

# IFA INTERNATIONAL TAX CONFERENCE

Monday, May 16 & Tuesday, May 17 2022

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# FOREIGN AFFILIATE DUMPING RULES

## SPEAKERS:

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## MODERATOR:

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## FAD Rules – Overview

- At a high level, the FAD rules (set out in section 212.3 of the Income Tax Act) may apply where a Canadian corporation controlled by a non-resident person (or non-arm's length group of non-resident persons) makes an investment in a foreign affiliate.
- Where the rules apply, the Canadian corporation may be deemed to pay a dividend to its non-resident parent, subject to dividend withholding tax. In certain circumstances, the paid-up capital of a cross-border class of shares may be reduced instead.

## FAD Rules – Overview

- The foreign affiliate dumping rules target two types of transactions (but apply much more broadly):
  - A. Debt dumping – Canadian corporation borrows funds to acquire shares of a foreign affiliate, deducting interest while relying on exempt surplus to offset dividend income from the foreign affiliate.
  - B. Surplus “stripping” – Canadian corporation buys shares of foreign affiliate from non-resident parent, allowing for transfer of cash to non-resident parent without dividend withholding tax.

## Conditions for Application - “CRICs” and “Subject Corporations” (212.3(1)(a))

- The FAD rules require an investment to be made:
  1. By a corporation resident in Canada, referred to as a “CRIC”;
  2. In a non-resident corporation (the “subject corporation”) that either immediately after the investment is, or as part of the transaction, event or series becomes, a “foreign affiliate” of:
    - a) The CRIC; or
    - b) A corporation that does not deal at arm’s length with the CRIC (the “other Canadian corporation”).
- A “foreign affiliate” of a Canadian resident is, in very general terms, a non-resident corporation in which the Canadian resident owns (directly or indirectly) at least 1% of the shares, and together with related persons, at least 10% of the shares (see 95(1)). Special rules apply where there are multiple classes of shares, so that generally only the highest percentage interest is considered.



## Conditions for Application – Non-Resident Parent/Group of Parents (212.3(1)(b))

- The CRIC or an other Canadian corporation must immediately after the investment be, or after the investment and as part of the transaction, event or series become, controlled by:
  - A. A non-resident person; or
  - B. A group of non-resident persons not dealing with each other at arm's length (the “parent” or “group of parents”).

## Conditions for Application – Non-Resident Parent/Group of Parents (212.3(1)(b))

- Before March 19, 2019, the FAD rules only applied where the CRIC or other Canadian corporation was controlled by a non-resident corporation. Budget 2019 expanded the rules to include non-resident individuals, trusts and non-arm's length groups.
  - Expands potential application of FAD rules in circumstances involving, e.g., owner-managers, estates with non-resident beneficiaries, private equity funds.



## Conditions for Application – Safe Harbour (212.3(1)(b)(i)-(iii))

- In order for the FAD rules to apply, one of the following conditions must generally be met:
  - A. At the time of the investment, the parent, together with persons not at arm's length with the parent and partnerships of which the parent or a person not at arm's length with the parent is a member, own shares of the CRIC and the other Canadian corporation (if applicable) that represent more than 25% of the votes or value (certain interpretative rules apply in making this determination);
  - B. The investment is an acquisition by a CRIC of preferred shares of a subject corporation (see 212.3(19)); or
  - C. Under an arrangement entered into in connection with the investment, a person or partnership other than the CRIC or a person related to the CRIC has a material risk of loss or opportunity for gain or profit in respect of a property that relates to the investment.

## Conditions for Application – Exceptions (212.3(1)(c))

- The FAD rules will not apply if either of the following exceptions is available:
  - A. 212.3(16) – More closely connected business activities
  - B. 212.3(18) – Corporate reorganizations

## Meaning of “Investment” (212.3(10))

- An investment for the purposes of the FAD rules generally means:
  - an acquisition of shares of the subject corporation by the CRIC;
  - a contribution of capital to the subject corporation by the CRIC, which is deemed to include a conferral of a benefit;
    - CRA Document No. 2014-0526691C6 – CRA expressed view that guarantee of debt for no fee may constitute a conferral of a benefit, and so an investment. Generally no benefit if fair market value consideration and it would be reasonable in the circumstances to conclude that a party dealing at arm's length would provide the guarantee on the same terms.

## Meaning of “Investment” (212.3(10))

- Meaning of investment (cont'd):
  - an indirect acquisition by the CRIC of shares of the subject corporation through the direct acquisition by the CRIC of shares of another Canadian resident corporation of which the subject corporation is a foreign affiliate, where the total fair market value of all the shares of foreign affiliates held (directly or indirectly) by the other corporation exceeds 75% of the other corporation's total fair market value.
    - As a result, the FAD rules can apply where a non-resident acquires a Canadian target using a Canadian acquisition company, if more than 75% of the fair market value of the target's assets is derived from foreign affiliate shares.

## Meaning of “Investment” (212.3(10))

- Meaning of investment (cont'd):
  - a transaction under which an amount becomes owing by the subject corporation to the CRIC, subject to certain exceptions, including for short-term loans arising in the ordinary course of business of the CRIC repaid within 180 days, other than as part of a series, and “pertinent loans or indebtedness” (“PLOIs”);
    - Where a PLOI election is made, the CRIC is deemed to earn interest income in respect of the PLOI at a prescribed rate (currently 4.38%), or if the CRIC (or a non-arm’s length Canadian resident person or certain partnerships) has incurred debt to fund the PLOI, the interest payable on that debt, where higher. Election must be made in respect of each amount owing.
      - Not all ordinary course debts may fit into these exceptions – e.g., certain cash pooling arrangements (CRA Document No. 2013-0483751C6).

## Meaning of “Investment” (212.3(10))

- Meaning of investment (cont’d):
  - an acquisition of a debt obligation of the subject corporation by the CRIC from any person, subject to exceptions for debt acquisitions in the ordinary course of business from arm’s length persons and PLOIs;
  - an extension of the maturity date of a debt obligation owing by the subject corporation to the CRIC, excluding a PLOI;
  - an extension of the redemption, acquisition, or cancellation date of shares of the subject corporation owned by the CRIC; and
  - an acquisition by the CRIC of an option, interest, or right in shares of, an amount owing by, or a debt obligation of, the subject corporation, subject to the same ordinary course of business and PLOI exceptions.

## Consequences – Deemed Dividend (212.3(2)(a))

- Where the FAD rules apply, the CRIC is generally deemed to have paid a dividend to the parent in an amount equal to the total fair market value (“FMV”) at the time of the investment of any property (other than shares of the CRIC) transferred, obligation assumed or incurred, or benefit conferred, by the CRIC, or of any property transferred to the CRIC that reduces an amount owing to the CRIC that can reasonably be considered to relate to the investment.
  - CRA Document No. 2015-0581641C6 - CRA considered whether a deemed re-acquisition of foreign affiliate shares as a result of a paragraph 111(4)(e) election would result in an application of the FAD rules. The CRA was of the view that this deemed re-acquisition would be an investment, but that the deemed dividend would be equal to nil because there would be no transfer of property (or other amount referred to in 212.3(2)(a)).
  - Valuation issues (e.g., earn-outs, contingent liabilities).



## Consequences – Deemed Dividend (212.3(2)(a))

- Where there is a group of parents, each parent is generally deemed to have received its proportionate share of the dividend amount, determined based on the FMV of the shares of the CRIC that are held (directly or indirectly) by the parent of the total FMV of all the shares of the CRIC that are held (directly or indirectly) by all parents.

## Consequences – PUC Reduction(212.3(2)(b))

- In computing the paid-up capital (“PUC”) in respect of any class of shares of the CRIC at any time at or after the investment, there is to be deducted the amount of any increase in the PUC in respect of that class (determined without reference to this reduction so as to avoid a circularity issue) that can reasonably be considered to relate to the investment.

## Dividend Substitution Election (212.3(3))

- Subsection 212.3(3) provides an elective rule that allows for all or a portion of a dividend that would otherwise be deemed to be paid by the CRIC to the parent/group of parents to instead be deemed to be paid by the CRIC or certain other “qualifying substitute corporations” to the parent or another non-resident person related to the parent.
- A “qualifying substitute corporation” is defined in subsection 212.3(4) to mean, in very general terms, an upstream Canadian resident corporation in the group that meets certain conditions.
- This dividend substitution election may allow for a reduction of the withholding taxes applicable to the deemed dividend (i.e., by accessing a more beneficial treaty rate).

## PUC Reduction (212.3(7))

- Subsection 212.3(7) may allow for the deemed dividend to be reduced or eliminated to the extent the shares of the CRIC or a qualifying substitute corporation have PUC.
- Typically, only the PUC of a “cross-border class” of shares may be reduced.
  - A “cross-border class” of shares is generally a class of shares of the CRIC or a qualifying substitute corporation in respect of which a parent or a non-resident person not at arm’s length with a parent owns at least one share, and no more than 30% of the shares of which are owned by Canadian resident persons not at arm’s length with a parent.

## PUC Reduction (212.3(7))

- PUC is reduced under subsection 212.3(7) as follows:
  - a) Where PUC of an arm's length class of shares of the CRIC or a qualifying substitute corporation arose as a consequence of a transfer of property to the CRIC that was used by the CRIC to make the investment, the deemed dividend may first be reduced to the extent of such PUC.
  - b) Any remaining deemed dividend (after taking into account the reduction in a)) may be reduced by the PUC of a “cross-border class” of shares in respect of the investment.
  - c) If the amount of the remaining deemed dividend is less than the PUC of all cross-border classes of shares in respect of the investment, PUC is used in order of class of shares of which a non-resident parent or other non-resident person not at arm's length with a parent own the greatest proportion.

## PUC Reduction (212.3(7))

- The CRIC must file certain information with the CRA in order for the PUC offset rules to apply by its Canadian tax return filing due date, failing which there will be a deemed dividend.
- The information may be filed late and a refund of withholding tax obtained in certain circumstances (227(6.2)).

## Exception - “More Closely Connected” (212.3(16))

- Subsection 212.3(16) provides an exception for certain strategic business investments.
- This exception may be available in certain circumstances where the business activities of the subject corporation (and its subsidiaries) are more “closely connected” to the Canadian business activities of the CRIC (or other Canadian members of the corporate group) than to the business activities of other non-resident group members.
- This exception may also apply in certain circumstances where the investment is more closely connected to a controlled foreign affiliate of the CRIC (for the purposes of section 17).



## Exception – “More Closely Connected” - CRA Document No. 2013-0474671E5

- **Facts:**

- Canco is a corporation resident in Canada which carries on an active business in Canada. Canco is controlled by Parent, a non-resident corporation.
- US Holdco is a corporation resident in the United States. US Holdco is a wholly-owned subsidiary and controlled foreign affiliate of Canco. US Holdco is a holding company and does not carry on any active business activities directly.
- US Opco is a corporation resident in the United States. US Opco is a wholly-owned subsidiary and controlled foreign affiliate of Canco. US Opco carries on active business activities in the United States that are, and are expected to remain, similar to Canco's business activities in Canada.
- Canco makes an investment in US Holdco.

## Exception – “More Closely Connected” - CRA Document No. 2013-0474671E5

- **Issue:** For purposes of the “more closely connected business activities” exception, is the subject corporation required to carry on active business activities itself?
- **CRA Response:**
  - To determine whether the investment of a particular CRIC in a particular subject corporation meets the more closely connected business activities exception, the business activities of the subject corporation (US Holdco) and all its subsidiaries (US Opco), on a collective basis, must be considered.
  - The simple holding of shares by a holding company (such as the holding of shares of US Opco by US Holdco) is not a business activity and would therefore be ignored for the purposes of this test. Accordingly, the collective business activities of US Holdco and US Opco would be comprised only of those activities carried on by US Opco.

## Exception - “More Closely Connected” (212.3(16))

- In order for the exception to be available:
  1. Officers of the CRIC (or a non-arm's length Canadian resident corporation) must have had and exercised the principal decision-making authority in respect of the making of the investment, and a majority of those officers must have been resident and working principally in Canada;
  2. It must reasonably be expected that such officers will have and exercise the ongoing principal decision-making authority in respect of the investment, and that a majority of those officers will continue to be resident and work principally in Canada; and

## Exception - “More Closely Connected” (212.3(16))

- In order for the exception to be available (cont'd):
  3. The performance evaluation and compensation of those officers resident and working principally in Canada must reasonably be expected to be based on the results of the operations of the subject corporation to a greater extent than officers of non-resident group members (other than the subject corporation or its subsidiaries).

## Exception - “More Closely Connected” (212.3(16))

- The onus is generally on the taxpayer, rather than the tax authorities, to demonstrate this exception applies with respect to the investment.
  - What is required to establish the “more closely connected” exception in practice?

## Exception - Corporate Reorganizations (212.3(18))

- Subsection 212.3(18) provides exceptions for acquisitions of shares or debt obligations in the course of certain internal reorganizations and distributions. These exceptions generally apply to internal group transactions in which no incremental value is invested. These exceptions include (in each case, where certain other conditions are met):
  - An acquisition of shares or debt of a subject corporation from a related Canadian resident corporation;
  - Related party amalgamations;
  - Certain rollover transactions;
  - An indirect acquisition of shares of a subject corporation that results from a direct acquisition of shares of a Canadian resident corporation from a related corporation;
  - Certain exchanges of debt for shares.

## Exception - Corporate Reorganizations (212.3(22))

- Subsection 212.3(22) provides that a CRIC will not be considered to make an investment in a subject corporation as a result of a vertical amalgamation or a wind-up (to which 87(11) or 88(1) applies, as applicable).



## PUC Reinstatement (212.3(9))

- Subsection 212.3(9) provides for the reinstatement of the PUC of a class of shares of the CRIC or of a qualifying substitute corporation (“QSC”) that was previously suppressed under paragraph 212.3(2)(b) or subsection 212.3(7) immediately prior to certain transactions that represent:
  - a) A distribution by the CRIC or QSC of its investment in a subject corporation,
  - b) Proceeds from the disposition of such an investment, or
  - c) The income received in respect of such an investment.

## PUC Reinstatement (212.3(9))

- The amount of a PUC reinstatement is always tracked to a particular class of shares of a corporation and to a particular investment.
- Continuity rules in subsections 212.3(9.1) and (9.2) may assist on certain exchanges of debt investments for shares, or where there is a reorganization of the capital of a Canadian resident corporation.
- Subsections 219.1 (3) and (4) may similarly provide for PUC reinstatement on emigration.

## PUC Reinstatement - CRA Document No. 2016-0643931R3

- **Facts:**

- Target is a corporation resident in Canada. Target's shares derive more than 75% of their value from two wholly-owned non-resident subsidiaries, Subco 1 and Subco 2.
- Parent, a corporation resident in Canada indirectly controlled by a non-resident, acquires all of the Target shares.
- The FAD rules apply and PUC is reduced.
- Target and Parent amalgamate to form Amalco. Amalco bumps the Subco shares, and continues out of Canada.

- **Issue:**

- Whether the PUC that has been reduced as a result of the FAD rules can be reinstated immediately prior to emigration?

- **CRA Response:**

- Subsection 219.1(4) would apply to reinstate the PUC, provided that subsection 212.3(9) has not applied, and that the fair market value of the Subco shares is not less than the reinstatement amount.

