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August 15, 2012

Canadian government releases 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, moderately amended in response to consultations. The remaining budget proposals were also re-released, including those relating to the thin capitalization rules.

The budget proposed to introduce a rule that may deem a dividend to have been paid by a corporation resident in Canada ("CRIC") that is controlled by a non-resident company ("Parent") to the extent the CRIC makes an investment in the shares or debt of a foreign affiliate ("Subject Corporation"). Generally, the deemed dividend would apply 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 incremental amounts invested in existing foreign affiliates on or after the budget date. The deemed dividend would be subject to withholding tax that would not be refundable upon the unwinding of the investment. In addition, if the CRIC issued shares in exchange for the acquisition of the investment, while no deemed dividend would arise, the paid-up capital of those shares would be deemed to be nil, such that the paid-up capital could neither be returned tax-free to the shareholder nor count as equity for purposes of the thin capitalization rules.

Significant changes

While the basic structure of the rules has not changed, a number of significant modifications are contained in the new draft legislation. The positive changes include:

- An exception from the rules for certain loans made to foreign affiliates provided that a specified amount of interest is included in the CRIC's income (at least 5% based on current rates). If the loan is debt financed, the interest income cannot be less than the related interest expense of the CRIC or a non-arm's length Canadian corporation;
- A similar exception to the long-standing subsection 15(2) deemed dividend rules so that certain interest-bearing loans made by a CRIC to a related non-resident, whether or not the borrower is a foreign affiliate, will not be deemed to be a dividend even if outstanding for two taxation year ends of the CRIC. Interest income reported on such loans must be calculated as described above;

- An ability to elect to reduce the paid-up capital of the CRIC's shares in certain circumstances, rather than experience a deemed dividend to the Parent when the CRIC makes a foreign affiliate investment, and the ability in some cases to reinstate that paid up capital when the investment in the foreign affiliate is unwound and shares of the foreign affiliate (or cash proceeds) are distributed to the Parent. According to the Explanatory Notes, this change is intended to accommodate the use of Canada as a holding company jurisdiction where no Canadian tax advantage arises from the investment. It may provide a method for Parents of CRICs with existing foreign affiliates to continue to make investments through Canada and avoid the deemed dividend and double taxation consequences of the dumping rules (and avoid the split shareholding that would arise if the Parent were to make new investments in the foreign affiliates directly);

- The introduction of exceptions to the rules for the acquisition of shares of a foreign affiliate as the result of certain corporate reorganization transactions, although the exceptions are somewhat narrower than recommended by the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants. These include the acquisition of shares in a foreign affiliate from a related Canadian company, the amalgamation of Canadian related companies and various foreign reorganization transactions, such as the transfer of a top-tier foreign affiliate to a new foreign holding company for shares. Certain exceptions apply to debt taken back on foreign reorganizations and to preferred shares received as consideration, as discussed below. A special rule provides that the dumping rules will not apply to foreign affiliates acquired in the context of a vertical amalgamation or subsection 88(1) wind up (this is intended to provide relief for "bump" transactions).

The revised legislation is also less generous to taxpayers in other respects:

- The scope of the rules has been expanded to apply to the acquisition by a CRIC of the shares of a Canadian company if more than 50% of the value of the company's property is represented by shares of foreign affiliates. This is a radical departure from the original proposals and may affect the takeover of many Canadian multinationals;

- The business purpose exception has been modified and no longer contains a list of seven factors to be considered in determining whether the investment was made by the CRIC, 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 Canadian tax benefit. The new exception remains difficult to meet, and can be satisfied only if there is a closer connection between the foreign affiliate's business activities and the CRIC's Canadian business activities than to the business activities of any other related non-resident corporation. In addition, officers of the CRIC must have and continue to have the principal decision-making authority in respect of the investment and be evaluated and compensated on the results of the operations of the foreign affiliate to a greater extent than officers of another non-resident corporation. Lastly, a majority of those officers must be resident and work principally in Canada.

- The extension of the maturity date for debts owing by a foreign affiliate or of the date specified for the redemption, acquisition or cancellation of shares of a foreign affiliate will be deemed to be a new investment in the foreign affiliate and be caught by these rules;

- With the exception of shares of a top-tier foreign affiliate where the common shares of the affiliate are all owned by the CRIC (a "subsidiary wholly-owned corporation”), the acquisition of preferred shares of a foreign affiliate will be deemed not to meet the business purpose exception or corporate reorganization exception;

- No public company exception was provided even though it had been requested in many of the submissions;
- The rules remain especially problematic for Canadian companies held through one or more Canadian holding companies since the paid-up capital reduction election described above is not available where the CRIC’s shares are held by a Canadian resident corporation and the deemed dividend to the Parent may not qualify for the lower (often 5%) withholding tax rate on direct dividends, depending on the applicable tax treaty. In some cases, the elimination of Canadian holding companies to address these problems will present other tax issues, including foreign tax issues.

Options to consider going forward

The Department of Finance has requested comments on the revised legislation by September 13, 2012. It appears that its intention is to introduce a bill containing these changes in the fall session of Parliament, with a view to enactment by the end of the year.

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 business purpose 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.

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

- Interest-bearing loans to foreign affiliates or related non-residents to fund the foreign affiliates or deploy Canadian cash on a temporary basis (the 15(2) exception will allow such loans to remain outstanding rather than forcing repayment within two year ends);
- Investing through Canada and into shares of the foreign affiliates, and making the election to reduce paid-up capital of the CRIC;
- 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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