



International Fiscal Association

IFA Canada – YIN Webinar

Primer on Inbound Taxation Matters

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Agenda

1. Inbound Taxation Framework
2. Life Cycle of Investment
 - a. Form of Investment
 - b. Funding
 - i. Equity
 - ii. Debt
 - c. Repatriation to Shareholders – Further Considerations
 - i. Return of Capital
 - ii. Dividends
 - iii. Loans to Non-Residents
 - iv. ITA 212.1
 - v. Foreign Affiliate Dumping

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INBOUND TAXATION FRAMEWORK

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Policies Underlying Inbound Taxation

- Source-based taxation
 - Canada expects compensation for non-residents' exploitation of Canada's resources, infrastructure, services
 - Domestic rules seek to tax non-residents in a similar manner, and at a similar level, as Canadian residents (on non-residents' Canadian source income)
- Desire to encourage investment into Canada
 - Canada needs foreign investment
 - Canadian domestic taxation should not be a barrier to flow of capital and movement of goods and services
- Equivalent taxation regardless of form of investment
 - Level of Canadian taxation should not depend on the manner in which a non-resident invests into Canada

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Taxation Framework

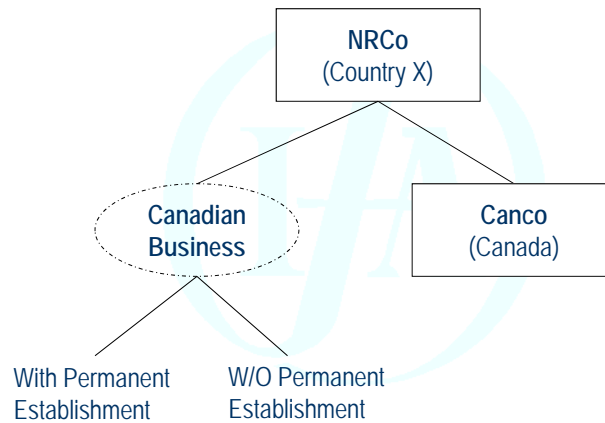
- Domestic Law
 - Part I – Income Tax
 - ITA 2(3), 115-116
 - Part XIII – Withholding Tax
 - Part XIV – Branch Tax
- Tax Treaties
 - Do not impose tax, but rather provide relief
 - Exempting the taxation of business income earned in Canada by non-residents unless such income is earned through a permanent establishment situated in Canada
 - Reducing withholding tax rates (royalties, dividends, interest, etc.)
 - Reducing branch tax rates
 - Purpose of tax treaties is also to prevent fiscal evasion

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FORM OF INVESTMENT

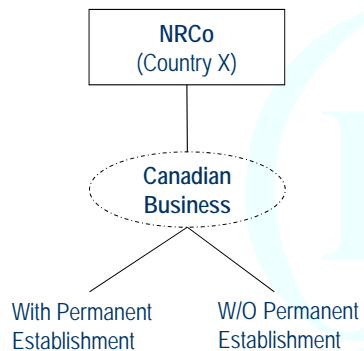
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Common Forms of Inbound Investment



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Branch



Domestic Law

Income Tax

1. Non-resident corporation subject to tax on income/gains from:
 - Carrying on business in Canada
 - Dispositions of "taxable Canadian property"
2. Branch losses potentially deductible to NRCo

Branch Tax

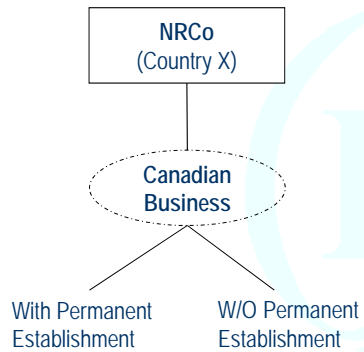
1. Additional 25% tax - on after tax profits not retained for use in the business carried on in Canada
 - Equivalent of dividend withholding tax

Regulation 105

15% withholding tax in respect of services rendered by a non-resident in Canada (not a final tax)

