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Canadian government introduces revised budget proposals on foreign affiliate "dumping"

The March 29, 2012 federal budget contained proposals that negatively affected investments made in shares or debt of foreign affiliates on or after the budget date by Canadian subsidiaries of foreign companies. On August 14, 2012, the government released revised foreign affiliate "dumping" proposals in response to consultations. See our Alerts of **March 29, 2012** and **August 15, 2012**. After further consultations, on October 15, the government tabled a Notice of Ways and Means Motion relating to the proposals and other budget measures in the House of Commons.

The rules remain substantially the same as the August proposals and will have a significant impact on many Canadian subsidiaries of foreign companies and on the acquisition of Canadian companies by non-residents. However, the government has made a number of technical changes to the proposals that are generally favourable to taxpayers.

General application of the rules

The dumping proposals may apply to deem a dividend to have been paid by a Canadian resident company ("CRIC") that is controlled by a non-resident company ("Parent") to the extent that the CRIC makes an investment in the shares or debt of a foreign affiliate ("Subject Corporation"). Generally, the deemed dividend applies to both debt issued by the CRIC to acquire the investment and to the CRIC's excess cash paid for or invested in the foreign affiliate, including cash invested in existing foreign affiliates on or after the budget date. The deemed dividend is subject to withholding tax that is not refundable upon the unwinding of the investment.

The August 14 proposals included an election to reduce the paid-up capital (PUC) of the shares of the CRIC in lieu of a dividend in certain circumstances. If the CRIC issues shares in exchange for the acquisition of the investment and the dumping rules apply, while no deemed dividend arises, the PUC of those shares is automatically deemed to be nil, such that the PUC cannot count as equity for purposes of the thin capitalization rules or be returned tax-free to the shareholder (subject to the PUC reinstatement rule discussed below).

In a very controversial development, the proposed rules were extended in August to apply to the acquisition by a CRIC of shares of another Canadian company if the value of the Canadian company is substantially attributable to the value of its foreign affiliates (the “indirect acquisition” rule).

Exceptions to the rules apply if the business of the foreign affiliate is closely connected to the business of the CRIC (the “more closely connected business exception”), if the investment is made as part of certain corporate reorganizations or if the CRIC and Parent elect to include interest in the CRIC’s income at a prescribed rate on certain loans made to foreign affiliates (the “pertinent loan or indebtedness election”).

While not directly related to the dumping proposals, the August version of the proposals also included a provision to allow loans to be made by a CRIC to its Parent or other related non-resident persons without the loans being deemed to be a dividend under subsection 15(2) of the Income Tax Act (the Act) provided that the CRIC includes interest in its income at a prescribed rate (the “15(2) pertinent loan or indebtedness election”).

Indirect acquisition rule

The indirect acquisition rule was the most controversial of the August changes to the draft legislation. The Department of Finance did not accept the recommendation to cast the rule as a specific anti-avoidance rule rather than as a rule of broad application. While the rules will continue to apply to the acquisition of shares of a Canadian Target company by a CRIC controlled by a non-resident Parent, the rules will only apply to the extent that the value of foreign affiliates owned by the Target exceeds 75% of the value of the Target (the threshold under the August proposals was 50%).

The proposals have also been amended to allow the PUC suppression rule and related PUC reinstatement rule to operate in the context of an indirect acquisition. Corporate reorganization exceptions have also been added, including a rule to prevent multiple applications of the indirect acquisition rule where investments are made through tiers of Canadian companies.

The Department of Finance chose not to accept the recommendation to include a rule to determine how to allocate consideration paid for the shares of the Target between Canadian and foreign assets. The explanatory notes indicate that a pro rata allocation would be the most reasonable method to use in the absence of specific factors that indicate otherwise.

More closely connected business exception

The more closely connected business exception (also variously known as the business purpose exception and the strategic business expansion exception) was modified in August. As originally stated in the budget, it was a test involving a consideration of 7 factors to determine whether or not the investment was made by the CRIC, instead of being made or retained by the Parent or another non-arm’s length non-resident, primarily for bona fide purposes other than to obtain a Canadian tax benefit.