## PUC Reinstatement - Tracing

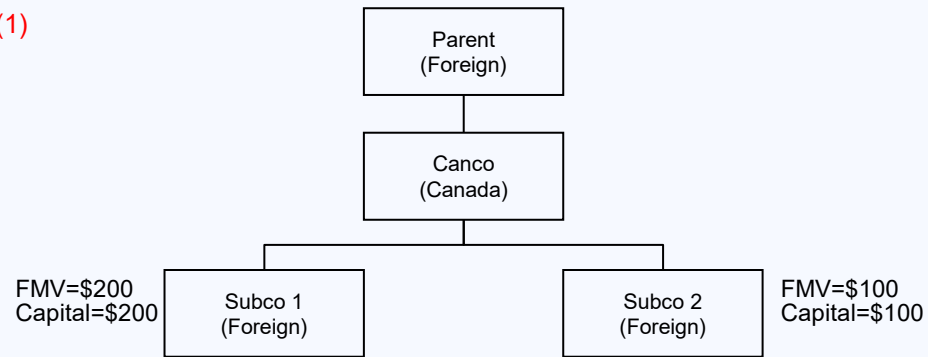
- Subsection 212.3(9) requires that there be a reduction of PUC in respect of the class referred to in subparagraph 212.3(9)(b)(i), or a receipt of certain property by the particular corporation referred to in the description of variable A in subparagraph 212.3(9)(b)(ii).
- Variable A in subparagraph 212.3(9)(b)(ii) describes three types of events, including, among other events, a reduction of PUC or dividend in respect of shares of the subject corporation, or the portion of a reduction of PUC or dividend in respect of shares of a foreign affiliate of the particular corporation that were substituted for shares of the subject corporation that can reasonably be considered to relate to the shares of the subject corporation.

## PUC Reinstatement - Tracing

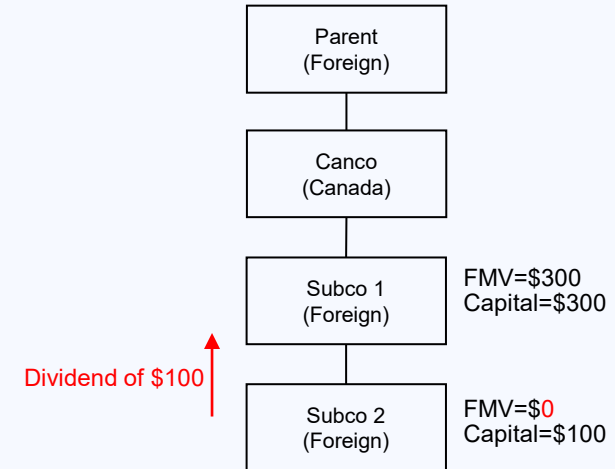
- **Issue:** If (i) the shares of the foreign affiliate that previously triggered the application of the FAD rules were transferred to another foreign affiliate by the CRIC in consideration for additional shares of the other foreign affiliate, (ii) the CRIC previously made capital contributions to the same class of shares of the other foreign affiliate, (iii) the other foreign affiliate only has one class of issued and outstanding shares, and (iv) the foreign affiliate made a dividend distribution to the other foreign affiliate who used the proceeds to make a return of capital to the CRIC, what would be the PUC reinstatement amount?

# PUC Reinstatement - Example

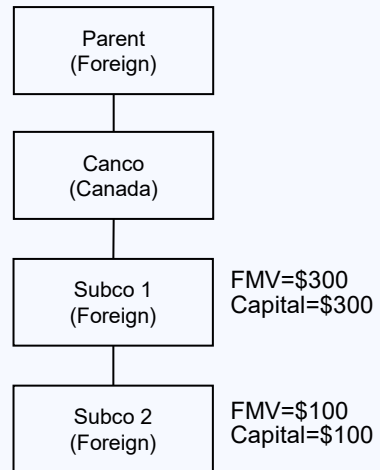
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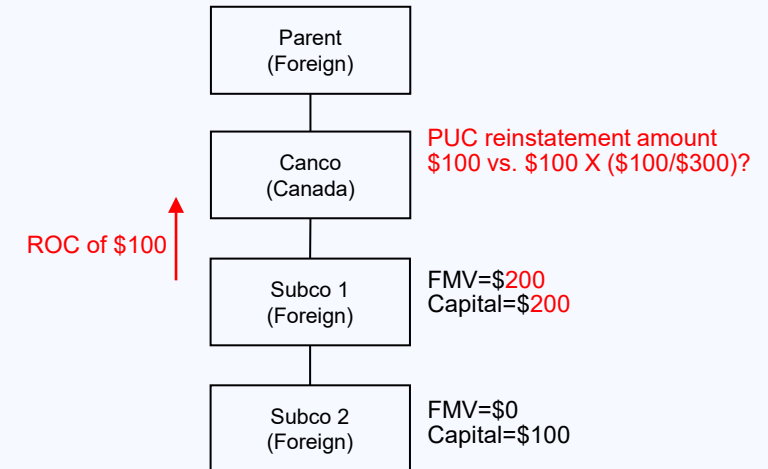
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(2)



(4)



# RECENT TRANSACTIONS

## SPEAKERS:

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**Derek Chiasson**, Norton Rose Fulbright Canada LLP,  
Montréal

**Ken Saddington**, Goodmans LLP, Toronto

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## YIN RAPPORTEUR:

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## MODERATOR:

**Alex Pankratz**, Baker McKenzie, Toronto





## TOPICS

1. Outbound Transactions
2. Inbound Transactions
3. Canopy/Acreage

## OUTBOUND TRANSACTIONS OUTLINE

1. Motivations / Benefits & Considerations
2. Recent outbound domestications
3. Maxar-type domestication transaction
4. Encana-type domestication transaction
5. Possible out-from-under steps
6. Inbound “F” reorganization vs. share-for-share with OFU

# 1. Motivations / Benefits & Considerations

## Recurring/common motivations and intended benefits

- Enhanced market position in the U.S. (including ability to win US government contracts)
- Perceived desirability of investing in US securities / enhance access to certain pools of capital
- Reflect growing relative importance of US presence versus Canadian
- Eliminating Canadian residency requirement for board of directors (e.g., 25% under the CBCA – note that not required under provincial corporate statutes in BC, AB, ON, QC, PEI, NS, NB)
- Mitigate certain Canadian tax inefficiencies (FAPI, FAD, etc.) or other US tax considerations (BEAT, PFIC, etc.)

# 1. Motivations / Benefits & Considerations (continued)

## Considerations in structuring a domestication

- Consider paid-up capital, loss carryforwards & surplus balances, status of shareholders, etc.
- Consider section 128.1 ITA departure tax and Part XIV emigration tax
- Consider impact of a “sandwich” structure and determine if an out-from-under is advisable
- Consider tax impacts in foreign jurisdiction (e.g., criteria for “F” reorganization in the US)

## 2. Recent outbound domestications

### ➤ Mood Media Corporation (2017):

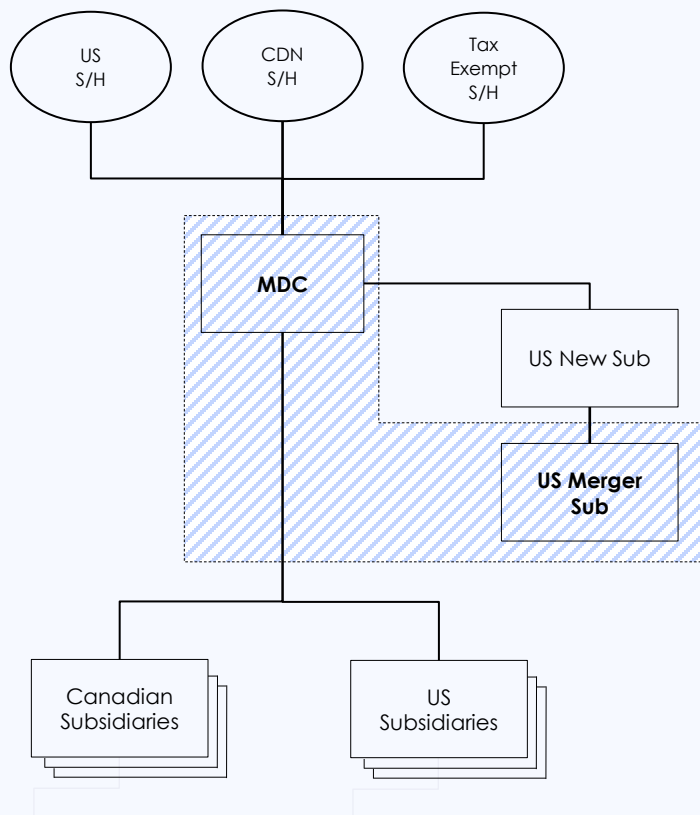
- A simple continuance under Delaware corporate law from the CBCA as the last step in an acquisition by way of plan of arrangement under the CBCA
- Context was a refinancing and buyout of the corporation further to a strategic review
- Corporation owned interest in various foreign affiliates, but no expression in the information circular that this was a key consideration
- All issued and outstanding shares are acquired, redeemed and cancelled for cash consideration – no deemed dividend expected as  $PUC \geq \text{cash consideration}$
- Intended to be a tax-deferred “F reorganization” for US tax purposes and that New Mood will be treated as a continuation of and successor to the company for US income tax purposes
- No discussion of section 128.1 ITA departure tax – absence of deemed dividend suggests that may not have been any latent gain on assets
- No discussion of Part XIV emigration tax – absence of deemed dividend suggests that  $FMV \text{ assets} \leq \text{applicable liabilities and PUC}$
- No “sandwich” created but is presumably a fully taxable transaction to the corporation

## 2. Recent outbound domestications (continued)

### ➤Kingsway Financial Services Inc. (2018):

- A simple continuance under Delaware corporate law from the OBCA
- No longer had material operations in Canada
- Intended to, *inter alia*, mitigate foreign accrual property income exposure as the group had US NOLs that were not FAPLs and to eliminate risk of becoming a passive foreign investment company (PFIC) for US tax purposes
- For Canadian shareholders, no disposition on the continuance
- For US shareholders (other than for shareholders holding  $\geq 10\%$  or whose shares have a FMV  $\geq$  US\$50,000) intended to be a tax-deferred “F reorganization” for US tax purposes – we understand that viewed as an acquisition by a US corporation of all assets of the Canadian corporation in consideration for shares of the US corporation and distribution of those shares to shareholders through a liquidation of the Canadian corporation
- No 128.1 departure tax as no latent gain on assets
- No Part XIV emigration tax as FMV assets  $\leq$  applicable liabilities and PUC
- No “sandwich” created, but is a fully taxable transaction to the corporation

## 2. Recent outbound domestications (continued)



### ➤ MDC Partners Inc. (2021):

- Continuance of MDC under Delaware corporate law from the CBCA, followed by a triangular merger with a new Delaware subsidiary, followed by MergeCo being converted to an LLC
- Occurred in the context of a transaction with the Stagwell group (but had previously been proposed as a standalone domestication) – but note that shareholders of MDC Partners not being bought out
- Substantial presence of operating business in U.S., as compared with diminishing importance of presence in Canada which represented only 7.4% of revenue in 2019
- Access new capital pools potentially restricted to investments in US corporations (e.g., certain US pension funds)
- Eliminating 25% Canadian residency requirement for BOD
- For Canadian shareholders, no disposition on continuance and tax deferred rollover pursuant to subsection 87(8) on the subsequent merger
- Approx \$21M of Canadian capital gains tax triggered, presumably as a result of the section 128.1 departure tax
- Unclear whether any Part XIV tax (i.e. if FMV assets  $\leq$  applicable liabilities and PUC)
- Tax benefit from elimination of U.S. Base Erosion and Avoidance Tax (BEAT) related to intercompany interest payments by US subsidiaries
- Additional tax expense for U.S. Global Intangible Low-Taxed Income (GILTI) which the company was not previously subject to as a Canadian corporation
- No “sandwich” created, but is a fully taxable transaction for the corporation

## 2. Recent outbound domestications (continued)

### ➤ Zomedica (2020):

- Continuance under Delaware corporate law from the ABCA
- Intended to reduce regulatory burden and compliance costs
- Enhance marketability of its shares
- Failed to receive sufficient support from shareholders

### ➤ Akumin Inc. (2022):

- Proposed domestication by way of continuance under Delaware corporate law from the OBCA
- Reduce operating expenses and transactional inefficiencies that currently result from being subject to Canadian corporate laws despite having no operations in Canada
- US tax consideration: status as a passive foreign investment company (PFIC)



### 3. Maxar-type domestication transaction

#### ➤ Maxar (2019):

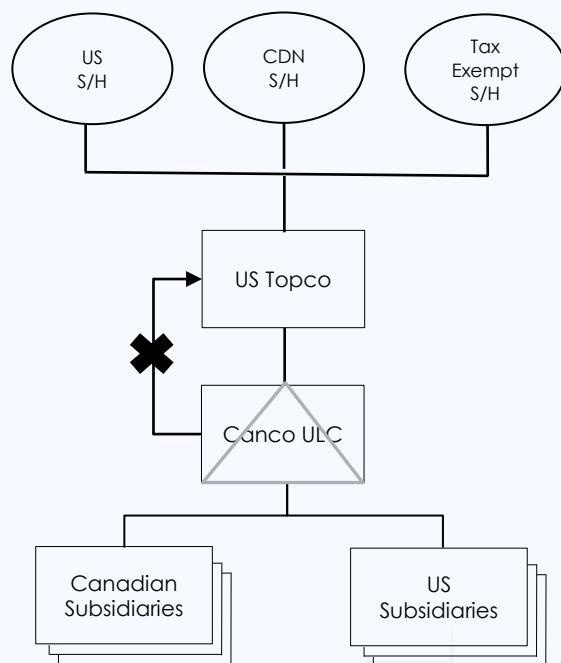
- On October 9, 2018, Maxar announced that it would be advancing a proposed domestication into the US by way of a plan of arrangement whereby the ultimate parent corporation of Maxar Technologies Ltd. (“Maxar Canada”) would become an entity incorporated under the laws of the state of Delaware.
- Two possible plan of arrangements were contemplated to implement the transaction:
  - Plan A: Shareholders of Maxar Canada would transfer their shares of Maxar Canada to a Canadian acquisition vehicle in exchange for shares of a new US corporation (“US Topco”); or
  - Plan B: Shareholders of Maxar Canada would transfer their shares of Maxar Canada directly to US Topco in exchange for shares of US Topco.
- US Topco would become the new publicly listed entity on the NYSE (with Maxar Canada’s shares being delisted from the TSX).

### 3. Maxar-type domestication transaction (continued)

- Choice between Plan A and Plan B was presumably dependent on the valuation of the shares of Maxar Canada.
- A Canadian acquisition vehicle is usually relevant to maximize paid-up capital, unless historical paid-up capital is higher than the FMV of the shares of the Canadian target.
- Maxar had been pursuing a “US Access Plan” for some time, which was aimed at driving incremental growth through the pursuit of US governmental space programs. Maxar’s ability to win new US government contracts to provide space systems, imagery and services under classified space and defense programs at various US agencies was viewed as enhanced by the US domestication.
- Enhanced market position: Greater exposure to US and international institutional investors and analysts.
- Per the management circular, the disposition of the shares of Maxar Canada was expected to be taxable for Canadian shareholders of Maxar Canada, while most US holders that owned Maxar Canada shares with a FMV of \$50,000 or more were expected to recognize a gain (if any), but not a loss, for US federal income tax purposes.