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Branch



Treaty Relief

Income Tax

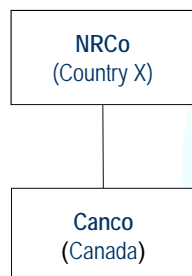
1. Carrying on business in Canada – income subject to tax only to the extent attributable to a permanent establishment situated in Canada
 - Requirement to file treaty based return
2. Dispositions of taxable Canadian property – potentially certain relief from taxation of capital gains

Branch Tax

1. Reduced branch tax rate
2. De minimis exemptions

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Corporate Subsidiary



Domestic Law

Income Tax

1. Canco subject to tax on worldwide income
2. Dividends paid to NRCo subject to withholding tax
3. NRCo subject to tax on its disposition of the shares of Canco if the shares are "taxable Canadian property"
4. Canco losses not deductible to NRCo

Treaty Relief

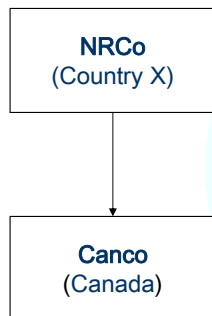
1. Reduced dividend withholding tax rate (to match reduced branch tax withholding rate)
2. Dispositions of taxable Canadian property – certain relief from capital gains

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FUNDING CANADIAN INVESTMENT

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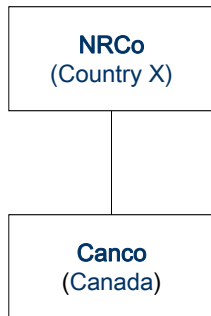
Equity Funding



- Capital can be returned without Canadian withholding tax up to the PUC of the shares
- No tax deduction in Canada for equity funding
- Capital gain may arise if return capital in excess of ACB of shares
- Dividends subject to Canadian withholding tax (25% unless reduced by a tax treaty)
- Must meet corporate solvency tests – both returns of capital and dividends
- Return of capital may be taxable in foreign jurisdiction

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Debt Funding



- Principal can be returned to NRCo without Canadian withholding tax
- Interest subject to Canadian withholding tax (25% unless reduced by a tax treaty)
- Interest limited by thin capitalization rules
- Interest rate subject to transfer pricing considerations (must be arm's length rate)
- Foreign exchange implications can be significant and are often overlooked
 - Can be managed through various hedging strategies or, potentially, with a functional currency election for Canco

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Part XIII Withholding Tax

- Withholding tax of 25% on amounts paid or credited by a person resident in Canada to a non-resident as, on account or in lieu of payment of, or in satisfaction of:
 - Management fees (ITA 212(1)(a))
 - Interest (ITA 212(1)(b) - non-arm's length or "participating debt" interest)
 - Rent, royalties (ITA 212(1)(d))
 - Pension benefits (ITA 212(1)(h))
 - Dividends (ITA 212(2))
 - Etc.
- Potential for treaty-reduced rates if conditions met (including beneficial ownership)

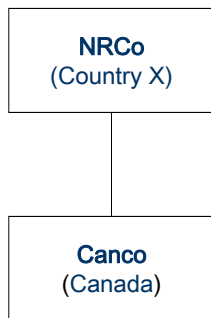
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Part XIII Withholding Tax

- Commonly overlooked withholding tax obligations
 - Amounts paid to a non-Canadian partnership
 - Amounts paid by a partnership to a non-resident (ITA 212(13.1))
 - Amounts paid by non-residents operating in Canada (ITA 212(13.2))
- Enforcement – withholding and remittance obligations on the Canadian payer (ITA 215)

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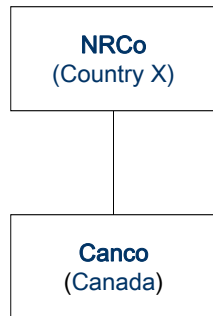
Thin Capitalization



- Thin capitalization rules intended to protect Canadian tax base
 - Rules restrict stripping of profits out of Canada through excessive interest deductions
- Interest disallowed where the Canadian company's debt-to-equity ratio in relation to "specified non-resident shareholders" is in excess of 1.5:1
 - Specified non-resident shareholder means a non-resident person which, alone or with persons with which it does not deal at arm's length, owns 25% or more of the shares of the corporation (in votes or value)
- Disallowed interest deemed to be a dividend subject to withholding tax
- Denied interest is permanently disallowed – i.e., no carryforward permitted

