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Canadian government reintroduces "upstream loan" rules and other foreign affiliate proposals

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On October 24, 2012, the Minister of Finance tabled in the House of Commons a 945 page Notice of Ways and Means Motion which consolidates draft legislation that has been outstanding for many years.

The legislation includes, among other matters, extensive technical amendments with respect to most aspects of the foreign affiliate rules, including the computation of foreign accrual property income (FAPI) and surplus and reorganizations of foreign affiliates.[1] Many of these changes were first proposed a decade ago and have been released more than once in draft form. With some notable exceptions discussed below, the provisions do not differ significantly from prior versions that were released in draft for consultation.

Upstream loan rules

The legislation includes extensive revisions to the "upstream loan" rules, which were originally released on August 19, 2011. The changes include greater transitional relief and a temporary measure to eliminate historical foreign exchange gains that will be welcomed by those taxpayers who had upstream loans outstanding as of August 19, 2011.

The upstream loan rules are anti-avoidance rules designed to prevent taxpayers from making upstream loans from foreign affiliates in order to avoid what would otherwise be taxable dividends that are not fully offset by deductions under section 113 of the Income Tax Act (Act). Numerous technical issues and concerns were identified by the tax community, including The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants. Many, although not all, of these issues have been addressed by the Department of Finance in the October 24, 2012 legislation. The key changes to the upstream loan rules are summarized below.

- Additional transitional relief has been introduced to provide taxpayers with adequate time to address loans or indebtedness that existed prior to August 19, 2011. If any such loans or indebtedness (or portions thereof) continue to be outstanding on August 19, 2014, they will be deemed to have arisen on

[1] This legislation is in addition to the 2012 budget legislation that was introduced October 15 and includes the foreign affiliate "dumping" proposals, as discussed in our **Alert of October 17, 2012**.

August 19, 2014, meaning that taxpayers will have until August 19, 2016 to address any “historical” loans or indebtedness. If not repaid by August 19, 2016, they will be included in income effective August 19, 2014.

- A temporary measure has been introduced to offset a taxpayer’s foreign exchange gain or loss on the repayment of an upstream loan against the related loss or gain of the foreign affiliate. The application of these provisions is limited to the repayment of a debt obligation (or portion thereof) that was outstanding on August 19, 2011 and that is repaid on or before August 19, 2016.
- A new rule has been introduced to collapse certain back-to-back loans into a single loan in order to avoid multiple income inclusions and other inappropriate consequences. Taxpayers have the ability to elect out of this rule for any loans made between August 19, 2011 and October 24, 2012.
- A new exception has been introduced to ensure that certain loans and indebtedness between a foreign affiliate and a branch of a Canadian life insurance company are not subject to the upstream loan rules, recognizing that a foreign branch of a Canadian life insurance company is similar to a wholly-owned foreign affiliate of a Canadian company.
- The reserve mechanism, which is intended to provide a taxpayer with an offsetting deduction to the extent that an actual dividend would have given rise to a deduction under section 113, has been amended in several ways including the following:
    - The new legislation clarifies that the reserve is to be computed with reference to all foreign affiliates in the chain of ownership extending from the taxpayer down to the creditor affiliate, also taking into account any “downstream” surplus of lower-tier affiliates owned by the creditor affiliate. “Sidestream” surplus of sister affiliates will not be available for the reserve;
    - The reserve mechanism has been extended to include a deduction for pre-acquisition surplus dividends, but only to the extent of the taxpayer’s adjusted cost base (ACB) in the shares of a relevant directly held (i.e., top tier) foreign affiliate. The deduction for pre-acquisition surplus dividends is not available where the debtor is a non-arm’s length non-resident person, such as a foreign parent or sister company, although in that case a deduction is available for any previously taxed FAPI. The exclusion for non-arm’s length non-resident persons is intended to prevent taxpayers from undertaking so-called “indirect repatriation strategies” that involve Canadian corporations repatriating profits to their non-resident parents on an indirect basis through foreign affiliates. Any indirect repatriation strategies that were implemented prior to August 19, 2011 qualify for the transitional relief referred to above, and can therefore remain in place until August 19, 2016 without invoking the upstream loan rules. Note that the loans must be repaid by the August 19, 2016 deadline. The disposition of the creditor affiliate by the taxpayer does not appear to be sufficient to avoid the application of the rules;
    - There is no longer a provision that prevents a taxpayer from claiming a reserve for a particular year simply because a dividend has been paid to the taxpayer (or another non-arm’s length Canadian) by a relevant foreign affiliate. Instead, certain “anti-double counting” rules have been

introduced to ensure that surplus and ACB cannot be accessed by a taxpayer more than once, including for another upstream loan or an actual dividend. The anti-double counting rules contain “all or nothing” conditions, meaning any amount that is used twice, no matter how small, will impact the taxpayer’s ability to claim a reserve.

  - A rule has been introduced to allow the reserve mechanism to operate properly where the taxpayer is a partnership of which a corporation resident in Canada is a member. The rule attributes the income inclusion at the partnership level to the corporate partner so that the corporation can claim a deduction under section 113 of the Act (which is not available at the partnership level). Also, the ability to claim a pre-acquisition surplus deduction is “turned off” because of the special deferred treatment given to pre-acquisition surplus dividends paid to a partnership.