# 3. Maxar-type domestication transaction

## Plan A - Inbound “F” Reorganization

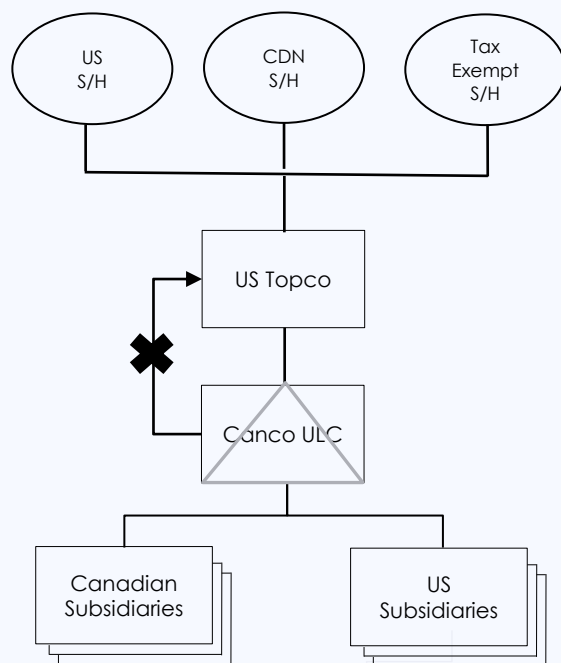


### Main (High-Level) Steps

1. A new US “C” corporation is formed (“US Topco”) by Canco;
2. US Topco forms a new Canadian ULC (“Bidco”);
3. Bidco acquires the shares of the Canadian target (“Canco”) and public shareholders receive shares of US Topco in consideration;
  - In consideration for the issuance of shares by US Topco to the public, Bidco simultaneously issues an equivalent number of shares to US Topco.
4. US Topco redeems its shares held by Canco for a nominal amount;
5. Canco elects not to be a public corporation for Canadian income tax purposes; and
6. Bidco and Canco are amalgamated as an unlimited liability company.
  - Canco may have to be continued to the jurisdiction of incorporation of Bidco prior to such step.

### 3. Maxar-type domestication transaction

#### Plan B - Inbound “F” Reorganization



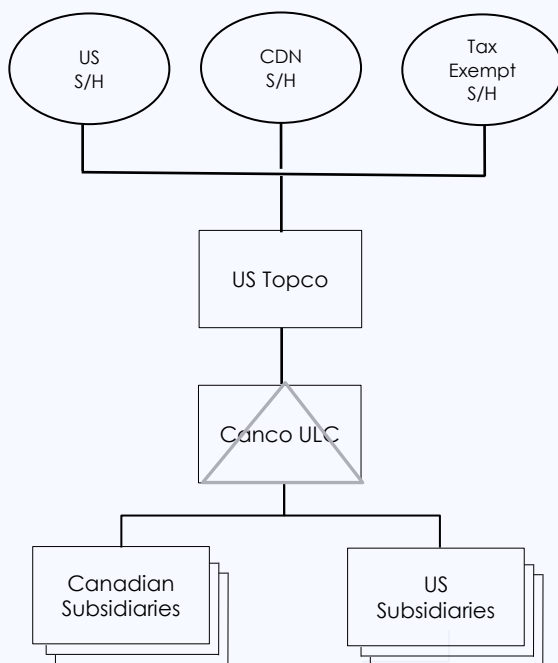
#### Main (High-Level) Steps

1. A new U.S. “C” corporation is formed (“US Topco”) by Canco;
2. US Topco acquires the shares of Canco and shareholders of Canco receive shares of US Topco as consideration;
3. US Topco redeems its share held by Canco for a nominal amount;
4. Canco elects not to be a public corporation for Canadian income tax purposes.
5. US Topco transfers shares of Bidco to Canco and Bidco and Canco are amalgamated as a ULC

➤ Key difference with the Plan A is that the acquisition of the shares of Canco is made directly by US Topco (i.e., without Bidco).

### 3. Maxar-type domestication transaction

#### Inbound “F” Reorganization



#### ➤ Selected tax considerations:

- Taxable disposition of shares of Canco by its Canadian shareholders;
- US holders who own Canco shares with a FMV of \$50,000 or more may generally incur a gain for US federal income tax purposes;
- Additional tax on dividends received by Canadian shareholders;
- Additional withholding tax cost for Canadian shareholders;
- Canco may be included in the US consolidated group;
- Future upside in US subsidiaries subject to Canadian tax;
- Future internal financing of subsidiaries will be more difficult.

## 4. Encana-type domestication transaction

### ➤ Encana (2020):

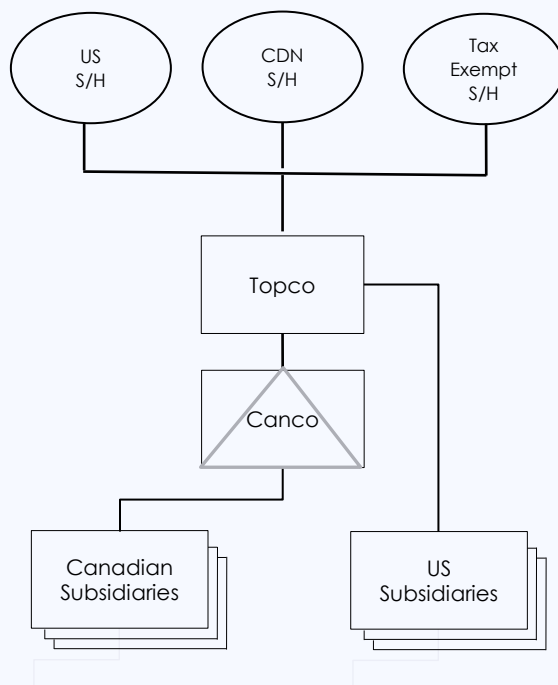
- Share exchange where all shares of Encana were exchanged for shares of Ovintiv (a new Canadian parent), the former Encana becoming an unlimited liability company, shares and interco debt of Alenco Inc. (a US subsidiary of Encana) being distributed to Ovintiv in consideration for assumption of debt by Ovintiv and repurchase of certain Encana shares held by Ovintiv and then Ovintiv was continued under Delaware corporate law from the CBCA
- Valuation perceived as discounted as compared with U.S. peers due, in part, to inability to access certain pools of capital in the U.S.
- Strong connection to the U.S. (employees, shareholders, capital investments)
- For Canadian shareholders, structured as a share exchange – (i) if shares traded above \$6.30, shares exchanged for Ovintiv shares and a note in a nominal amount (to break 85.1 rollover), with possibility of shareholders to elect under section 85, (ii) if shares traded for \$6.30 or less, section 85.1 share for share (we assume that PUC must have been around \$6.30, such that did not want 85.1 to apply if FMV was above \$6.30, to generally achieve ACB for Ovintiv at least equal to \$6.30 unless FMV was below that)

## 4. Encana-type domestication transaction (continued)

- For US shareholders (other than if holding  $\geq 10\%$  or shares having a FMV  $\geq \text{US}\$50,000$ ), intended to be a tax-deferred “F reorganization” for US tax purposes – we understand that Ovintiv viewed as a continuation of Encana, with Encana considered to have been liquidated as a result of the conversion to a ULC
- The management circular indicates that they did not expect any material departure tax or emigration tax, but does point out that, if many holders elect under section 85, it is possible that the ACB of the Encana shares to Ovintiv and the aggregate PUC and relevant liabilities of Ovintiv may be less than the aggregate FMV of its assets, which could result in a material tax liability to Ovintiv
- Regarding section 128.1 ITA departure tax, assuming PUC was approx. \$6.30 and given trading price which appears to have been approx. \$4.90 at the time of the transaction, it may well be that there was little or no latent gain on the assets.
- Regarding Part XIV emigration tax – if PUC was approx. \$6.30 and given trading price which appears to have been approx. \$4.90 at the time of the transaction, it suggests that FMV assets  $\leq$  applicable liabilities and PUC
- Unclear whether Alenco represented the entirety of the non-Canadian group, but, at least as regards Alenco, there was no “sandwich” structure created, but the distribution of Alenco would have been a fully taxable transaction for the corporation

## 4. Encana-type domestication transaction

### Continuance



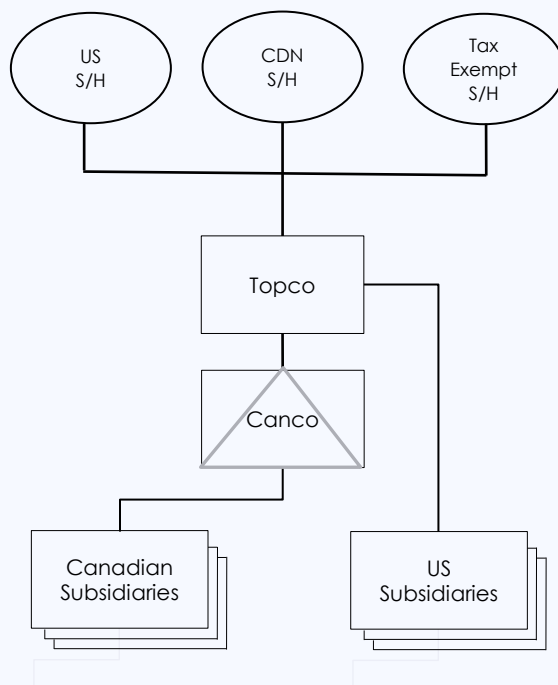
### Main (High-Level) Steps

1. Canco incorporates a new corporation in Canada ("Topco");
2. Shareholders of Canco exchange their shares of Canco for shares of Topco;
3. Canco is continued into a new Canadian jurisdiction (e.g., British Columbia) to become an unlimited liability company;
4. Some or all foreign subsidiaries are distributed by Canco to Topco;
5. Continuance of Topco from its Canadian jurisdiction to Delaware.



## 4. Encana-type domestication transaction

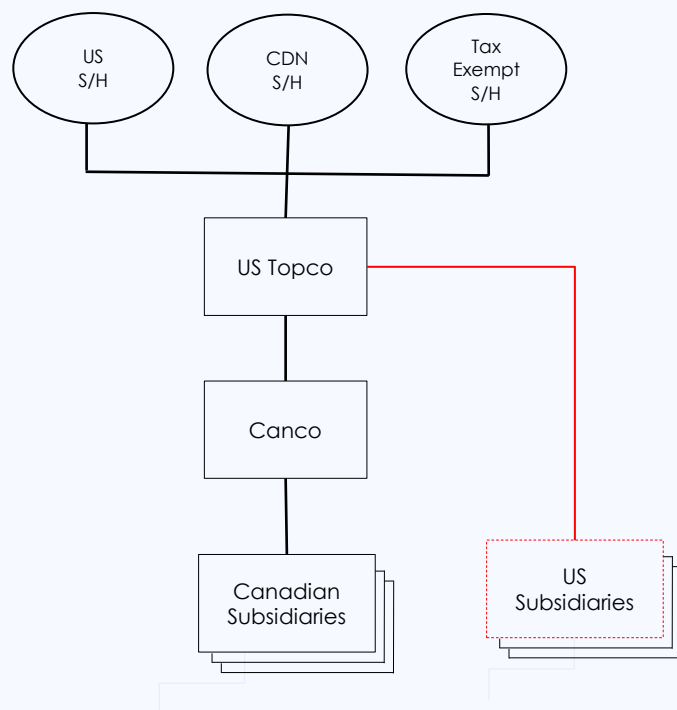
### Continuance (cont'd)



#### ➤ Selected tax considerations:

- Possible rollover for Canadian shareholders on share exchange;
- Non-resident shareholders: consider if Canco shares are taxable Canadian properties;
- Distribution of foreign subsidiaries by Canco – possible realization of capital gains on them;
- Part XIV emigration tax (consider if FMV assets  $\leq$  applicable liabilities and PUC); and
- Departure tax – possible realization of capital gains on Topco's assets.

## 5. Possible out-from-under steps

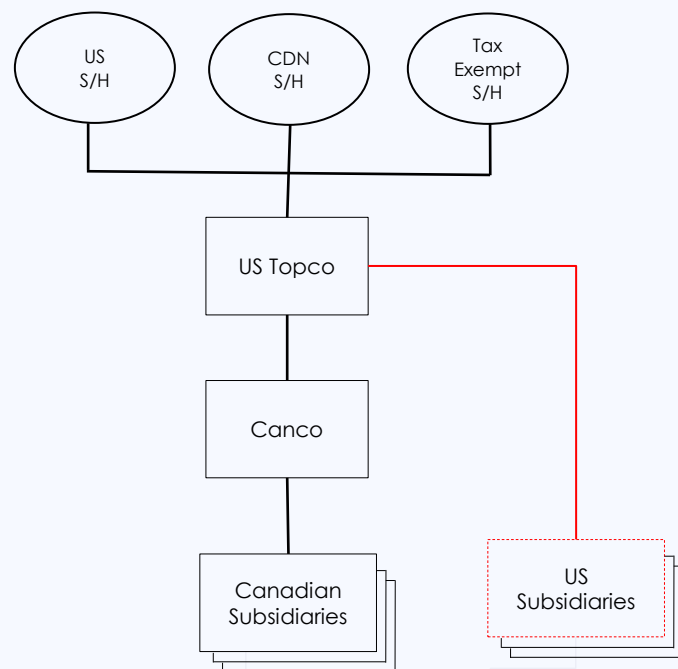


- There are many ways to implement an out-from-under (e.g., sale, return of capital, dividend in-kind, etc.)

*Possible out-from-under steps:*

1. Canco sells the shares of the US Subsidiaries to US Topco in consideration for the issuance of a note by US Topco ("Note 1");
2. Canco subsequently makes a return of PUC satisfied by the issuance of a note ("Note 2"); and
3. Note 2 is offset with Note 1.

## 5. Possible out-from-under steps (cont'd)

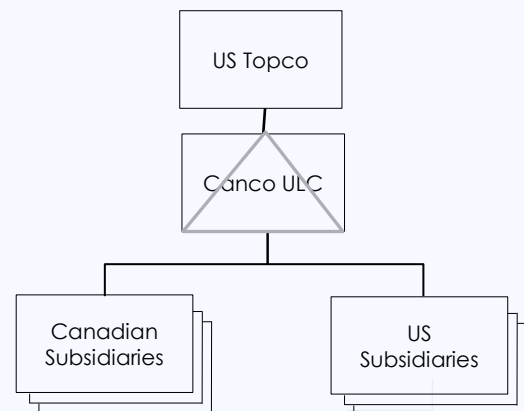


### *Out-from-under*

#### ➤ Selected tax considerations:

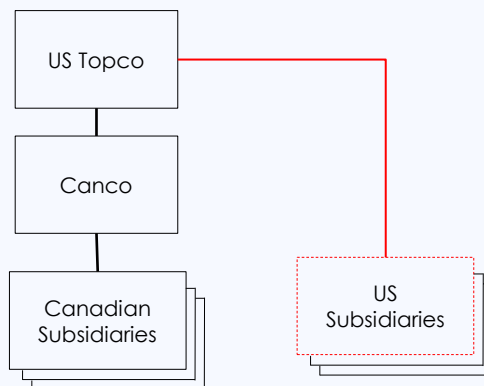
- Would result in a disposition of the transferred shares of the US Subsidiaries (a gain may be realized). Consider loss carry-forwards and surplus balances available;
- Consider whether out-from-under should be implemented by way of sale of shares or return of capital. Consider available PUC;
- Requires valuation of the US Subsidiaries to compute potential gain and value of distribution, as the case may be;
- Is helpful to address inefficiencies of “sandwich” structure (FAD, double layers of withholding tax, etc.).

## 6. Inbound “F” Reorganization vs Share-for-share with OFU



### *Inbound F Reorganization:*

- No need for immediate valuation; out-from-under (“OFU”) is accomplished for US tax purposes with no associated US tax cost.
- Future Canada tax liability attributable to built in gain on US subsidiaries will accrue and could become significant and have adverse consequences (inability to restructure, impact value in case of potential acquisitions, etc.).
- Possibility to implement OFU for Canadian tax purposes only.
- Flow of US profits need to go through Canco, using planning of PUC reduction to avoid withholding taxes – risk of future withholding tax (i.e., PUC reduced to nil) to be assessed.
- Structure involves hybrid entity.
- Application of the FAD rules, if not OFU.
- Need to manage U.S. dual consolidated loss rules with regard to Canco.
- Less clarity on reposition of external debt.



### *Share-for-Share Exchange with OFU:*

- Need to perform valuation of US entities.
- Potential material US and Canadian tax costs attributable to OFU transaction.
- Future increase in value of the US group accrues only in the US.
- Clear pipeline for repatriation of US profits to public shareholders.
- Likely easier to reposition external debt.
- Clarity of non-taxation of share-for-share transaction to US shareholders.
- Possibility of double-dip (Canadian needs for financing) needs further thinking.