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Thin Capitalization

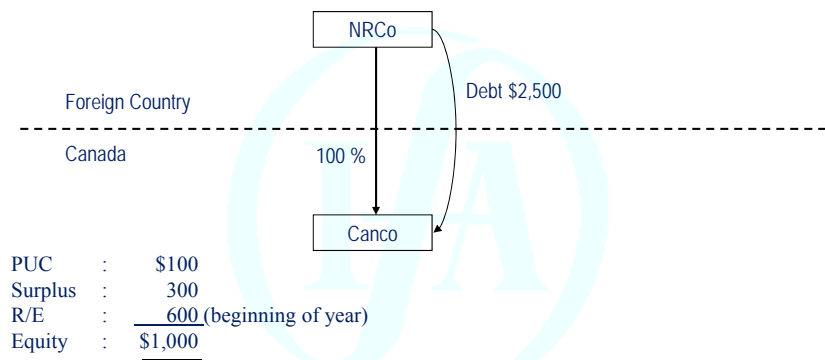


- Debt to equity ratio
 - Equity consists of:
 - Unconsolidated retained earnings at the beginning of the year (deficits ignored)
 - Average of the beginning of the month PUC and contributed surplus balances
 - Only PUC of shares owned by specified non-residents is counted
 - Debt is average of highest monthly amounts
- Timing differences for computation of equity and debt can have significant adverse consequences

- CRA document: 2015-0610601C6 – Foreign currency debt to be converted to Canadian dollars on the day the loan was issued

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Thin Capitalization Rules - Example

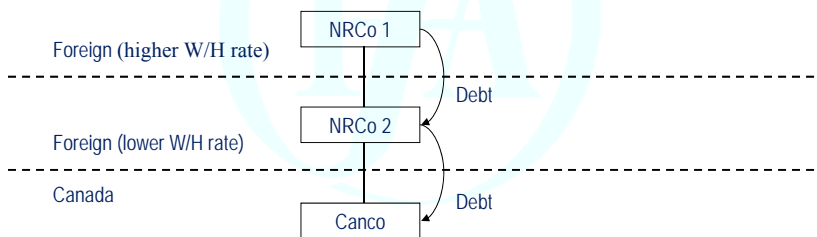


- Thin cap calculation: $[\$2,500 - (1.5 \times \$1,000)] / \$2,500 = 1,000 / 2,500$
- Therefore, since 1.5:1 ratio is exceeded, 10/25 of interest payable by Canco to NRCo will be denied as a deduction

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ITA 212(3.1) – Back to Back Loans

- Budget 2014 introduced new subsection 212(3.1)
 - Intended to restrict treaty shopping in respect of withholding tax on interest
 - Applies to certain back to back loan arrangements to disregard intermediate loan
- Applicable to amounts paid or credited after 2014



- Canco deemed to pay interest to NRCo 1

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ITA 212(3.1) – Back to Back Loans

- New: Budget 2016 proposes to extend the back to back loan rules to:
 - Rents and royalties
 - Character substitution transactions
 - Shareholder loans
- Budget 2016 also proposes to clarify the application of the back to back loan rules to multiple intermediary structures

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REPATRIATION OF PROFITS – FURTHER CONSIDERATIONS

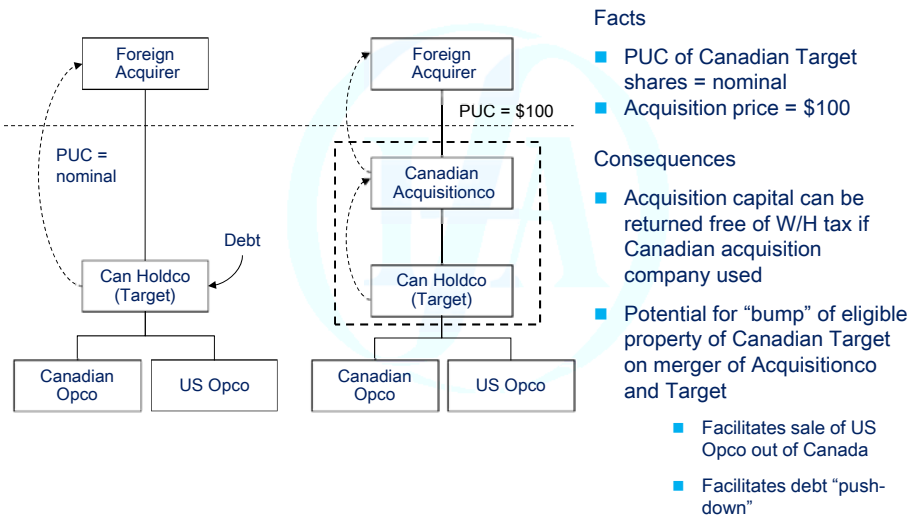
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PUC Returns

