident can dispose of the holding company shares without being subject to Canadian tax because the Canadian real property interests are not held directly by the holding company.

This more generous language is being replaced as a result of changes to the capital gains article of the Barbados-Canada tax treaty, negotiated as part of the protocol signed by the two countries on November 8,

[14]*See* CRA document 2008-0304441I7, Mar. 23, 2009.

Table 3. Summary of Recurring Tax Deadlines

Transaction	Action/Deadline
Taxpayer incurred a deductible expense owing to a non-arm's-length person in its 2010 tax year.	Taxpayer must ensure it actually pays the expense by December 31, 2012, to avoid having to add back the amount in income for its 2013 tax year (or file a deemed paid election).
Taxpayer accrues and deducts employee expenses (for example, salary, wages, pension benefits) in its 2012 tax year.	Taxpayer must ensure that it actually pays the expenses by June 28, 2013.
Shareholder of Canco (or a person not at arm's length with the shareholder) became indebted to Canco (or to a related Canco) during Canco's 2011 tax year.	Unless an exception applies, the debt must be repaid by December 31, 2012, or else the amount of the debt is included in the debtor's income (if the debtor is Canadian resident) or deemed to be a dividend subject to Canadian nonresident withholding tax (if the debtor is nonresident).
Foreign-controlled Canco and its foreign parent corporation validly elect to have the new section 17.1 ITA interest imputation rule apply to a particular debt owing by a foreign affiliate, to avoid application of subsection 15(2) ITA and/or new foreign affiliate dumping rules.	Subject to possible temporary transitional relief, Canco must include in its income for the 2012 tax year at least a minimum amount of interest on the debt calculated at a prescribed rate (less any interest on the debt otherwise included in Canco's income for the year).
Shareholder of Canco or a person connected to the shareholder (other than another Canco) incurs a debt to Canco that arises or remains outstanding during the debtor's 2012 tax year.	Unless an exemption applies, the debtor must pay Canco a minimum amount of interest on the debt by January 30, 2013, or else be deemed to have received either a taxable benefit included in income for the 2012 year (if the debtor is Canadian resident) or a dividend subject to Canadian nonresident withholding tax (if the debtor is nonresident).
Nonresident incurs a debt to Canco at a nil or low rate of interest that arises or remains outstanding in Canco's 2012 tax year.	Unless an exemption applies or the debt is repaid within one year after it arose, Canco must include in its income for the 2012 tax year interest computed at a prescribed rate on the outstanding debt (less any interest on the debt otherwise included in Canco's income for the year).

Note: It is assumed for the purpose of these examples that the relevant tax year ends on December 31.

2011.[15] While this protocol had not yet come into force as of the date of writing, if it does come into force by the end of 2012, the more restrictive language will take effect for tax years beginning on or after January 1, 2013. Residents of Barbados holding shares that derive their value principally from Canadian real property should consider whether disposing of such shares before the end of 2012 would be beneficial in their circumstances.

II. Recurring Tax Deadlines

Table 3 summarizes the recurring tax deadlines discussed below.

A. Accrued but Unpaid Expenses

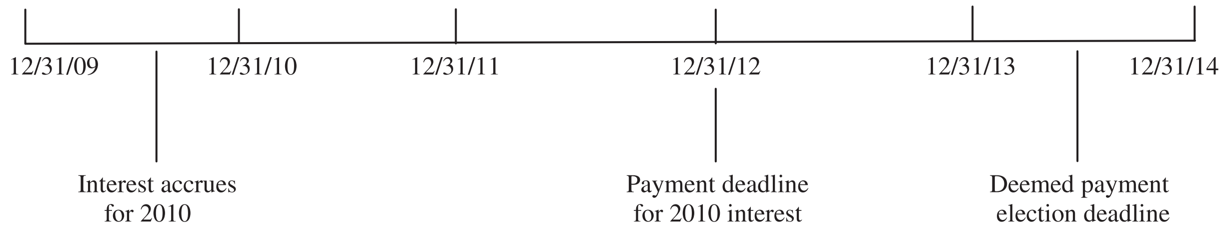
When a taxpayer owes an amount to a non-arm's-length person that is deductible for tax purposes, section 78 of the ITA limits how long it can go unpaid before the deduction gets reversed. An amount incurred by the taxpayer to a non-arm's-length person in one tax year must be paid by the end of the second succeeding tax year of the payer. If it remains unpaid by that time, the amount is added back into the taxpayer's income in the next immediately following tax year, effectively reversing any deduction previously taken. This means that if a taxpayer incurred a deductible expense to a non-arm's-length person in its 2010 tax year, the taxpayer must actually pay the expense by the end of the 2012 tax year to avoid having to add back the amount in income for the 2013 tax year. (See Figure 3.)