## Concluding thoughts on Outbound Transactions

## INBOUND TRANSACTIONS OUTLINE

1. Contact Gold
2. U.S. Inversion

## Contact Gold Repatriation Transaction

- Contact Gold was a Nevada corporation with common shares listed on the TSXV
- Contact Gold redomiciled back to Canada by way of:
  - Plan of conversion under Nevada law
  - Immediately thereafter, amalgamation by way of a plan of arrangement under British Columbia law
- Rationale
  - Reduced regulatory compliance costs
  - Enhanced ability to access capital markets and increase number of investors

## Contact Gold – Plan of Conversion

- Plan of conversion made, and articles of conversion filed, under Nevada law and continuation application filed in British Columbia
- To convert Contact Gold from a Nevada corporation to a British Columbia corporation (Contact Gold (BC))
  - Shares and other securities of Contact Gold converted to shares and other securities of Contact Gold (BC)



## Contact Gold – Plan of Arrangement Steps

- Not to be effected until certificate on continuation for Contact Gold (BC) issued
- Shares of Contact Gold deemed to be converted into post-continuation shares
- Other securities deemed to be converted into post-arrangement securities
- Contact Gold (BC) and a wholly-owned British Columbia subsidiary merged (with the same effect as if they had amalgamated under section 269 of the *Business Corporations Act* (British Columbia)), with Contact Gold (BC) surviving the merger

## Contact Gold – Canadian Tax Considerations of Continuation

- Corporate level:
  - Deemed to be incorporated in Canada and resident of Canada
  - Deemed disposition and reacquisition of property at fair market value
  - Silent on other implications
- Shareholder level:
  - Residents – no change in adjusted cost base of shares
  - Non-Residents – step-up in adjusted cost base of shares to fair market value at time of continuation
  - Potential for deemed dividend if Contact Gold (BC) eligible for and makes election under paragraph 128.1(2)(b) of the Tax Act

## Contact Gold – Canadian Tax Considerations of Amalgamation

- Corporate level:
  - Silent on implications, but assume rollover based on favourable CRA rulings that parent-subsidiary amalgamations with a survivor qualify as an “amalgamation” for purposes of subsection 87(1) of the Tax Act
    - CRA document nos. 2006-0178571R3, 2010-0355941R3 and 2016-0643931R3
- Shareholder level:
  - Residents – rollover
  - Non-Residents – adjusted cost base of shares equal to fair market value at time of continuation

## Contact Gold – US and Go-Forward Tax Considerations

- Corporate level:
  - Contact Gold (BC) pre and post-merger expected to be a US domestic corporation and subject to US tax on its worldwide income
  - Foreign tax credit considerations going forward
- Shareholder level:
  - Continuation and amalgamation expected to be tax-deferred / non-event for US tax purposes, although non-residents subject to FIRPTA considerations
  - Foreign tax credit considerations going forward

## Other Types of Transactions

- Cross-border amalgamations
- Share for share exchanges with new Canadian parent

## US Inversion

- Domestication of a US corporation can give rise to an “inversion” for US tax purposes
  - Can arise in other contexts, like RTOs and significant US acquisitions
- Code section 7874(b) treats certain “inverted” corporations as domestic corporations for US tax purposes
  - Subject to US tax on worldwide (including non-US) income
  - Payments to non-US persons subject to US withholding tax
- Becoming more common to see transactions involving inverted corporations

## US Inversion

A Canadian corporation that engages in a transaction meeting the following three tests is treated as a US domestic corporation:

- Acquisition of substantially all the assets of a US corporation (including indirectly through the acquisition of shares of the US corporation)
- By reason of the acquisition, former owners of the US corporation hold 80% (by vote or value) of the Canadian corporation
- The Canadian corporation's group does not have “substantial business activities” in Canada
  - 25% of employees by headcount & compensation;
  - 25% of assets (excluding intangibles); and
  - 25% of income

## Inversion Considerations

- Payments made by an inverted Canadian corporation can be subject to Canadian and US withholding tax
- Foreign tax credit issues
  - Generally only entitled to a FTC to the extent of Canadian tax otherwise payable on US-source income
  - Payment may not give rise to US-source income
  - No FTC in the absence of other US-source income not bearing full tax
  - Similarly, no US-source income for a treaty-based credit
  - 20(12) deduction may be available
- Similar FTC issues in the US with respect to Canadian withholding tax



## Inversion Considerations

- Corporate-level tax consequences may be manageable – inverted corporation is often a holding entity
- Additional Canadian tax considerations may arise on any acquisition of an inverted Canadian target
  - Any structuring requires consideration of Canadian and US rules
  - Potential for additional structural tax if a Canadian buyer acquires an inverted target

## Inversion Considerations

- From a Canadian perspective, it may be possible to remove inverted entities from the structure after the acquisition if a bump is available
  - May place limitations on consideration that can be given for target
  - US tax implications need to be considered

# CANOPY/ACREAGE

## Canopy Acquisition of Acreage

- Canopy Growth Corporation and Acreage Holdings, Inc. entered into amended Arrangement Agreement under which Canopy would acquire majority of Acreage when US federal law changes to permit the general cultivation, distribution and possession of marijuana
- Acreage is inverted
- Canopy also has option to acquire the remainder of Acreage

## Canopy/Acreage – Arrangement Steps

- Canopy pays US\$37.5 million to existing Acreage shareholders
- Acreage undertakes a capital reorganization, such that each Acreage share is exchanged for (i) 0.7 “Fixed Shares” and (ii) 0.3 “Floating Shares”
  - Terms of Fixed Shares and Floating Shares include an embedded call right in favour of Canopy, but otherwise have *pari passu* common share terms

## Canopy/Acreage – Arrangement Steps

Options give Canopy:

- The right to acquire each Fixed Share for 0.3048 of a Canopy common share (deemed to be exercised if US federal law changes)
- The right (but not the obligation) to acquire all of the Floating Shares for cash, Canopy common shares, or a mix
  - Cash consideration per Fixed Share equal to 30-day VWA trading price of Floating Shares, subject to a US\$6.41 minimum
  - Canopy share consideration per Fixed Share equal to cash consideration divided by 30-day VWA trading price of Canopy common shares

## Canopy/Acreage - Tax Considerations

- US\$37.5 million payment to Acreage shareholders treated as a payment for granting Canopy the call option and governed by section 49
  - Amount must be reasonably allocated between call over Fixed Shares and call over Floating Shares
- Shareholders deemed to have disposed of property with adjusted cost base of nil for an amount equal to the amount received
- If relevant call option is exercised, subsection 49(1) treatment unwound and the payment is included in the shareholder's proceeds of disposition of the Fixed Shares or Floating Shares, as applicable
  - If exercised in a subsequent year, taxpayer entitled to refile tax return, and CRA obliged to reassess tax in order to exclude the subsection 49(1) consequences

## Canopy/Acreage - Tax Considerations

Acquisition of Fixed Shares and, if applicable, Floating Shares, effected as follows:

- All Fixed Shares held by Non-US Shareholders are transferred to Canopy for Canopy common shares
- If Canopy exercises its right to acquire the Floating Shares, all of the Floating Shares are transferred to Canopy for Canopy common shares and/or cash
- A subsidiary of Canopy merges (the “Merger”) with *and into* Acreage, such that Acreage survives. On the Merger:
  - Fixed Shares held by US Shareholders are transferred to Canopy for Canopy shares
  - Fixed Shares held by Canopy are exchanged for Mergeco shares
  - Floating Shares are exchanged for Mergeco shares
  - Mergeco issues Mergeco shares to Canopy in consideration for Canopy issuing its shares to US Shareholders



## Canopy/Acreage - Tax Considerations

- Plan of Arrangement provides that the Merger is intended to qualify as an amalgamation for purposes of subsection 87(9) of the Tax Act
  - CRA has ruled that amalgamations with a survivor qualify as an amalgamation for purposes of subsection 87(1) of the Tax Act
  - The transaction should not be taxable in Canada at the corporate level
- Merger construct potentially allows for US reorganization treatment
- If Acreage doesn't survive, amalgamation potentially taxable in US at Acreage level

## Canopy/Acreage - Tax Considerations

- Canadians do not exchange Fixed Shares on the Merger – exchanged directly with Canopy for Canopy Shares. Shareholders entitled to file section 85 elections
  - The shareholder's portion of the US\$37.5 million payment allocated to the Fixed Shares considered boot under section 49
  - Subsection 87(4) and section 85.1 not available
- If Floating Shares aren't acquired, Canadians who acquire Mergeco shares on the Merger should not realize tax

# THANK YOU!

# CROSS-BORDER TOPICS OF INTEREST

## SPEAKERS:

**Carrie Aiken**, Blake, Cassels & Graydon LLP, Calgary

**Christopher Anderson**, Davies Ward Phillips & Vineberg LLP, Toronto

**Nik Diksic**, EY Law LLP, Montréal

**Francesco Gucciardo**, Aird & Berlis LLP, Toronto

## YIN RAPPORTEUR:

**Samantha D'Andrea**, EY Law LLP, Montréal

## MODERATOR:

**Laura Gheorghiu**, Gowling WLG (Canada) LLP, Montréal



# FOREIGN AFFILIATE DUMPING RULES IN M&A

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# Foreign Affiliate Dumping Rules in M&A

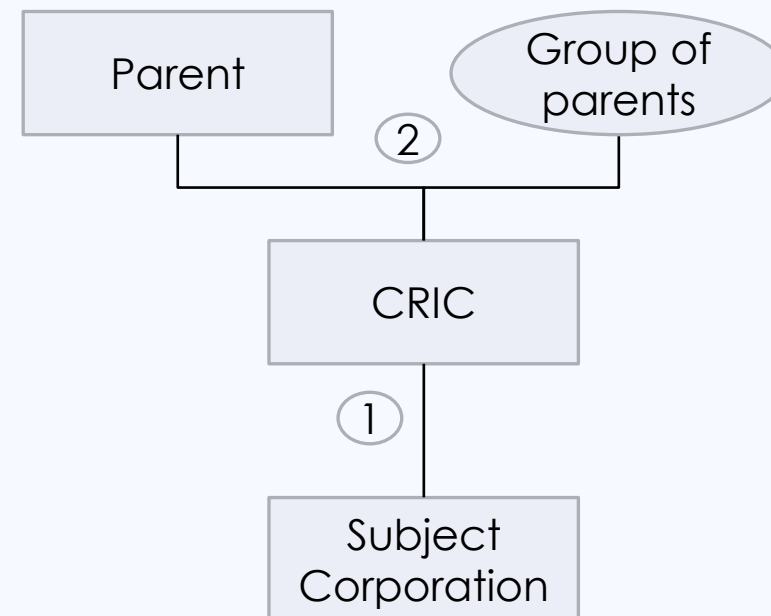
Relevance of the concept of “series of transactions or events ” in the FAD rules

- Common law series
- 248(10)
- *Copthorne v. The Queen* (2012 DTC 5007)
- *Agence du revenu du Québec v. Custeau* (2020 QCCA 1496)

## 212.3(1) – triggering events

### 212.3(1)(a) ①

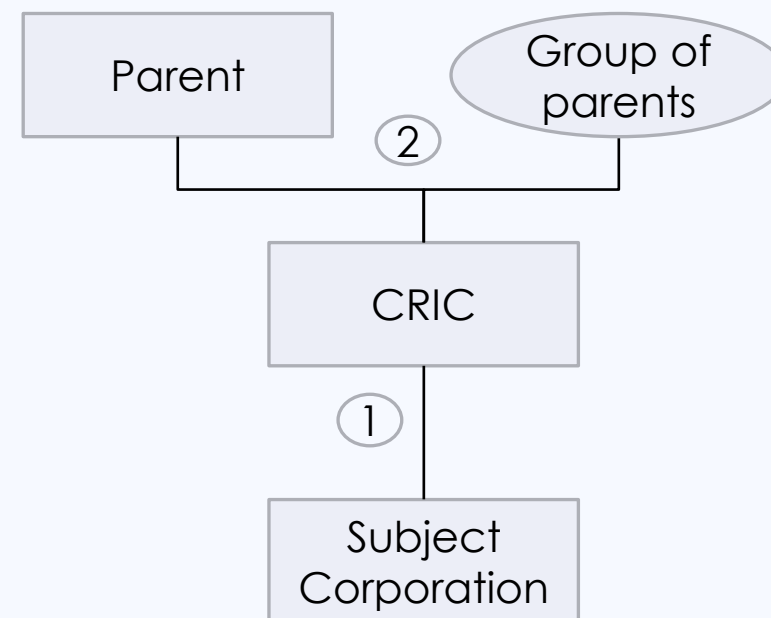
- Investment by a CRIC in a subject corporation that is, or becomes as part of a transaction or event or series of transactions or events that includes the making of the investment, a foreign affiliate of the CRIC or a corporation that does not deal at arm's length with the CRIC (an “other Canadian corporation”)



## 212.3(1) – triggering events

### 212.3(1)(b) ②

- The CRIC or an other Canadian corporation is immediately after the investment time, or becomes after the investment time and as part of a transaction or event or series of transactions or events that includes the making of the investment, controlled by a single non-resident person (“parent”) or a group of non-resident persons not dealing with each other at arm’s length (“group of parents”)





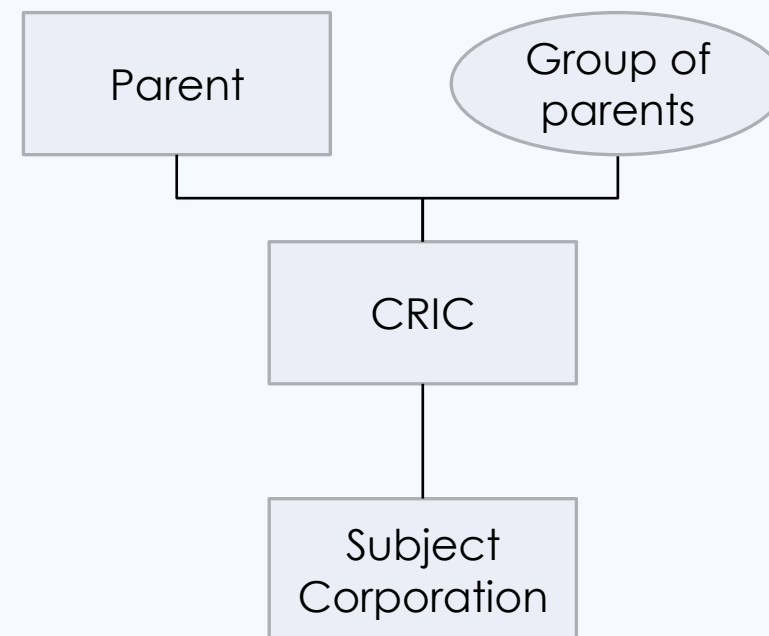
## 212.3(1) – triggering events

### 212.3(1)(b)(i)

- Ownership requirement at the investment time (based on assumed exercise of 251(5)(b) rights)
- When does Parent have a 251(5)(b) right?
- Is that the beginning of the series?
- Can the series begin earlier?