- The definition of “specified amount” has been amended to limit the specified amount of an upstream loan to the difference between the taxpayer’s surplus entitlement percentage (SEP) in the creditor affiliate and the taxpayer’s SEP in the debtor affiliate. On this basis, a loan from one foreign affiliate to another foreign affiliate that is not a controlled foreign affiliate (CFA) will only result in an income inclusion to the extent that the taxpayer has a lower SEP in the debtor affiliate than the creditor affiliate.
- The definition of “specified amount” has also been amended to ensure that there is no double income inclusion where a corporation resident in Canada is a member of a partnership that holds a creditor affiliate. In such cases, there will only be one income inclusion – at the partnership level – which will be attributed to the corporate partner, as discussed above.
- The definition of “specified debtor” has been amended, in the case of a taxpayer that is a partnership, to include (i) any member of the partnership that is a corporation resident in Canada (if the creditor is a foreign affiliate of that corporation) and (ii) a person with which a person described in (i) does not deal at arm’s length (other than a CFA of the partnership or of a member of the partnership that owns, directly or indirectly, an interest in the partnership that represents at least 90% of the fair market value of all such interests).
- While the upstream loan rules have not been formally extended beyond loans and indebtedness, the explanatory notes make it clear that any attempts to circumvent the rules will be subject to review under the general anti-avoidance rule (GAAR). The types of transactions referred to by the Department of Finance include back-to-back loans and similar financial arrangements, the use of debt-like equity interests such as preferred shares, and synthetic lending arrangements such as the factoring of receivables or the sale of securities at a discount.

Distributions from a foreign affiliate

The August 19, 2011 proposals included a measure to treat all *pro rata* distributions received on the shares of a foreign affiliate as dividends, regardless of their legal character, with the exception of liquidating distributions and share redemptions. Corporate shareholders were given the ability to access their ACB in the shares of a top-tier foreign affiliate through a pre-acquisition surplus election, but other shareholders were disadvantaged since they could no longer access their ACB on a tax-free basis as a return of paid-up capital.

The October 24 draft legislation addresses this issue through a new concept referred to as a “qualifying return of capital” or “QROC” election. Under the new legislation, deemed dividend treatment will no longer apply to a foreign affiliate distribution that is a reduction of paid-up capital, provided the taxpayer (together with all other connected persons and partnerships, if any) elects to treat the distribution as a QROC. In that case, the distribution will be respected as a reduction of paid-up capital, thereby decreasing the taxpayer’s ACB in the shares of the foreign affiliate. The QROC election is not limited to non-corporate shareholders, although as a practical matter it is anticipated that corporate shareholders will generally access their ACB in the shares of a foreign affiliate through a pre-acquisition surplus election rather than a QROC election. The pre-acquisition surplus election has also been extended to distributions made by lower-tier affiliates.

On a related note, the October 24 draft legislation includes an amendment to clarify that any non-*pro rata* distributions by a foreign affiliate are to be included in income as a shareholder benefit, on the basis that they are not dividends, nor are they reductions of paid-up capital that would decrease the taxpayer’s ACB in the shares of the foreign affiliate.

Foreign tax credit (FTC) generator rules

The FTC generator proposals may apply to deny deductions for foreign accrual tax and underlying foreign tax in respect of certain foreign affiliates if, generally, an investment is made in a foreign affiliate and that investment is not considered to be an equity investment under the relevant foreign tax law (so-called hybrid instruments). The October 24 legislation generally limits the application of the proposed rules to circumstances where the affiliate with the FAPI or taxable surplus is in the same ownership chain as the affiliate that has issued the hybrid instrument, except in certain instances of cross-chain funding of foreign affiliates. A new provision requires the rules to apply even if investment is considered to be equity under the relevant foreign tax law, if the income from the investment is deductible for local country tax purposes. The FTC generator rules are generally effective for taxation years ending after March 4, 2010, but many of the October 24 changes are applicable to taxation years that end after October 24, 2012.

Absorptive mergers

The August 19, 2011 draft legislation contained a provision to ensure that certain “absorptive mergers” qualify as “foreign mergers” for purposes of certain rollover provisions. While the other provisions concerning mergers and liquidations were unchanged from previous drafts, the October 24 legislation contains a welcome amendment to this provision to ensure that “downstream” mergers (in which a foreign parent corporation merges with a subsidiary and the subsidiary is the “survivor”) can qualify as “foreign mergers”. The provision is applicable retroactively to mergers or combinations that occur after 1994 unless the taxpayer elects not to apply the provision to mergers or combinations that occurred before August 20, 2011.

Surplus reclassification rule

The August 19, 2011 proposals included a broad anti-avoidance rule allowing exempt earnings generated on a transaction to be recharacterized as taxable earnings if the transaction was an avoidance transaction, within the meaning of the GAAR. While the provision is still very broad, and, unlike the GAAR, does not include a requirement that the transaction be abusive, Income Tax Regulation 5907(2.02) has been narrowed to apply only to exempt earnings arising from a disposition of property (other than money) to certain designated persons. This change brings the rule more in line with the former proposals, which suspended the creation of surplus on the transfer of assets to certain non-arm's length persons.

Foreign accrual capital losses

The August 19, 2011 proposals included rules that limited the use of foreign accrual capital losses to the reduction of capital gains included in FAPI. There was some uncertainty surrounding the application of those losses before and after the effective date of the provision. The coming-into-force provision applicable to the measure has been changed to apply in respect of capital losses incurred in taxation years of a foreign affiliate that end after August 19, 2011 and a new example of the intended application of the rule has been included in the explanatory notes.

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