Alternatively, the taxpayer and non-arm's-length creditor can file a joint Form T2047 to deem the amount to have been paid and loaned back to the taxpayer, which will avoid the income addback. When the non-arm's-length creditor is a nonresident, the deemed payment of the expense will often trigger Canadian withholding tax. A common situation when this arises is interest expense owing by one member of a corporate group to another. This election form must be filed by the time the taxpayer's income tax return for that following year (2013 in the example) is due.

Another rule applies to a taxpayer's accrued but unpaid employee expenses, that is, salary, wages, pension benefits, retiring allowances, and other remuneration (except reasonable vacation or holiday pay or a deferred amount under a salary deferral arrangement). The taxpayer must pay any such expense by 179 days

[15] *See* http://www.fin.gc.ca/n11/11-113-eng.asp.

Figure 3. Accrued Non-Arm's-Length Interest and Subsection 78(1)



after the end of the tax year in which it was incurred. If the expense is not paid within that period, the taxpayer will not be able to deduct it in the year it was incurred but only in the year when it is actually paid.

B. Debts Owing to Cancos

If a shareholder of a Canco (or someone connected to such a shareholder) owes Canco an amount that remains outstanding for too long, the amount will be treated as income from Canco under subsection 15(2) of the ITA. Subject to some exceptions, the general rule is that if a person is a shareholder of a Canco (or a person not dealing at arm's length with such a shareholder) and has become indebted to Canco (or to a corporation related to Canco), the amount of the debt is included in that person's income. If a debt owed by a nonresident person is caught by the rules, the amount of the debt is deemed to be a dividend received by the nonresident from Canco and is subject to Canadian nonresident withholding tax at the 25 percent domestic rate (unless reduced under an applicable tax treaty).

There are some exceptions to this rule. The principal exception is when the indebtedness is repaid within one calendar year after the end of Canco's tax year in which the indebtedness arose; for example, for a debt incurred during the tax year of Canco ending on December 31, 2011, the deadline for repayment is December 31, 2012. To qualify for the exception, the repayment cannot be part of a series of loans or indebtedness and repayments. It is therefore very important to make sure that outstanding amounts that could trigger an income inclusion (or deemed dividend) are repaid within the required time limit.

This income inclusion rule does not apply to:

- debts owing by another Canco;
- amounts owing between nonresidents of Canada;
- certain loans to employees;
- debts arising in the ordinary course of the creditor's business when there are bona fide arrangements for repayment made at the outset; or
- debts arising after March 28, 2012, that the taxpayer and its foreign parent corporation have validly elected to make subject to a new interest imputation regime, introduced in the 2012 federal budget and set out in draft section 17.1 of the ITA.

The regime created under section 17.1 of the ITA in effect allows taxpayers to avoid the application of subsection 15(2) of the ITA (and the foreign affiliate dumping rules, as described in Section I.B of this article) by ensuring that Canco realizes a sufficient amount of actual and/or deemed interest income on the debt each year, comparable to an arm's-length debt. In the context of subsection 15(2) of the ITA, the option to elect into the section 17.1 regime applies to debts that meet the following conditions:

- the debt becomes owing to Canco after March 28, 2012;
- the debtor is a particular nonresident corporation (Foreignco) that either controls Canco or does not deal at arm's length with another nonresident corporation that controls Canco[16];
- Canco and the nonresident corporation that controls it jointly elect to have section 17.1 of the ITA apply to the debt;
- subsection 15(2) of the ITA would otherwise apply to the debt; and
- the amount that would be included in Canco's income for a tax year in respect of the debt under section 17.1 of the ITA cannot be reduced under a relevant tax treaty.

If Canco and its foreign parent corporation jointly make a valid election to have the section 17.1 regime apply to a particular qualifying debt, subsection 15(2) of the ITA will not apply to the debt.[17] Instead, Canco will be required to include in its income for the relevant tax year a minimum amount of interest on the

[16]Look-through provisions extend these rules to debts owed by and to partnerships in most cases.