### 212.3(1)(b)(ii)

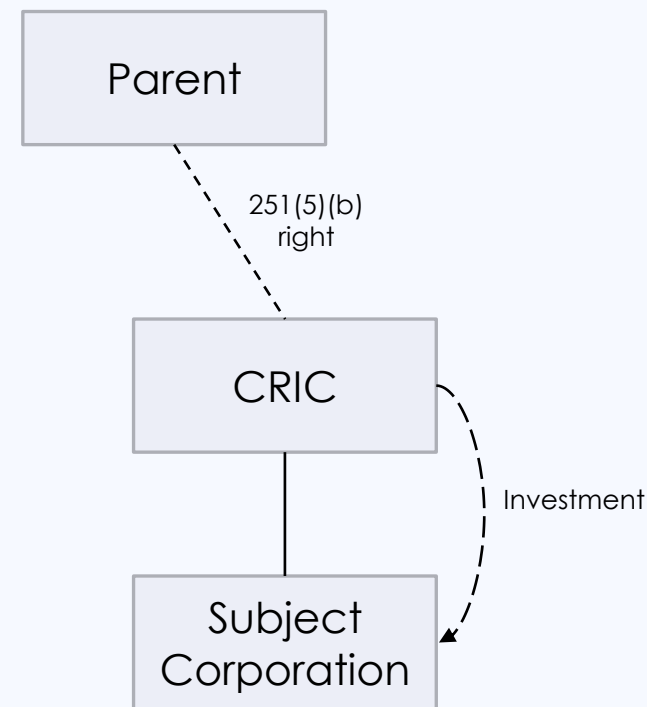
- No investment time ownership requirement for investment that is subject to 212.3(19)



## 212.3(16) – applicability to pre-closing transactions

### 212.3(16)

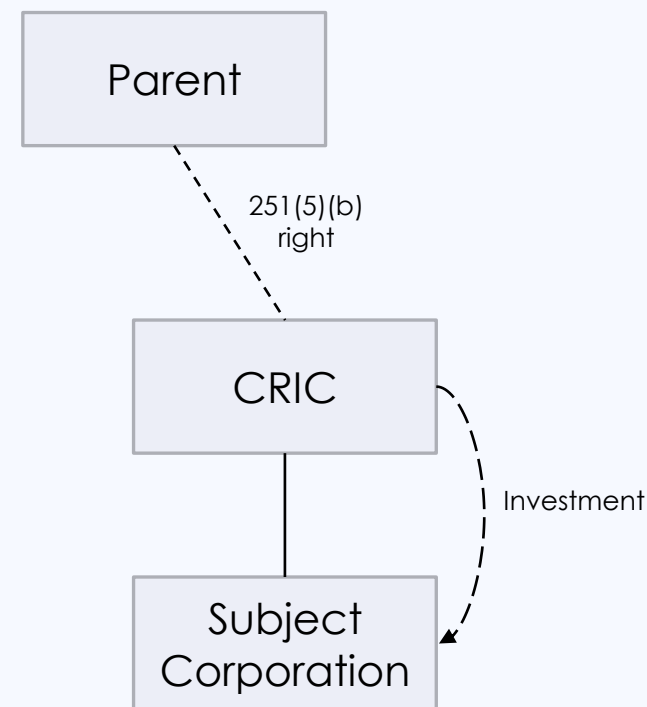
- (a) – more closely connected test
- (b) – principle decision making authority test
- (c) – ongoing principal decision making authority and performance evaluation/compensation test



## 212.3(16) – applicability to pre-closing transactions

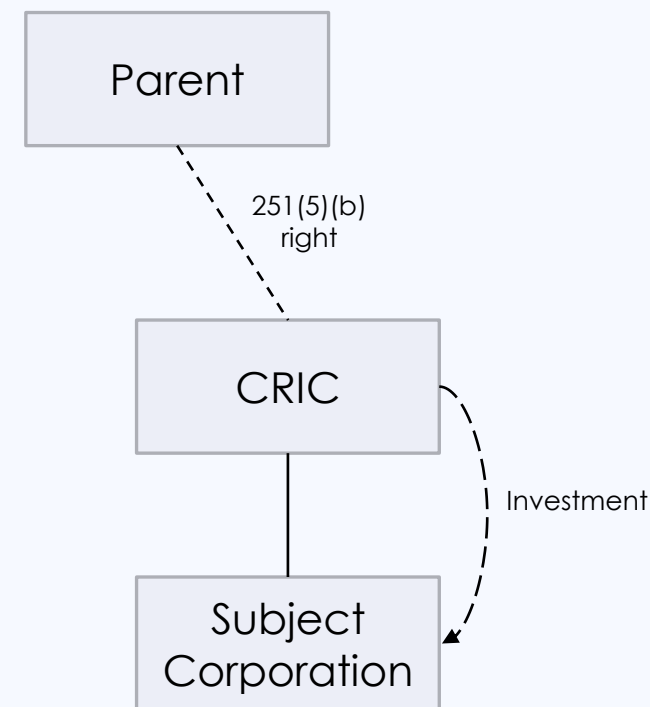
Pre-closing transactions entered into by CRIC at the request of the Parent

- “More closely connected test” – 251(5)(b) right expands the related non-resident group at the investment time
- Who has “principal decision making authority”?



## 212.3(16) – applicability to pre-closing transactions

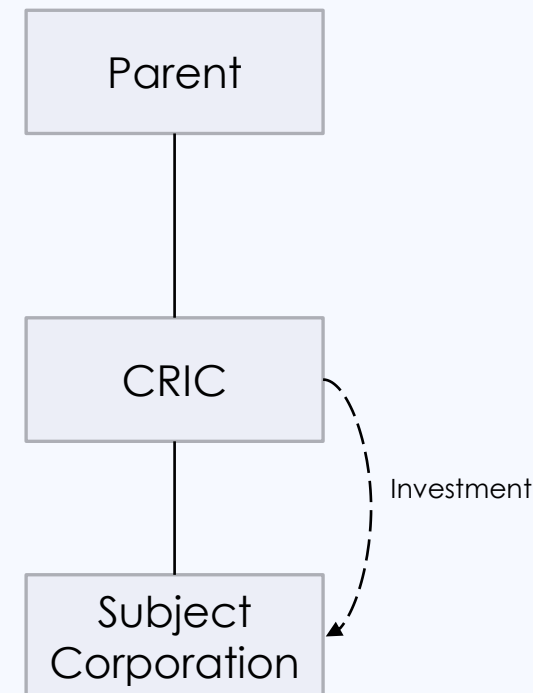
- Is it “reasonable to expect” that officers of the CRIC will have ongoing principal decision making authority in respect of the investment?
- Is it “reasonable to expect” that the performance evaluation and compensation of the officers of the CRIC will be based on the results of the subject corporation “to a greater extent” than will be the performance evaluation and compensation of “any” officer of a non-resident corporation that does not deal at arm’s length with the CRIC?



## 212.3(16) – applicability to post-closing transactions

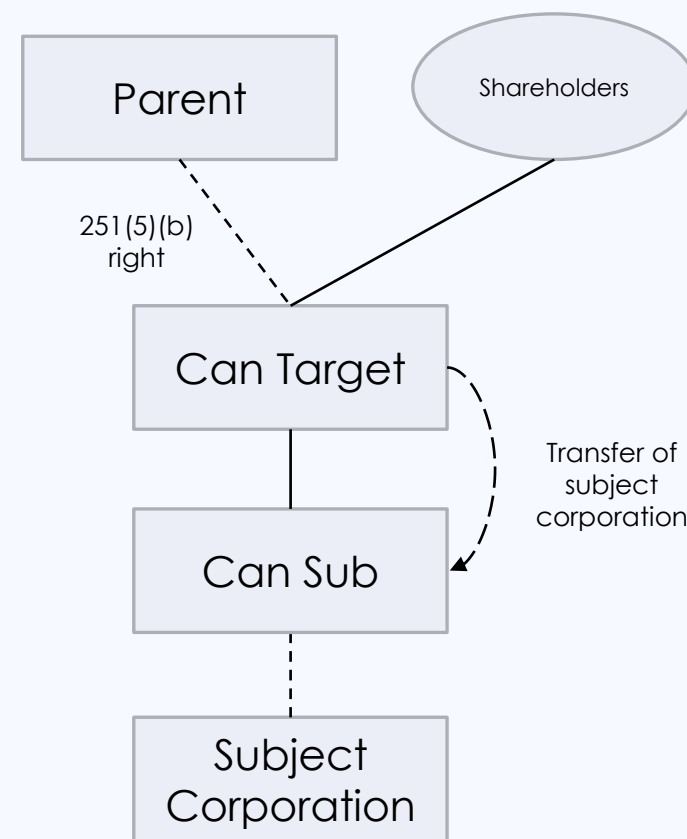
### 212.3(16)

- Same general issues as pre-closing transactions, but perhaps harder to satisfy given possible Parent involvement
- In addition, be mindful of the dual officer rule in 212.3(17)



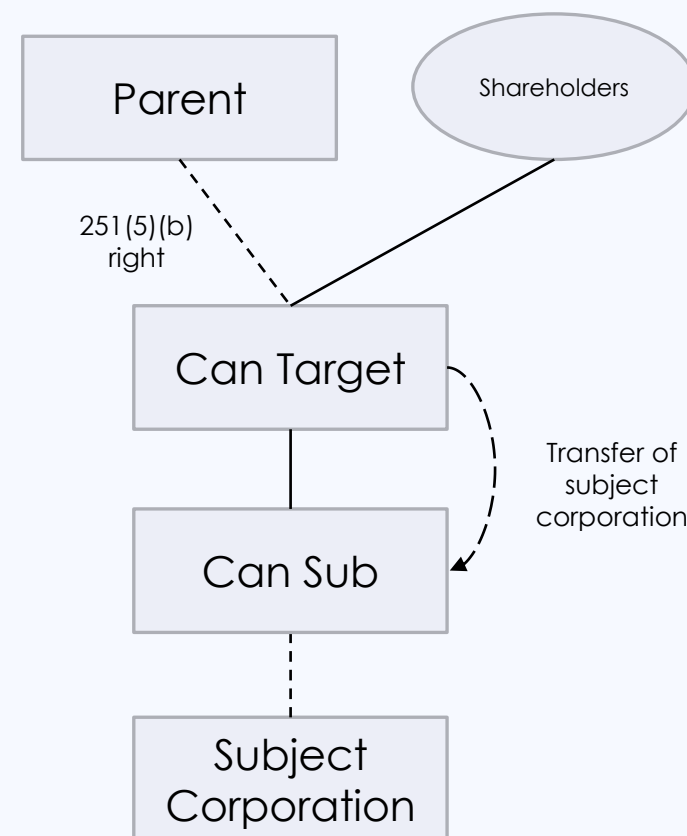
## 212.3(18)(a)(i) – applicability to pre-closing transactions

- Can Target to Can Sub – related party transfer
- Additional conditions:
  - (i)(A) – each shareholder of the disposing corporation immediately before the investment time is the CRIC or a corporation resident in Canada that is related to Parent, and at no time in the series and before the investment time dealing at arm's length with Parent (ignoring 251(5)(b) rights), OR



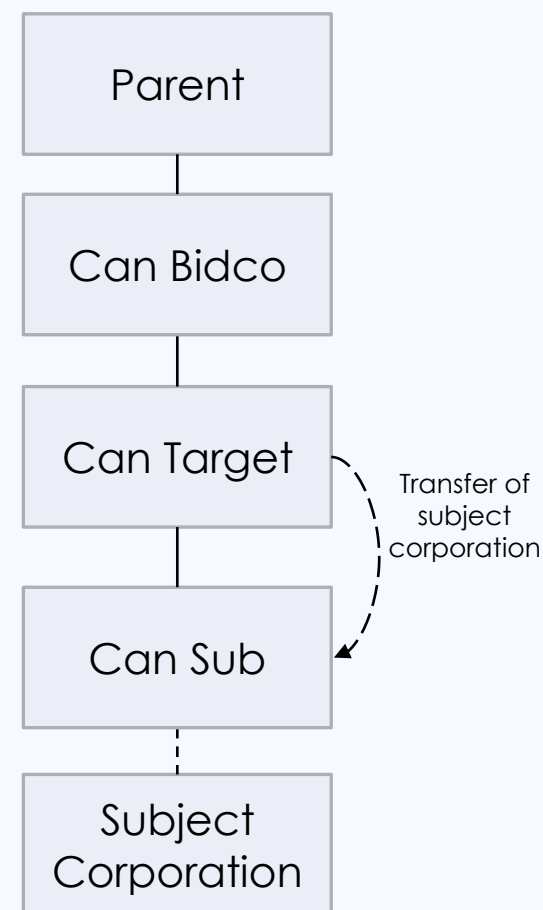
## 212.3(18)(a)(i) – applicability to pre-closing transactions

- (i)(B) – the disposing corporation is at no time in the series and before the investment time dealing at arm's length with the Parent (ignoring 251(5)(b) rights)
- When does the series begin?
- When will it be possible to say that the relevant shareholders or the disposing corporation never dealt with the Parent at arm's length during the series?



## 212.3(18)(a)(i) – applicability to post-closing transactions

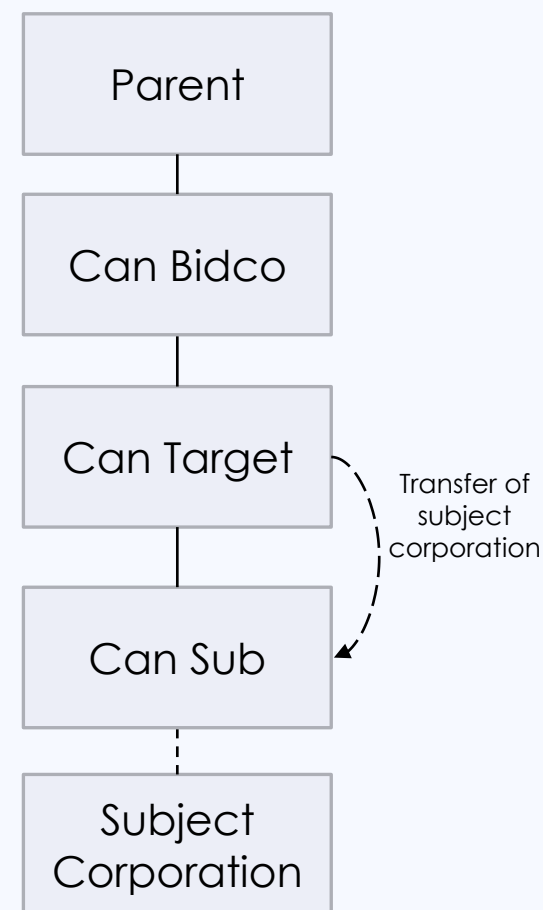
- Can Target to Can Sub – related party transfer
- Additional conditions:
  - (i)(A)(I) – each shareholder of the disposing corporation immediately before the investment time is the CRIC or a corporation resident in Canada that is related to Parent, and at no time in the series and before the investment time dealing at arm's length with Parent (ignoring 251(5)(b) rights) or a non-resident person that participates in the series and is, at any time in the series and before the investment time, related to the Parent





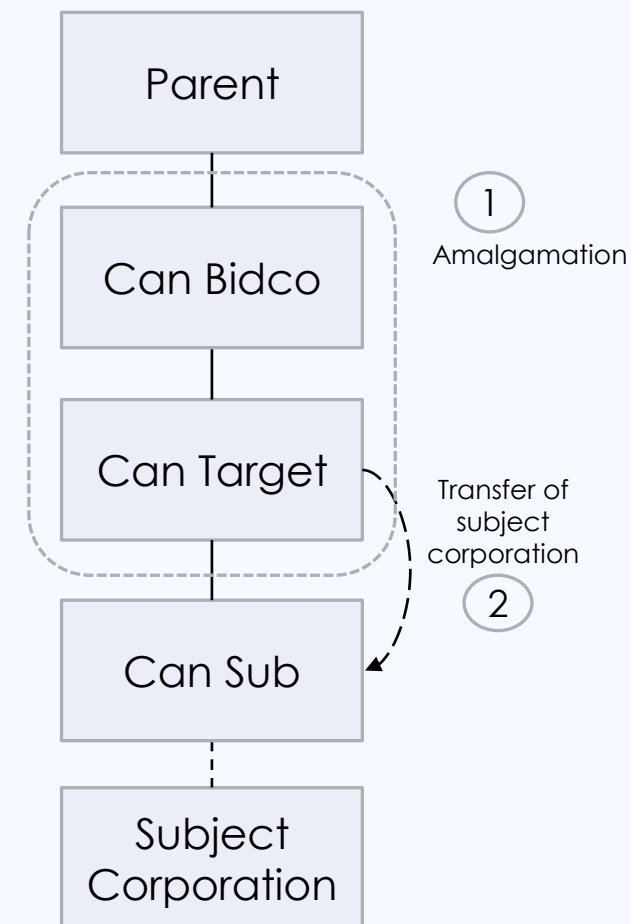
## 212.3(18)(a)(i) – applicability to post-closing transactions

- Can Bidco would satisfy the first part
- However, under 212.3(18)(a)(i)(A)2, Can Bidco also must never deal at arm's length with a non-resident person that participates in the series and is, at any time in the period and before the investment time, related to the Parent
- Does the subject corporation “participate in the series”?