- “Paid-up capital” (PUC) is an important tax attribute to a non-resident acquirer
 - Can be returned free of Canadian withholding tax
 - Forms part of “equity” for thin capitalization purposes
- A non-resident generally should use a Canadian acquisition company to acquire a Canadian target corporation

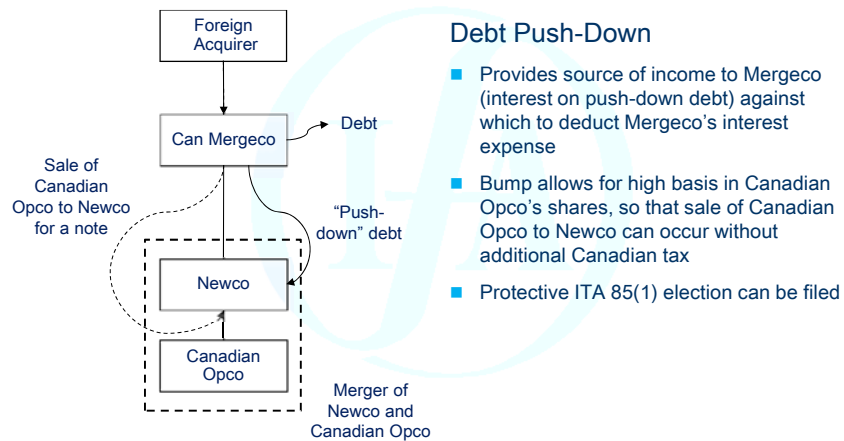
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Using a Canadian Acquisition Company



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Using a Canadian Acquisition Company



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Loans to Non-Residents – Shareholder Benefit

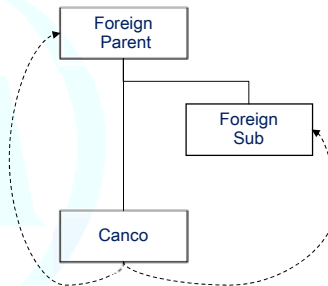
- ITA 15(2) requires a person (other than a corporation resident in Canada) or a partnership that is:

- a) A shareholder of a particular corporation
- b) Connected with a shareholder of a particular corporation, or
- c) A member of a partnership that is a shareholder of a particular corporation

to include in computing its income any loan received from the particular corporation or the amount of any indebtedness that became owing

- Loan effectively treated as a distribution of profit
- Amount is deemed to have been paid to the non-resident as a dividend subject to Canadian withholding tax – ITA 214(3)(a)

Examples of ITA 15(2)
S/H Loans



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Loans to Non-Residents – Shareholder Benefit

- ITA 15(2) will not apply where:

- The loan is repaid within 1 year after the end of the taxation year in which the loan was made, and not as part of a series of loans and repayments
- The loan was made to a foreign affiliate (i.e., a foreign subsidiary) of the particular corporation or to a foreign affiliate of a person resident in Canada with which the particular corporation does not deal at arm's length (provided the foreign affiliate is not a shareholder in the Canadian corporation – incestuous ownership)
- The loan is between non-residents
- Loan made in ordinary course of business

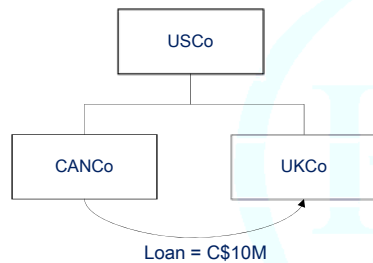
- If loan later repaid, a refund of the Canadian withholding tax previously remitted may be claimed – ITA 227(6.1)