The August version provided that the exception could be met only if three tests were satisfied. First, there had to be a closer connection between the business activities of the Subject Corporation and its subsidiaries and the Canadian business activities of the CRIC or a non-arm’s length Canadian resident than between the business activities of the Subject Corporation and its subsidiaries and the business activities of any other related non-resident corporation (such as the Parent). Second, officers of the CRIC or a non-arm's length Canadian resident had to have and continue to have the principal decision-making authority in respect of the investment. Third, those officers had to be evaluated and compensated based on the results of the operations of the Subject Corporation to a greater extent than officers of another non-resident corporation (other than the Subject Corporation and its subsidiaries). A majority of those officers had to be resident and work principally in Canada.

The October 15 legislation substantially retains the tests set out in the August version and will remain very difficult to meet. However, the requirements have been relaxed somewhat.

With respect to the first test, an investment in a particular Subject Corporation may now be exempt from the rules even if the activities of the Subject Corporation and its subsidiaries are more closely connected to those of a controlled foreign affiliate[1] of the CRIC than to the activities of the CRIC or a non-arm's length resident corporation. The test now provides that the business activities of the Subject Corporation and its subsidiaries must, on a collective basis, be more closely connected to the Canadian business activities of the CRIC or a non-arm's length Canadian resident than to the business activities of any non-arm's length non-resident corporation other than the Subject Corporation and its subsidiaries or a controlled foreign affiliate of the CRIC.

In addition, the second and third tests involving the officers of the CRIC can now be met in respect of a particular officer if he or she is resident and working principally in a country where a controlled foreign affiliate of the CRIC (a "connected affiliate") is resident and carrying on a business that is at least as connected to the business of the Subject Corporation and its subsidiaries as is the business of the CRIC or a related Canadian resident corporation. Therefore, if key officers of the CRIC are located in another country where the CRIC has a controlled foreign affiliate with significant operations, those officers may count for purposes of the more closely connected business exception depending on the facts. However, a new rule with respect to "dual officers" provides that those officers cannot also be officers of the Parent, for example.

Concern was raised by the tax community that a special purpose foreign affiliate such as a financing company could not meet the more closely connected business exception even if its activities relate to the business of a foreign affiliate that does meet the exception. A new exception to the dumping rules has been added for an investment in a foreign affiliate that uses property received from the CRIC within 30 days to make a loan to a controlled foreign affiliate of the CRIC, provided that an investment in the borrower would have met the more closely connected business exception and the borrower uses the proceeds of the loan in an active business carried on in its country of residence.

The exception is very narrowly drafted and does not allow for other special purpose entities that might not otherwise qualify for the more closely connected business exception such as a leasing or licensing company, or permit the funds borrowed to be used for other purposes such as the acquisition of another foreign affiliate that carries on an active business. It is unclear why the exception is so narrow. If it is not expanded, those CRICs that can generally meet the more closely connected business exception in respect of their operating affiliates may be unfairly limited in the

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[1] Within the more restricted definition in section 17 of the Income Tax Act, which requires the affiliate to be controlled by Canadian residents. The more restricted definition is used for all purposes of the more closely connected business exception.

structures they can use for business or tax purposes relative to Canadian multinational enterprises which are not controlled by a foreign shareholder.

Reorganization exceptions

The reorganization exceptions have been expanded to include indirect investments as described above and to apply to the conversion of debt to equity (other than preferred shares of a foreign affiliate unless the affiliate is a subsidiary wholly-owned corporation[2]). The Department of Finance has also clarified that a reorganization exception applies to the transfer of a top-tier foreign affiliate to another foreign affiliate for shares even if the applicable rollover provision does not apply.[3]

PUC suppression rule and new dividend substitution election

The August proposals introduced an election to reduce the PUC of the CRIC's shares in certain circumstances (the PUC suppression election), rather than deeming a dividend to the foreign Parent when the CRIC makes a foreign affiliate investment, and the ability in some cases to reinstate that PUC when the investment in the foreign affiliate is unwound and shares of the foreign affiliate (or cash proceeds) are distributed to the Parent (the PUC reinstatement rule). The PUC suppression election (which will now apply automatically if its requirements are met) was intended to accommodate the use of Canada as a holding company jurisdiction where no Canadian tax advantage arises from the investment. It also allowed CRICs to invest excess cash in foreign affiliates at the cost of a reduction in PUC (which limits the CRIC's ability to deduct interest under the thin capitalization rules). However, the rules were too narrowly drafted and the PUC suppression election was not available in a number of common fact situations including circumstances where the shares of the CRIC were held through one or more Canadian or foreign holding companies.