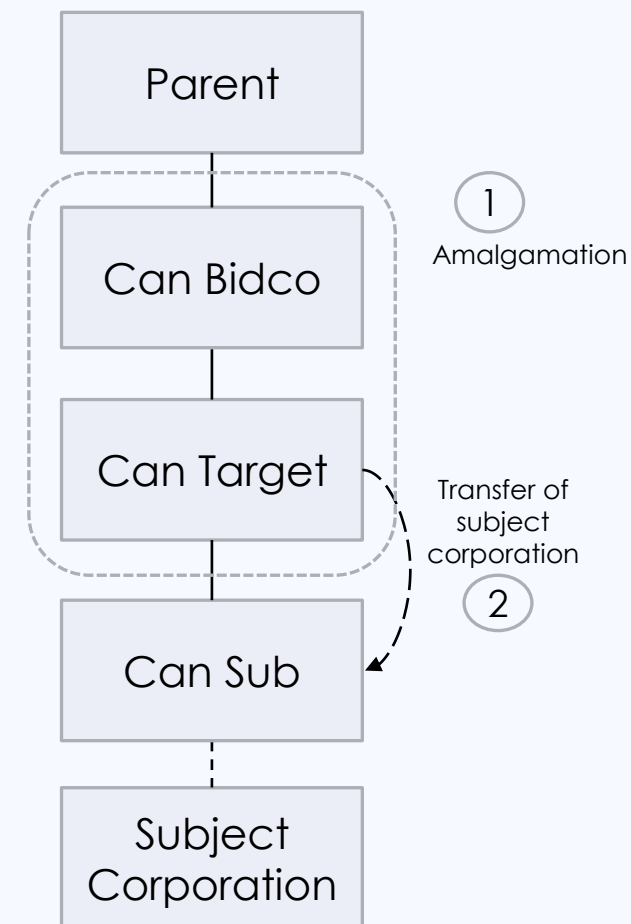
## 212.3(18)(a)(i) – applicability to post-closing transactions

- Amalgamation not an investment because of 212.3(22)
- However, pursuant to 212.3(22)(a) continuity rule, Amalco is deemed to be the same corporation as, and a continuation of, both predecessor corporations



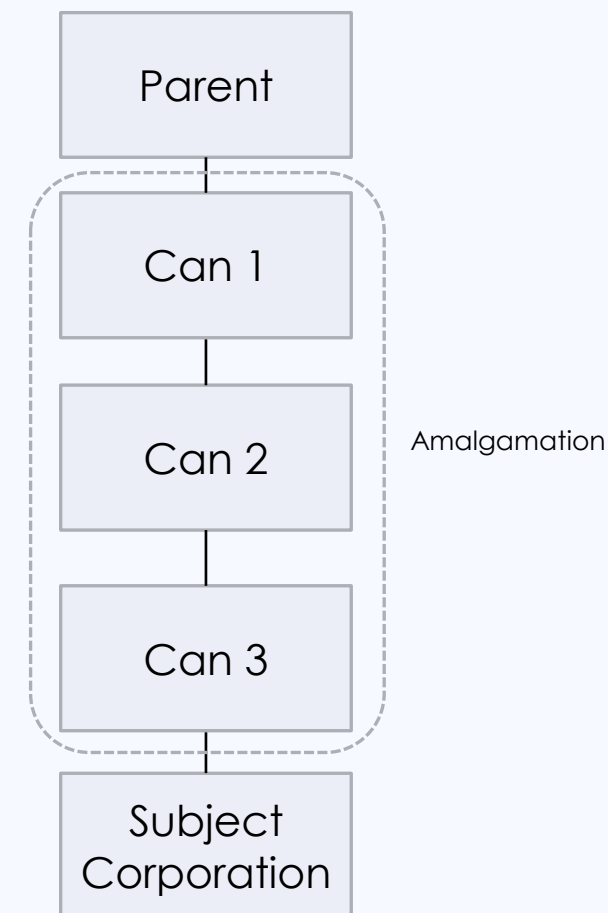
## 212.3(18)(a)(i) – applicability to post-closing transactions

- As a result, conditions in 212.3(18)(a)(i) cannot be satisfied in respect of the transfer of the subject corporation to Can Sub
- Shareholders of disposing corporation (Amalco) are not the CRIC or a related corporation resident in Canada
- Disposing corporation (deemed to be continuation of Can Target) presumably dealt at arm's length with Parent during the series and before the investment time



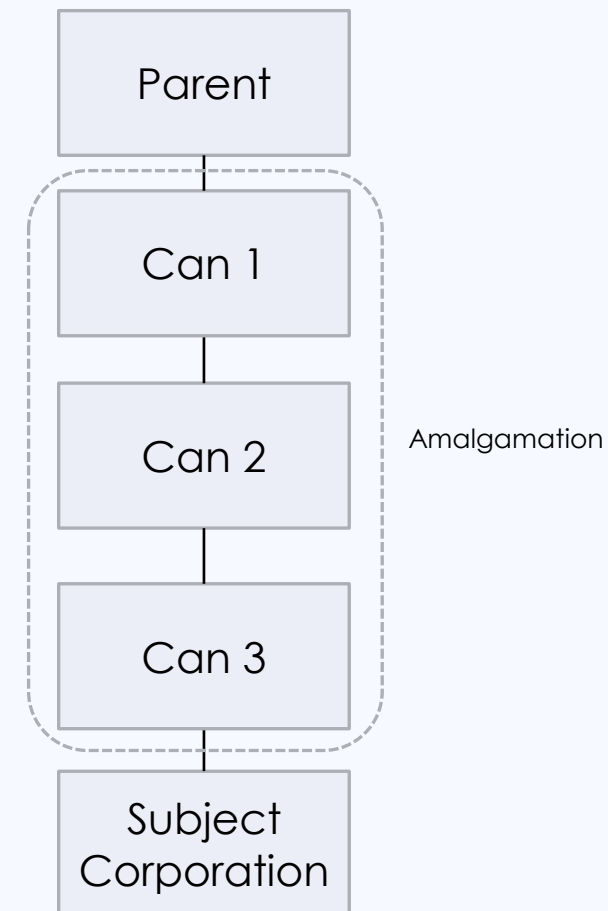
## 212.3(18)(a)(ii) / 212.3(22) – amalgamations

- Amalgamation of Can 1, Can 2 and Can 3 is not an 87(11) amalgamation covered by 212.3(22)
- 212.3(18)(a)(ii) applies to other 87(1) amalgamations, but with conditions:
  - (A) – none of the predecessor corporations dealt at arm's length with the Parent during the series and before the investment time, OR
  - (B) each shareholder of the predecessor is either the CRIC or a related corporation resident in Canada that is related to the Parent, and at no time during the series and before the investment time dealt at arm's length with the Parent



## 212.3(18)(a)(ii) / 212.3(22) – amalgamations

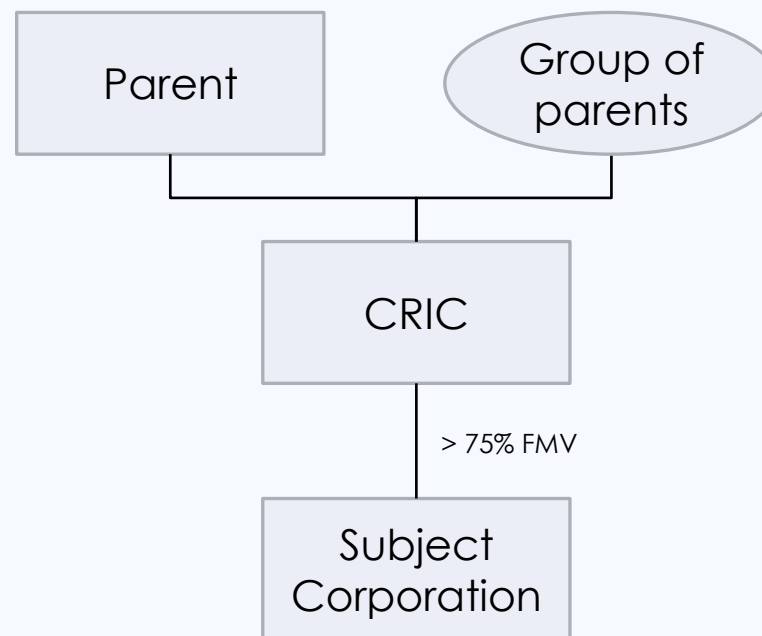
- Conditions are not met
- Sequential amalgamations of Can 1 and Can 2, and then Amalco and Can 3 would both be covered by 212.3(22)



## 212.3(10)(f) – indirect investment

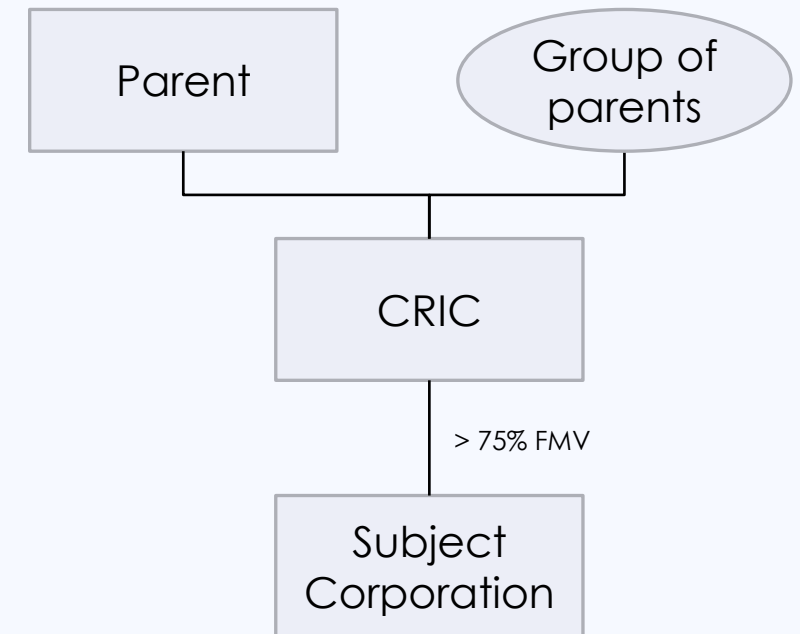
### 212.3(14)

- Condition deemed to be satisfied at the time of the acquisition if
  - Any property (other than shares of FA that is referred to in (10)(f))) held directly or indirectly by the other corporation is disposed of, after the time of acquisition, directly or indirectly by that corporation as part of a series of transactions or events that includes the acquisition, and
  - At any time that is subsequent to the acquisition time and that is during the period during which the series occurs, the condition in (10)(f) would have been satisfied



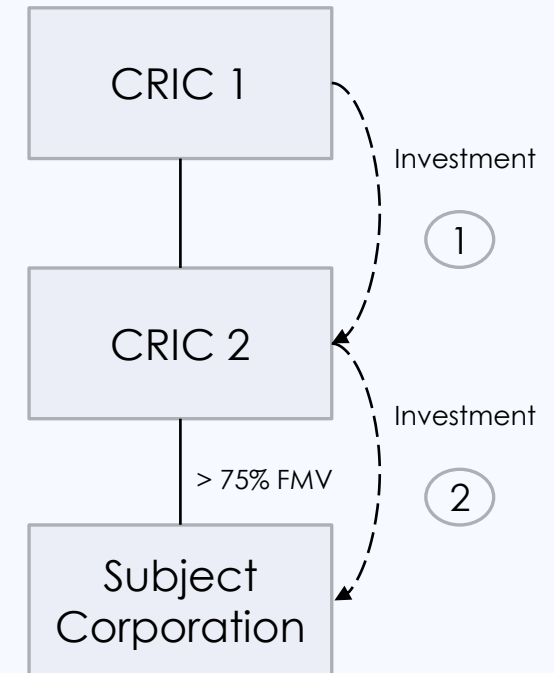
## 212.3(10)(f) – indirect investment

- Need a disposition and satisfaction of the condition as part of the series
- Condition is deemed satisfied – but consequences based on what values?
- Presumably based on values at the first time after the acquisition time that the condition is satisfied?



## 212.3(18)(c)(v)

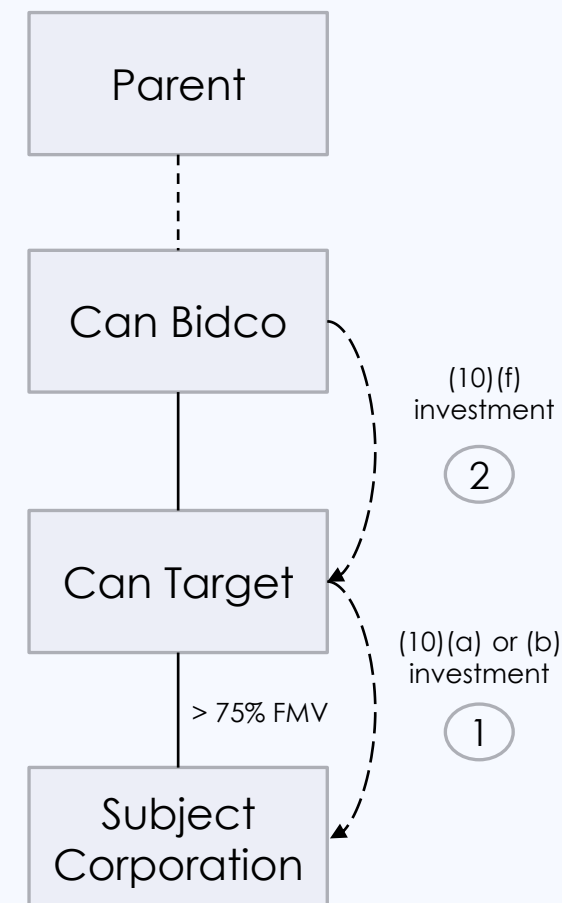
- 212.3(2) does not apply to the (10)(f) investment by CRIC 1 in CRIC 2, provided CRIC 2 uses property transferred by CRIC 1 to make the direct investment in the subject corporation, and
- The two investments occur within 90 days of each other, and
- Are part of the same series of transactions or events





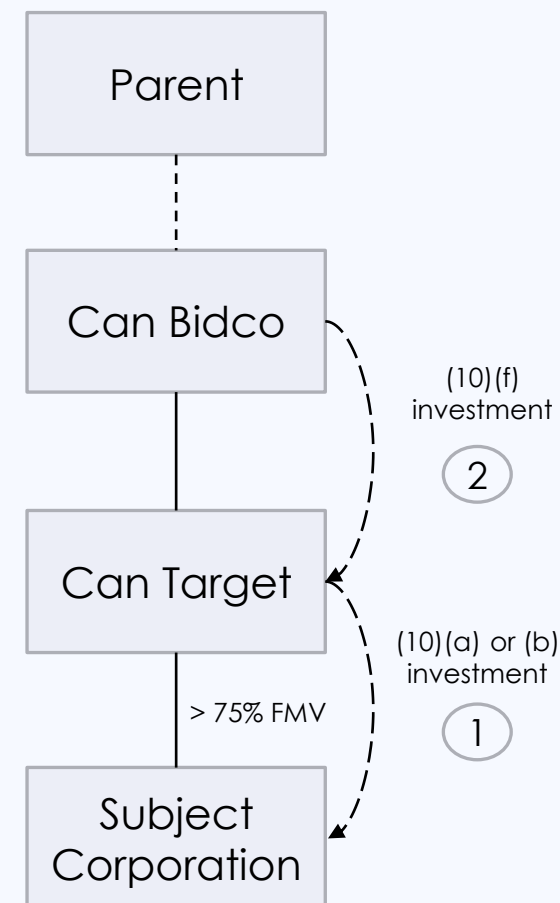
## 212.3(5.1)