- ITA 80.4(2) – interest benefit (subject to withholding tax)

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Loans to Non-Residents – Shareholder Benefit

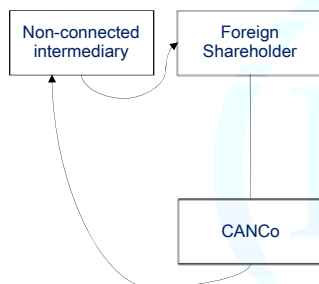
Example



- Provided none of the exemptions apply, ITA 15(2) and ITA 214(3) will deem UKCo to have received a dividend of C\$10M from a corporation resident in Canada
- UKCo should be subject to Canadian withholding tax on the C\$10M dividend
- As UKCo does not own any shares of Canco, C\$1.5M (15%) of Canadian withholding tax should be payable

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Loans to Non-Residents – Shareholder Benefit



- Proposed back to back loan rules
 - Budget 2016 – Finance has proposed to introduce back to back loan rules for “upstream” shareholder loans, similar to the existing back to back loan rules in ITA 212(3.1)
 - Intention is to prevent the repatriation of funds out of Canada by way of loans that circumvent the existing rules in ITA 15(2)

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Loans to Non-Residents – “PLOI” Rules

- Exception to subsection 15(2) income inclusion
- If loan is a “pertinent loan or indebtedness” (“PLOI”), ITA 17.1 should apply and the corporation resident in Canada (“CRIC”) is required to include into income:
 - the greater of:
 - i. interest at a prescribed rate; and
 - ii. interest actually paid or payable by the CRIC,
 - less any interest already included in computing the CRIC’s income in respect of the loan
- The prescribed rate applicable to a PLOI is 4% plus 90 day T-bill rate

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Loans to Non-Residents – “PLOI” Rules

- Conditions for loan to be a PLOI (ITA 15(2.11) and ITA 212.3(11))
 - Amount became owing after March 28, 2012
 - Loan is owing to a CRIC that is controlled by a non-resident
 - Loan would otherwise be subject to the provisions of ITA 15(2) or ITA 212.3(2) if not a PLOI
 - The CRIC and the non-resident jointly elect to treat all loans between the CRIC and the debtor to be PLOI

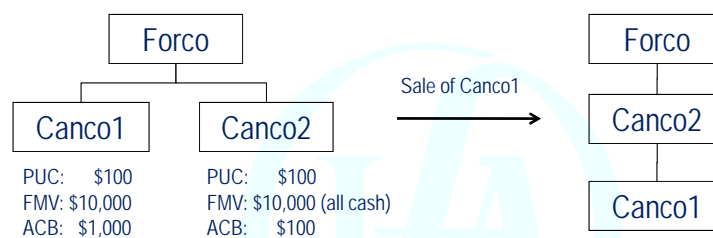
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ITA 212.1 – Non-Arm's Length Sale of Shares

- ITA 212.1 is the equivalent of ITA 84.1 in a domestic context
- Prevents profits earned in Canada from being repatriated tax free by way of an internal sale of shares
- Applies where:
 - Non-resident disposes of shares of a Canadian corporation
 - Purchaser is a corporation resident in Canada
 - Seller and purchaser are not dealing at arm's length
 - Purchaser is "connected" with the target Canadian corporation after the disposition (ITA 186(4) – 10% votes and value)

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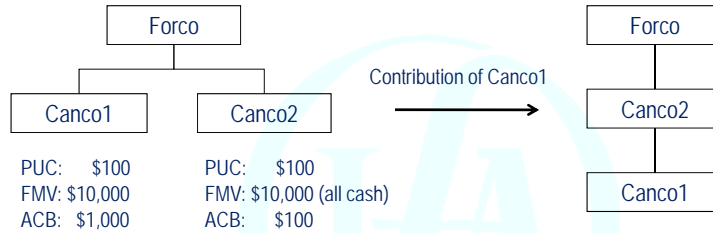
ITA 212.1 – Deemed Dividend Example



- Canco1 is sold to Canco2 for cash of \$10,000
- Without ITA 212.1, Forco may realize a treaty protected gain of \$9,000, such that it would have been able to strip \$10,000 of cash out of Canada free of Canadian taxation
- ITA 212.1 deems a dividend of \$9,900 (FMV of non-share consideration minus PUC) to be paid by Canco2
- Dividend is subject to Part XIII withholding tax