Holding company structures were also problematic under the August version of the proposals in circumstances where the rules applied to deem a dividend to have been paid by a CRIC to the foreign Parent, since in many cases the relevant tax treaty would not allow the direct dividend rate of withholding tax (typically 5%) for dividends paid to the foreign Parent by an indirectly held Canadian subsidiary.

The legislation now addresses both these issues. A new dividend substitution election has been provided to deem the dividend that would otherwise be deemed to have been paid by the CRIC to the foreign Parent to have been paid in certain cases by a "Qualifying Substitute Corporation" ("QSC") and received by the foreign Parent or what the explanatory notes refer to as a "Substitute Non-resident" (a non-resident corporation controlled by the Parent). A QSC is a corporation resident in Canada that is controlled by the non-resident Parent, that has a direct or indirect ownership of shares of the CRIC and at least one share of which[4] is owned by the Parent or a non-resident corporation with which the Parent does not deal at arm's length.

The ability to suppress PUC has been extended to the shares on which the deemed dividend is considered paid as a result of the dividend substitution election. The requirements are very complex, but in general, it is now possible to reduce the PUC

[2] The reorganization and the more closely connected business exceptions do not generally apply to preferred share investments in a foreign affiliate unless the CRIC and non-arm's length Canadian residents own all the shares of the affiliate including the common shares. The proposals have been amended to allow the inclusion of shares owned by certain related Canadian residents in determining the subsidiary wholly-owned corporation status of the foreign affiliate, but the exception is still fairly narrow. It excludes, for example, situations in which common shares of an investee foreign affiliate are owned by another subsidiary wholly-owned corporation that is a foreign affiliate.

[3] No deemed dividend will apply on a transaction described in subsection 85.1(3) of the Act even if subsection 85.1(4) of the Act applies.

[4] Per the explanatory notes, at least one share must be owned. The legislation refers to "shares".

of shares of a Canadian holding company that are held by the Parent or another non-arm's length non-resident in lieu of the deemed dividend that would otherwise be subject to withholding tax.

Where the PUC of the CRIC itself is reduced, a favourable change allows the PUC to be reduced where the shares are held by a non-arm's length non-resident rather than the foreign Parent directly. However, other situations continue to be problematic, including circumstances where the CRIC has more than one class of shares.

PUC reinstatement rule

The PUC reinstatement rule allows the PUC that was reduced under the PUC suppression rule (or on the transfer of a foreign affiliate investment to the CRIC in exchange for shares[5]) to be reinstated prior to a return of PUC to the Parent. The PUC reduction must have related to an investment in a Subject Corporation that was the acquisition of shares of a foreign affiliate, the contribution of capital to a foreign affiliate or an acquisition of a Canadian company to which the indirect acquisition rule applied.[6] In general, the rule allows the Subject Corporation shares, or property substituted therefor, to be distributed to the foreign Parent or non-arm's length non-resident shareholder as a return of capital without attracting withholding tax (up to the original value of the investment). Where the shares are sold, the rule allows the proceeds of disposition to be so distributed within 180 days (provided that the reorganization exception did not apply to the disposition). A new addition to the rule allows the reinstatement of PUC to enable the repatriation of a dividend or a return of capital received from the foreign affiliate within the prior 180 days.

Pertinent loan or indebtedness (PLOI) exception

The August legislation provided an exception from the rules for certain loans made by a CRIC to a foreign affiliate provided that a specified amount of interest is included in the CRIC's income (at least 5% based on current interest rates). If the "pertinent loan or indebtedness" is directly or indirectly debt-financed, the imputed interest income cannot be less than the related interest expense of the CRIC or a non-arm's length Canadian corporation.

One of the requirements for making the PLOI election is that the debt arose on or after the budget date. However, the extension of the maturity date for debts owing by a foreign affiliate is deemed to be a new investment in the foreign affiliate and is caught by the rules if the extension occurs on or after the budget date. Therefore, the rules now provide that the PLOI election can be made in respect of such debts. In addition, the rules have been revised so that the PLOI election is made on a debt-by-debt basis and not in respect of all debts owing by the Subject Corporation that would otherwise be caught by the rules.[7]

Subsection 15(2) PLOI exception

While somewhat confusing, the August legislation also included another election which is also generally referred to as the PLOI election. However, this election does not apply in respect of the dumping rules and loans to foreign affiliates. This election provides an exemption to the long-standing rule in subsection 15(2) of the Act that

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[5] That is a welcome change from the August version of the legislation that did not allow PUC to be reinstated in circumstances where the PUC was denied on the direct acquisition of property by the CRIC.