- Intended to prevent double application of FAD rules in circumstances where
  - Can Target makes a (10)(a) or (10)(b) investment in the subject corporation and that investment is subject to 212.3(2), and
  - Can Bidco subsequently makes a (10)(f) investment in CRIC, that is an indirect investment in the subject corporation



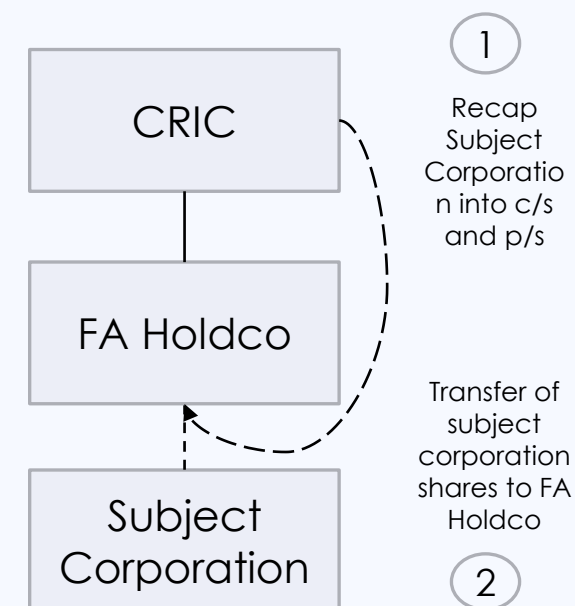
## 212.3(5.1)

- Additional conditions:
  - Can Target is not controlled by Parent immediately after the investment time in respect of the first investment, and
  - Can Target becomes, after the time that is immediately after the investment time in respect of the first investment and as part of the same series, controlled the Parent because of the second investment
- Note: Only applies if the first investment is made under (10)(a) or (10)(b)



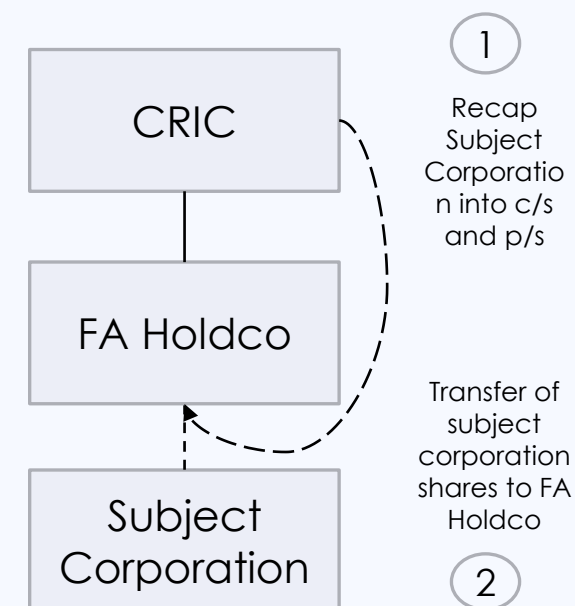
## 212.3(19) – preferred share investments

- Investment in preferred shares subject to 212.3(19)
- “throughout the series”, subject corporation would be a “subsidiary wholly-owned corporation” of the CRIC taking into account only shares owned by
  - the CRIC
  - a Canadian resident corp that is a subsidiary wholly-owned corporation of the CRIC,
  - a corp resident in Canada of which the CRIC is a subsidiary wholly-owned corporation



## 212.3(19) – preferred share investments

- Conditions would not be met
- Note again that 212.3(19) is not subject to any ownership (or deemed ownership) requirement by the Parent – just needs to be part of the series that includes the CRIC becoming controlled by the Parent



# 111(4)(e) PLANNING – IMPACT OF PROPOSED “SUBSTANTIVE CCPC” RULES

FRANCESCO GUCCIARDO

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

- Pre-closing “111(4)(e)” planning in the context of the cross-border acquisition of a Canadian private company had become an increasingly common technique in recent years:
  - Target company makes a designation under paragraph 111(4)(e) in its acquisition of control return so as to achieve a taxable step-up in basis of certain properties (e.g. depreciable capital properties, such as goodwill)
  - Target pays safe and/or capital dividends immediately before closing so as to achieve a step-up in outside basis in the shares held by sellers

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

- Purchase price generally reduced by the amount of tax payable by target company as a consequence of the designation
- Such tax would be based on general corporate rates (e.g. exclusive of any refundable tax component) due to the fact that the non-resident's purchase right in respect of the shares of target under the SPA disqualified target from being a CCPC
- The monetized outside basis in the shares as part of the transaction generally neutralized the impact of any purchase price reduction
- In general, purchaser has the same total outlay (e.g. Adjusted Purchase Price plus inside tax), seller is in approximately the same after-tax position following the sale and Target has some stepped up basis in underlying depreciables.

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

- A cornerstone of the traditional “111(4)(e)” planning is that any gains realized by Target as a consequence of a designation that is made under paragraph 111(4)(e) is subject to tax at ordinary corporate rates and not subject to the refundable tax otherwise levied on CCPCs
- Budget 2022 (April 7, 2022) proposes an extension of the refundable tax regime to “substantive CCPCs”
  - A “substantive CCPC” is a Canadian resident private corporation that is not a CCPC but that is ultimately controlled (in law or in fact) by Canadian-resident individuals
  - An extended definition of control will aggregate shares owned, directly or indirectly, by Canadian resident individuals and deem a corporation to be controlled by a Canadian resident individual where Canadian individuals own, in aggregate, sufficient shares to control the corporation



## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

- Budget 2022 *specifically* notes that these rules would cause a corporation to be a substantive CCPC in circumstances where the corporation would have been a CCPC but for the fact that a non-resident or public corporation has a right to acquire its shares
- An anti-avoidance rule will be introduced to address arrangements or transactions where it is reasonable to consider that a particular arrangement, transaction or series was undertaken to avoid the refundable tax regime

# 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

## Simplified Illustration – Individual Vendor

Base Sale	111(4)(e) Sale (Pre-Budget 2022)	111(4)(e) Sale (Post Budget – No Grandfathering)
Proceeds: \$10,000,000	Goodwill Value: \$5,000,000	Goodwill Value: \$5,000,000
Share Cost: \$1,000,000	111(4)(e) Gain/Step-Up: \$5,000,000	111(4)(e) Gain/Step-Up: \$5,000,000
Taxable Capital Gain: \$4,500,000	Inside Tax: \$662,500* (Non-CCPC Rate) (@26.5%)	Inside Tax: \$1,254,166.67* (CCPC Rate) (@50.167%)
Personal Tax: \$2,408,850 (@53.53%)	PUC Bump: \$2,500,000 (CDA)	Refundable: \$766,666.67
After-Tax Proceeds: <b>\$7,591,150</b>	Proceeds: \$9,337,500	PUC Bump: \$2,500,000 (CDA)
	Share Cost: \$3,500,000 (\$1M + \$2.5M tax-free CDA bump)	Proceeds: \$8,745,833.33
	Taxable Capital Gain: \$2,918,750	Share Cost: \$3,500,000 (\$1M + \$2.5M tax-free CDA bump)
	Personal Tax: \$1,562,407 (@53.53%)	Taxable Capital Gain: \$2,622,916.66
	After-Tax Proceeds: <b>\$7,775,093</b>	Personal Tax: \$1,404,047.29 (@53.53%)
		After-Tax Proceeds: <b>\$7,341,786.04</b>

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

### Substantive CCPCs

**36 (1) Subsection 248(1) of the Act is amended by adding the following in alphabetical order:**

**Substantive CCPC** means a private corporation (other than a Canadian-controlled private corporation) that at any time in a taxation year

- (a) is controlled, directly or indirectly in any manner whatever, by one or more Canadian resident individuals, or
- (b) would, if each share of the capital stock of a corporation that is owned by a Canadian resident individual were owned by a particular individual, be controlled by the particular individual. (SPCC en substance)

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

**(2) Section 248 of the Act is amended by adding the following after subsection (42):**

**Substantive CCPC — anti-avoidance**

(43) For the purposes of this Act, a corporation (other than a Canadian-controlled private corporation) that is resident in Canada and would not, in the absence of this subsection, be a substantive CCPC, is deemed to be a substantive CCPC if it is reasonable to consider that one of the purposes of any transaction (as defined in subsection 245(1)), or series of transactions, was to cause the corporation not to qualify as a substantive CCPC.

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

(3) Subsections (1) and (2) apply to

(a) taxation years of a corporation that begin on or after Budget Day, if

(i) the corporation’s first taxation year that ends on or after Budget Day ends due to a loss restriction event caused by a sale of all or substantially all of the shares of a corporation to a purchaser before 2023,

(ii) the purchaser deals at arm’s length (determined without reference to a right referred to in paragraph 251(5)(b)) with the corporation immediately prior to the loss restriction event, and

(iii) the sale occurs pursuant to a written purchase and sale agreement entered into before Budget Day; and

(b) in any other case, taxation years that end on or after Budget Day.

## 111(4)(e) Planning – Impact of Proposed “Substantive CCPC” Rules

- Rules should not deny the ability to achieve a step-up in basis via a 111(4)(e) designation by monetizing tax attributes of the target company
- Coming into force provisions (e.g. grandfathering or exception for arm's length acquisition transactions completed on or after April 7, 2022 and before 2023 for which a written agreement was entered into before April 7, 2022) should help alleviate any GAAR concerns participants have/had with respect to previously executed “111(4)(e)” planning
- Subject to the ultimately enacted legislation, there may still be circumstances where traditional “111(4)(e)” planning is a viable and useful planning tool

# EARNOUTS AND OTHER FORMS OF NON-SHARE CONSIDERATION IN CROSS-BORDER STRUCTURES

CHRISTOPHER ANDERSON

## Earnouts paid to non-residents

- At the 2019 CTF Annual Conference Roundtable, CRA was asked whether a purchaser is required to withhold tax when an earn-out payment is made to a non-resident shareholder?
- Consistent with views adopted at the 2005 APFF Conference, CRA stated it would generally not apply WHT when a non-resident disposes of shares, the consideration for which includes an earnout payment, provided that the first four conditions in paragraph 2 of IT-426R are met, namely:
  1. The vendor and purchaser are dealing with each other at arm's length
  2. The gain or loss on the sale of shares is clearly of a capital nature

See CRA document no. 2019-0824461C6.



## Earnouts paid to non-residents

3. It is reasonable to assume that the earnout feature relates to underlying goodwill, the value of which cannot reasonably be expected to be agreed upon at the date of sale
4. The earnout feature in the sale agreement must end no later than 5 years after the end of the first taxation year of the corporation (whose shares are sold) in which the shares are sold

See CRA document no. 2019-0824461C6.

## Earnouts paid to non-residents

- At the 2021 APFF Roundtable, the CRA stated that the cost recovery method could not be used by a limited partnership that is vendor
- Where the conditions for the cost recovery method are NOT met, there are two potential outcomes:
  1. paragraph 12(1)(g) could apply to the vendor; or
  2. the FMV of the earnout right could be included in the POD of the vendor in the year of sale, with subsequent settlements of the rights being treated as separate dispositions
- As an alternative, consider structuring as a reverse earnout

## Earnouts: treatment on immigration/emigration

- The FMV of an earnout right will generally be part of the non-resident's POD for the purposes of s. 116 of the ITA. Any subsequent disposition of this right, in whole or in part, by the non-resident will generally not be taxable under Part I of the ITA since such right does not constitute TCP for purposes of the ITA. When the non-resident immigrates to Canada, the right will be deemed to have been disposed of by the non-resident and re-acquired for proceeds equal to its FMV. Any disposition of the right after the non-resident became a Canadian resident should be subject to tax under Part I of the ITA and could result in a taxable capital gain (see CRA document no. 2006-0196211C6)
- To the extent that payments made subsequent to emigration would be dependent on the use of, or production from, property (i.e., subject to paragraph 12(1)(g)), the CRA is of the view that such portion would be subject to Part XIII withholding tax (see CRA document no. 2013-0494251E5)

# Contingent Value Rights (CVRs)

## **Contractual Rights:**

- closely resemble earnouts
- in respect of an asset sale, it is expected that the value of the rights will form part of the POD to the vendor (see CRA document no. 9403435)
- in respect of a share sale, query whether amounts have any correlation with the property of the entity sold (i.e., “dependent on the use of or production from property”)

# Contingent Value Rights (CVRs)

## Debt-based CVR:

- tax consequences largely determined by rules in the ITA applicable to debt holders
- non-interest-bearing debt vs. contingent-interest debt
- issuer of a debt-based CVR should consider potential application of debt forgiveness rules
- arguably a contractual CVR should generally not be considered a debt obligation (i.e., *Barejo* should be limited to the particular facts of that case)

## Contingent Value Rights (CVRs) – Market Trends (2017-present)

- Contractual rights-based CVRs most common
- Often disclaimer that the Canadian federal income tax consequences in respect of CVRs are not entirely clear, particularly in respect to whether a CVR is income or capital
- CVRs generally considered capital property (i.e., additional proceeds received)
- As such, disposition by a resident holder will generally result in a capital gain (or loss). Disposition by a non-resident holder will generally not be subject to tax under the ITA, unless such CVRs are, or are deemed to be, TCP
- Canadian WHT should generally not apply to the payment of CVRs to NR shareholders

## Tax Receivable Agreements (TRAs)

- Primarily used as a planning tool for IPOs of US enterprises, but are becoming more common in Canada
- A TRA is, effectively, no different than a contractual rights-based CVR. It is a contract for payments based on a predefined contingency, namely tax savings. As such, the Canadian-tax considerations should be no different than those already canvassed

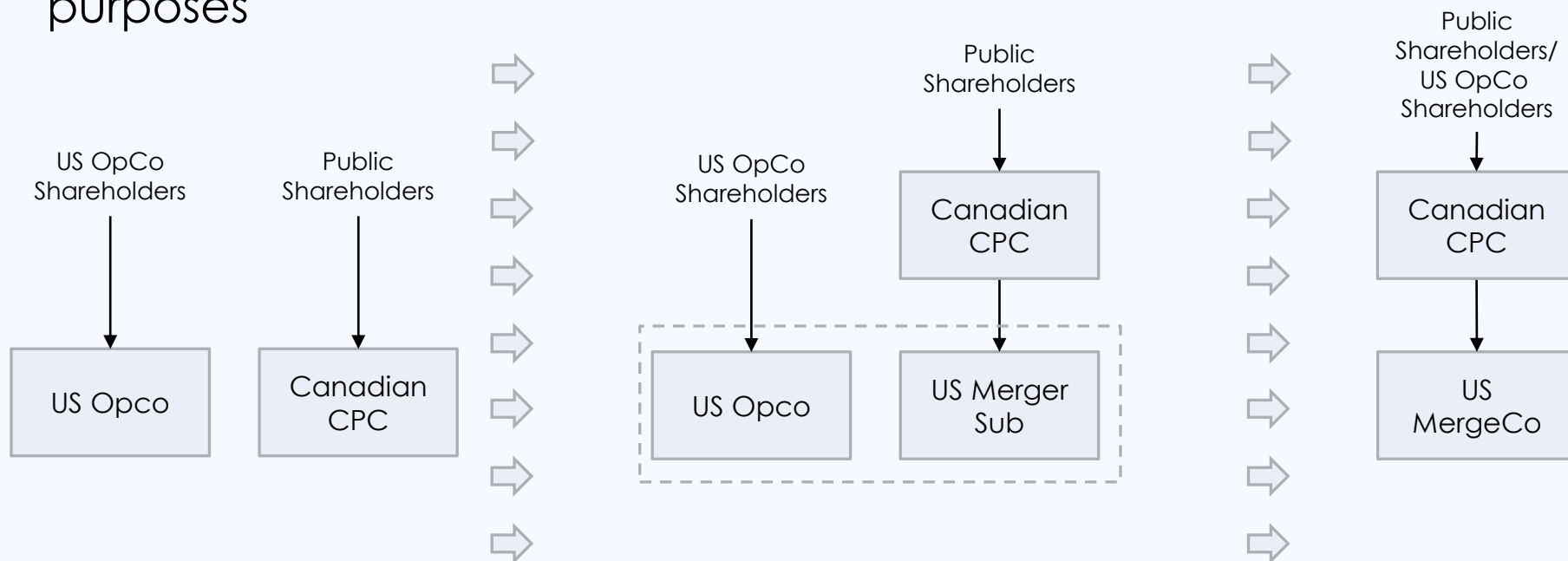
# CANADIAN TAX ISSUES WHEN DEALING WITH CANADIAN COMPANIES THAT ARE TREATED AS INVERTED FOR US TAX PURPOSES