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ITA 212.1 – Example of PUC Grind

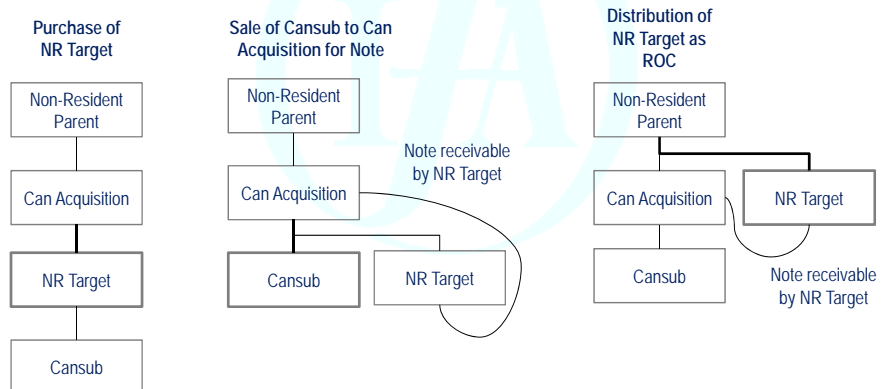


- Forco contributes its shares of Canco1 to Canco2 in exchange for shares of Canco2 having a FMV of \$10,000
- PUC of shares of Canco2 should be reduced by \$9,900 (\$10,000 - \$100) to \$200 (\$100 + \$10,000 - \$9,900)

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ITA 212.1 – Budget 2016 Proposed Changes

- Proposed that exemption for “sandwich” unwind transactions in subsection 212.1(4) be amended
- Example of “abusive” subsection 212.1(4) transaction:

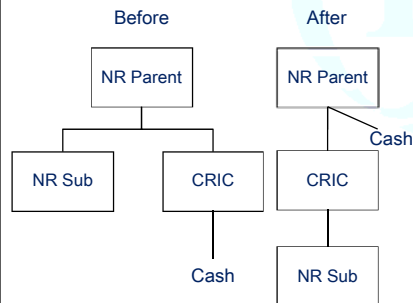


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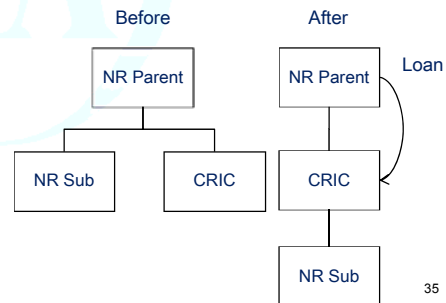
Foreign Affiliate Dumping – ITA 212.3

- Rules target “investments” (including shares, debt, options, etc.) in a foreign affiliate (“FA”) by a corporation resident in Canada (“CRIC”) if the CRIC is controlled by a non-resident corporation, in order to discourage:
 - “debt dumping”
 - “surplus stripping”
- Example of targeted transactions:

Surplus Stripping



Debt Dumping



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Foreign Affiliate Dumping – ITA 212.3

- “Investment” broadly defined (shares, contribution of capital, debt, etc.) and includes indirect acquisitions of FA shares by way of an acquisition of another Canadian-resident corporation
- Exception if a “closer connection” test satisfied
 - FA’s business activities must be “more closely connected” to the Canadian business activities of CRIC (and non-arm’s length CRICs)
 - Principal decision making authority over acquisition of FA and of FA post-acquisition must be exercised by officers of CRIC and majority must be resident, and work principally, in Canada
- Existing structures generally grandfathered

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Foreign Affiliate Dumping – ITA 212.3

- Exceptions for various reorganizations, including:
 - Canco to Canco transfers between related parties, including amalgamations, wind-ups, etc.
 - Foreign to foreign rollovers, and
 - Certain capital reorganizations and distributions
- Some overrides to reorganization exceptions:
 - Preferred shares are acquired on certain reorganizations/distributions
 - Debt is assumed by Canco as part of certain liquidation/distributions

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Questions?

Thank you for participating in this webinar!

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