[17]The interest imputation rules in section 17 of the ITA described in Section II.D of this article will also not apply if the debt is subject to the regime in new section 17.1 of the ITA.

debt for any of the year that it remains outstanding. Generally, these rules require Canco to include in income for the year an amount equal to interest on the outstanding debt computed at a prescribed rate (currently 5 percent, adjusted quarterly), minus any interest on the debt actually included in income for the year (for example, if the debt actually bears interest at 3 percent, the section 17.1 regime requires another 2 percent to be included in Canco's income). In this way, Canco can elect to report a minimum amount of actual and/or deemed interest on the debt, as an alternative to having the debt deemed to be a dividend paid by Canco to its foreign parent corporation. When a nonresident corporation acquires control of a Canco that was not controlled by a nonresident corporation immediately before that time, an exemption from the deemed interest accrual requirement is provided for 180 days, giving the nonresident parent time to review and clean up outstanding debts owing to Canco.

The election to opt in to the section 17.1 regime is made on a debt-by-debt basis. Generally, Canco is required to file the election for a particular debt by its tax return filing due date for the tax year in which the debt first became owing. However, Canco may late-file the election within three years after the relevant due date if it pays a penalty.

C. Interest Benefit on No/Low Interest Debts

If a shareholder of a Canco (or a person connected to such a shareholder) has incurred a debt to Canco (or to a related corporation), subsection 80.4(2) of the ITA requires the debtor to pay Canco at least a minimum amount of interest on the debt each year, or be deemed to have received a taxable benefit that is included in income. An interest benefit will be included in the debtor's income for a tax year to the extent that interest on the loan or debt computed at a prescribed rate exceeds interest on the loan or debt for the period actually paid to Canco within 30 days after the end of the year.

This rule applies even when the loan or debt has been outstanding for only part of a year. However, it does not apply:

- to debtors that are Cancos; or
- when the amount of the loan or indebtedness has been included in income under the rules in subsection 15(2) of the ITA described in Section II.B of this article.

If the debt was incurred for income earning purposes (for example, to buy common shares), the debtor may have an interest expense deduction for Canadian tax purposes that offsets the interest benefit included in income. Otherwise, it will be important to ensure that an appropriate amount of interest is in fact paid to Canco within 30 days of the end of the relevant tax year, in order to prevent a deemed income inclusion.

When a loan or debt incurred by a nonresident person is caught by this rule, the resulting interest benefit is deemed to be a dividend received by the nonresident and is subject to Canadian nonresident withholding tax at the 25 percent domestic rate (unless reduced under an applicable tax treaty).

D. Interest on Nonresident Debts to Cancos

When a nonresident person owes an amount to a Canco, section 17 of the ITA applies to ensure that the Canco reports at least a minimum amount of interest on that debt for tax purposes. Specifically, to the extent that the debt has remained outstanding for more than one year and Canco includes in its income for a tax year an amount that is less than a ''reasonable'' rate of interest on the debt, Canco must include in income for the year an amount equal to interest on the outstanding debt computed at a prescribed rate, minus any interest on the debt otherwise included in Canco's income for that year.

This rule makes it important to ensure that no- or low-interest debts owing to Cancos by nonresidents are repaid within the one-year limit.[18]

Certain debts are excluded from the application of this rule, including:

- debt described in Section II.B of this article that has been deemed to be a dividend and subjected to nonresident withholding tax under subsection 15(2) of the ITA;
- an amount owing by an unrelated nonresident when the amount arose in respect of goods sold or services provided by Canco in the ordinary course of its business and on arm's-length terms and conditions;
- debt owing by a closely held controlled foreign affiliate (CFA) of Canco that relates to an active business carried on by the CFA (or another CFA of Canco); and
- debt that Canco and its foreign parent corporation have elected to make subject to the new interest inclusion rule in section 17.1 of the ITA described in Section II.B of this article. ◆

[18]This rule governing direct debts is supported by an indirect debts provision, which applies where a Canco has made a loan or transfer to an intermediary that in turn makes a loan or transfer to the nonresident. In those circumstances, the nonresident is deemed to owe an amount directly to Canco, so that the direct debt rules apply.