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Canadian budget impacts investment in foreign affiliates by Canadian subsidiaries, tightens thin capitalization limit

Today's federal budget contains proposals that may negatively impact the investment in foreign related corporations by Canadian subsidiaries of foreign companies. In addition, the budget will decrease the amount of interest deductible on certain debts owed to non-resident related persons by reducing the allowable thin capitalization limit to a 1.5 to 1 debt-to-equity ratio.

Deemed dividend on investment in a foreign affiliate

The government proposes to introduce a rule that may deem a dividend to have been paid by a Canadian company ("Canco") that is controlled by a non-resident company ("Parent") to the extent of any non-share consideration (cash, debt or other property) given by the subsidiary in exchange for the acquisition of an investment in a foreign affiliate. The deemed dividend will be subject to withholding tax, which may be reduced if Parent is a resident of a tax treaty jurisdiction. The withholding tax is not refundable if the structure is unwound. The measure also proposes to disregard the paid-up capital of any shares of the subsidiary provided as consideration for the investment.[1]

The proposed rule is not intended to apply to "the legitimate expansions of …Canadian-based businesses". Therefore, a long list of factors must be considered to determine whether the investment was made by Canco, instead of being made or retained by Parent or another non-arm's length non-resident, primarily for bona fide purposes other than to obtain a tax benefit, as that term is defined for purposes of the general anti-avoidance rule. The budget papers refer to this as a "business purpose" test, although those words are not included in the detailed Notice of Ways & Means Motion. These factors will generally include:

[1] Paid-up capital can be returned tax-free to a non-resident shareholder and counts as "equity" for purposes of the thin capitalization rules. The paid-up capital of shares issued for this purpose will not count for thin capitalization purposes, nor will contributed surplus arising from contributions of property to Canco by a shareholder for no consideration.

- Whether the business activities of the foreign affiliate are more closely connected to those of Canco or certain related Canadian companies[2] versus those of Parent or another non-resident;
- Whether Canco fully participates in the profits or increase in value of the foreign affiliate (although it is stated that if Canco does so participate that is not a relevant factor!);
- Whether the investment was made at the direction or request of Parent or other non-resident;
- Whether Canco's senior officers (who are resident and work principally in Canada) were involved in negotiations and have decision-making authority with respect to the investment; and
- Whether such senior officers are evaluated or compensated in connection with the foreign affiliate's results and exercise reporting authority with respect to its operations.

The Department of Finance has requested comments on these factors before June, 2012.

Interest on funds borrowed to invest in foreign affiliates is generally deductible, and will continue to be so after these proposals (subject to thin capitalization rule restrictions) while dividends received out of the exempt surplus of a foreign affiliate can be received tax-free by a Canadian corporate shareholder. While the 2008 Report of the Advisory Panel on Canada's System of International Taxation ("the Panel") recommended the introduction of measures to limit so-called "debt dumping" transactions, in which shares of foreign related companies (particularly preferred shares) are acquired in exchange for debt, it should be noted that the proposal is much broader.

For example, it applies to transactions that do not involve the issuance of debt. Therefore, the proposal, now referred to as "foreign affiliate dumping" rather than "debt dumping", will limit opportunities to utilize a Canadian subsidiary's excess cash by investing in foreign affiliates. In addition to shares, the proposal also applies to the investment in debts of foreign affiliates, other than those arising in the ordinary course of business, and options in respect of shares and debts of foreign affiliates.

The proposal will apply to transactions or events that occur on or after March 29, 2012, with very limited grandfathering for certain agreements entered into with arm's-length persons prior to the budget. Therefore, taxpayers who have previously acquired foreign affiliates from their parent company or other foreign related company should be unaffected by the proposal except to the extent they wish to make additional investments in such affiliates. There is no relief for additional investments in an existing foreign affiliate. That may be particularly punitive if the investments were originally made before Canco was acquired by Parent, if the operations of the foreign affiliates have subsequently become integrated with the global operations of Parent and the ability to meet the business purpose test has thus become questionable.

The Department of Finance estimates that the proposal will account for over $1.3 billion in tax savings to the government between 2012 and 2017. The budget papers state that the Department will continue to monitor developments to determine if further action is warranted.

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[2] Relief is restricted to subsidiary wholly-owned corporations owned by Canco and those Canadian companies of which Canco is a subsidiary wholly-owned corporation. It is unclear why this provision is so restrictive.

Thin capitalization rules

The Panel also recommended a number of changes to the thin capitalization rules, which limit, in certain circumstances, the deductibility of interest on debts owing to certain non-resident persons (generally, certain non-resident shareholders or persons connected with such shareholders). The budget generally adopts the Panel's recommendations. In particular, the currently permissible debt-to-equity ratio for such debts will be lowered from 2 to 1 to 1.5 to 1, effective for taxation years commencing after 2012.

In addition, if the deduction of interest is disallowed under the rules, the interest will become subject to withholding tax as a deemed dividend. The deemed dividend will be allocated to particular non-resident creditors proportionately based on their share of debts owing by the Canadian corporation. This proposal will apply to taxation years ending on or after March 29, 2012.

For taxation years beginning on or after that date, the thin capitalization rules will be extended to apply to debts of partnerships, where at least one of the partners is a Canadian resident corporation. Debts of a partnership will be allocated to the partners on a proportionate basis. Where the partner's debt-to-equity ratio is exceeded, an amount will be included in computing the income of the partner. The partnership's interest expense will not be denied.

Third party debt that is guaranteed by related non-resident persons will continue to be outside the scope of the rules.

One relieving change is also proposed. The thin capitalization rules will no longer apply to a debt owing to a controlled foreign affiliate of the taxpayer, provided that the interest is included in the Canadian corporation's Foreign Accrual Property Income. The coming-into-force provision is not particularly generous, however, being restricted to taxation years of a Canadian corporation that end on or after March 29, 2012.

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