[6] As noted above, the rules have been amended such that the PUC suppression rule and PUC reinstatement rule should also apply to indirect acquisitions of foreign affiliates.

[7] Certain debts arising in the ordinary course of business are exempt from the dumping rules. The PLOI election, and the subsection 15(2) PLOI election described below are not available if a tax treaty limits Canada's right to tax the interest income on the debt.

deems a dividend to arise if a loan is made by a CRIC to a related non-resident other than a foreign affiliate and the loan is outstanding for two taxation year ends of the CRIC. If this election is made, the loan can remain outstanding beyond this limit without a deemed dividend arising. This provides another option for Canadian subsidiaries to repatriate cash to foreign Parents through loans in lieu of investing the cash in foreign affiliates.

However, the CRIC must report an amount of interest income on the debt during the period in which the debt is a PLOI, whether or not the debt is interest-bearing, and the interest cannot be less than the prescribed rate. As noted above, the prescribed rate for this purpose is currently 5%. If the debt is directly or indirectly debt-financed, the deemed income inclusion cannot be less than the related interest expense.[8]

Positive changes have been made to these rules. The election can now be made on a debt-by-debt basis so that debts that would not otherwise be subject to subsection 15(2) of the Act do not get swept into the deemed interest income regime. The election is now also available for loans made to and from certain partnerships. Continuity rules are provided where the lender undergoes an amalgamation or wind-up.

Unfortunately, the election is only available for debts that arose after March 28, 2012. If a pre-budget debt is repaid and traceable to another loan made after the budget, there is a concern that the new loan will be part of a “series of loans and repayments” and the original loan will not be considered to have been repaid.

Filing of elections

The latest proposals include provisions to allow for the late filing of certain elections. For example, the subsection 15(2) PLOI election can be filed at any time up to three years after the normal filing deadline, provided a minor penalty of $100 per month is paid. This will allow a taxpayer to determine whether the loan would otherwise be subject to the subsection 15(2) deemed dividend rule and the PLOI election would be beneficial. The dividend substitution election and PLOI election with respect to the dumping rules now have similar extended filing deadlines and penalties.

In addition, if the ordinary filing due date for these elections would otherwise occur before the day that is 120 days after the legislation receives Royal Assent, the filing deadline has been extended to 365 days after Royal Assent.

Options to consider going forward

It appears likely that the legislation will receive Royal Assent before the end of the year.[9] For foreign controlled Canadian companies owning foreign affiliates, the rules represent a significant challenge. The reorganization exceptions should help. However, it will be necessary to consider whether the more closely connected business exception can be met for new investments in those affiliates. In many, if not most cases, the exception will not provide any relief, and the risk of a deemed dividend for new investments will be high.

[8] Note that if no interest is charged on the debt, a benefit may still arise to the borrower under subsection 80.4(2) of the Act at the basic prescribed rate (currently 1%) and be treated as a deemed dividend subject to withholding tax. Therefore, it may be advisable to charge interest on the debt in an amount no less than the basic prescribed rate.

[9] The proposals are currently contained in a notice of ways and means motion and at the time of writing have not yet received first reading in the House of Commons. (From an accounting perspective, this means that they are not yet substantively enacted for IFRS purposes, which would require passage of first reading, or US GAAP, which would require Royal Assent.)

Taxpayers should examine the tax cost of moving the foreign affiliate investments out from under Canada, including both capital gains and dividend withholding taxes. If this cost is prohibitive, taxpayers may wish to consider:

- Using the PLOI elections to make loans to foreign affiliates or related non-residents;
- Having the foreign Parent make new equity investments in the foreign affiliates through Canada, and using the PUC suppression rule to reduce the PUC of the CRIC or a Canadian holding company;
- Using Canadian cash to make the investment if there is excess PUC available for the PUC suppression rule (taking account the impact on the thin capitalization calculation);
- Moving the affiliates under a common foreign holding company, paying dividends up to the holding company for investment back down in those affiliates that need cash;
- Financing the foreign affiliates from equity contributed by the Parent (subject to concerns about split shareholdings and the impact of diluting the CRIC's ownership level in the foreign affiliates for certain tests such as the "qualifying interest" test); or
- Making loans from the Parent or another related non-resident to the foreign affiliates, subject to foreign tax concerns.

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