FRANCESCO GUCCIARDO



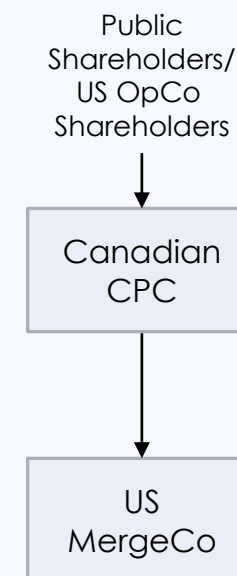
## CPCs & Cross-Border (US) RTOs

- Small and mid-sized US companies might seek quick, flexible and efficient access to the Canadian capital markets by completing a reverse takeover with a Canadian-listed capital pool company, often driven by the additional non-tax benefit of achieving foreign private issuer status for US securities law purposes



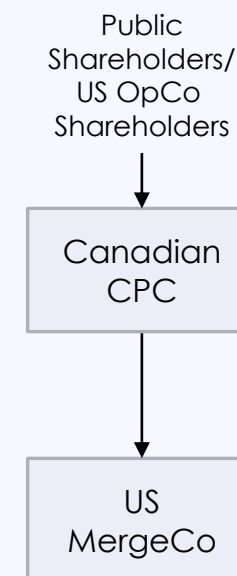
## CPCs & Cross-Border (US) RTOs – US Inversions

- Presume 80%+ of the shares of Canadian CPC are owned by the former US OpCo Shareholders
- (Presuming no exception is met), section 7874 of the *US Internal Revenue Code* (anti-inversion rules) applies to deem Canadian CPC to be a US-resident corporation for US federal income tax purposes – US MergeCo is an “inverted” US company
- Seek qualified US tax advice regarding the application of this provision, the thresholds that must be met in order to trigger an inversion and the type that may be triggered, the availability of any exceptions, and general US tax consequences of an inversion to the company(ies) and shareholders



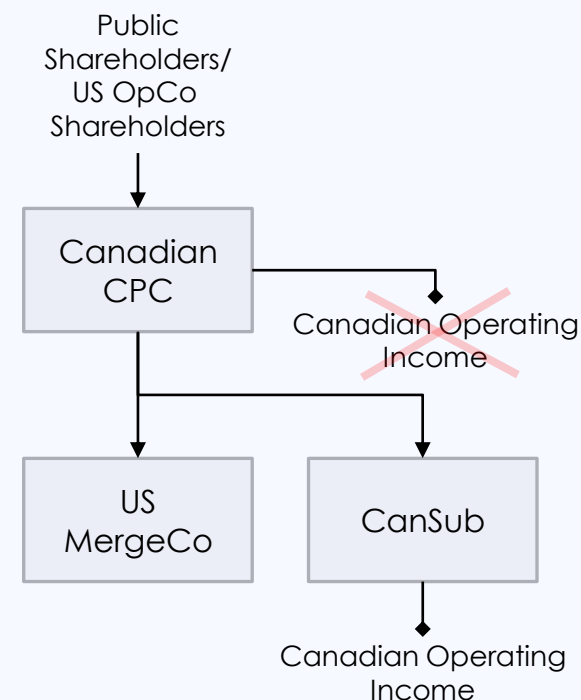
## CPCs & Cross-Border (US) RTOs – US Inversions

- *Canada-US Tax Convention* does not relieve the dual residency issue created as a result of an inversion because the US rules specifically and unilaterally override treaties (e.g. Article IV(3)(a) would otherwise tie-break to Canadian CPC's jurisdiction of formation)
- Canadian CPC is subject to both US and Canadian income tax on its worldwide income and dividends paid by Canadian CPC subject to both Canadian and US withholding tax, as applicable



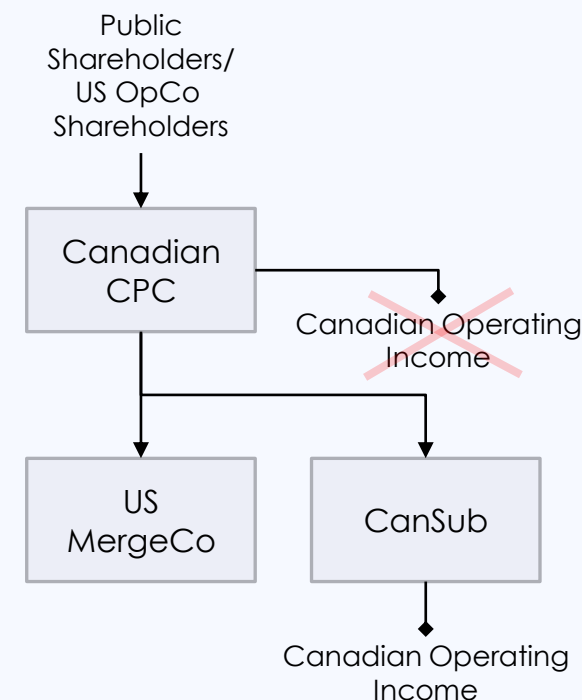
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- Canadian CPC should not carry on business in Canada directly as US taxes paid on Canadian business income of Canadian CPC will not generally be creditable against Canadian taxes payable on that income (e.g. a credit for business income tax paid to the U.S. is generally limited to such tax paid by the taxpayer for the year “in respect of businesses carried on by the taxpayer in that country...” and the income sourcing rules at Article XXIV(3) of the *Canada-US Tax Convention* does not operate so as to source the income to the US)



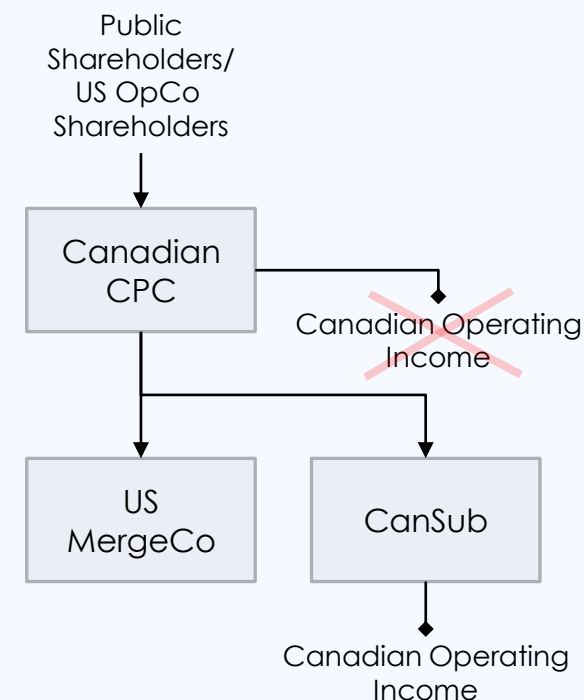
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- In the context of a CPC RTO, Canadian CPC would not be expected to earn any income directly; future Canadian business should be earned via a subsidiary Canadian operating corporation, and partnership and/or joint venture interests held via a blocking Canadian holding company
  - US tax advice is needed to confirm that the subsidiary Canadian corporations would be regarded and that the income earned by or allocated to such corporations not imputed to Canadian CPC on an accrual basis or otherwise, and not subject to the US Global Intangible Low-Taxed Income (GILTI) regime



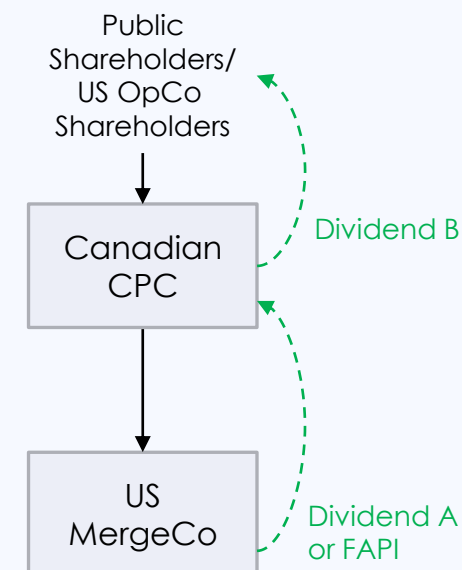
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- US shares a similar exemption regime as Canada on repatriation of foreign active profit to the US (e.g. dividends paid by CanSub to Canadian CPC) such that the interposition of blocking entities should not be expected to result in current US taxation on the active business income of the Canadian subsidiary



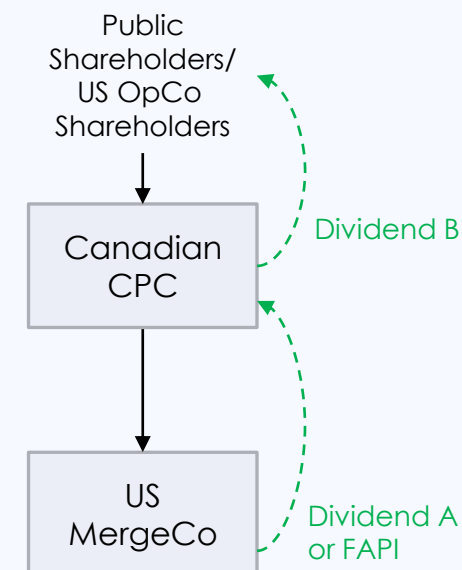
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- **Dividend A** – provided that the dividend is paid out of exempt surplus, Canadian CPC should receive the dividend from US MergeCo tax-free for Canadian federal income tax purposes (similarly, there should be no US withholding tax or mainstream US tax)



## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

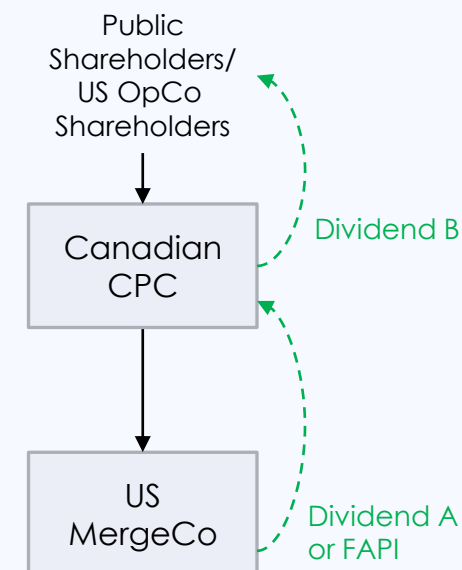
- **FAPI** – it is conceivable that US MergeCo may generate foreign accrual property income (FAPI) (e.g. underlying investment business)
  - Consider technical issues in claiming a deduction under subsection 91(4) for foreign tax if the US taxes in respect of that income is legally paid by Canadian CPC (e.g. could be the case where Canadian CPC is the parent company for a US group that files a consolidated return, although the members of the group are jointly liable and generally enter into an internal tax sharing agreement)





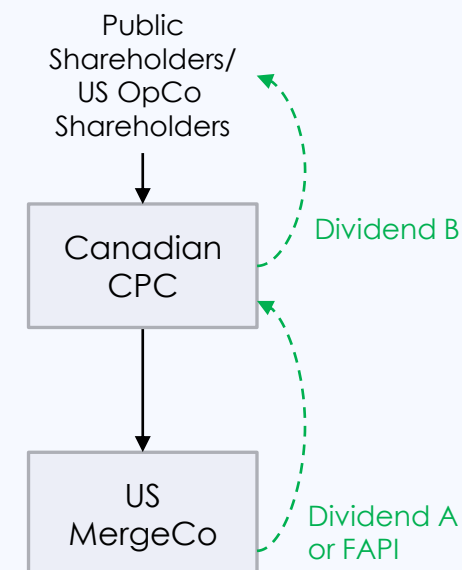
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- “foreign accrual tax” is generally tax paid by a foreign affiliate of the taxpayer (whether the particular affiliate that generated the income or another foreign affiliate of the taxpayer in certain circumstances)
- The condition that the tax be *paid by* a foreign affiliate would not appear to be met



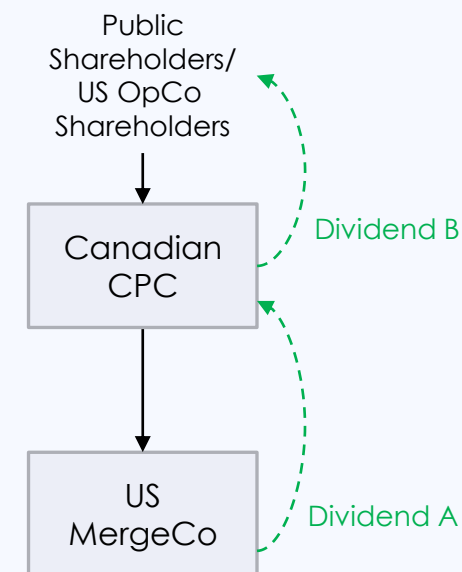
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- If the U.S. tax on the FAPI is not a foreign accrual tax, the carve-out in subsection 126(1) and 20(12) denying a credit or deduction in respect of non-business income tax that may be claimed by corporations where the tax may reasonably be regarded as having been paid by the taxpayer in respect of income from a share of the capital stock of a foreign affiliate is problematic
- Similar crediting challenge in the US for any Canadian taxes ultimately payable



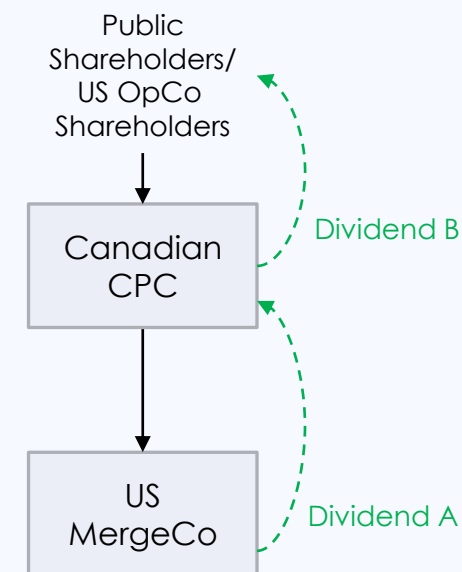
## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- **Dividend B** – Canadian withholding tax applies in respect of dividends paid by Canadian CPC to non-resident shareholders and US withholding tax applies in respect of dividends paid by Canadian CPC to non-US shareholders
  - US withholding tax imposed on a Canadian-resident shareholder should qualify as a “non-business income tax” per subsection 126(1)
  - However, as it is paid by a Canadian corporation the dividend does not qualify as income from a U.S. source as required in the mid-amble of paragraph 126(1)(b)



## CPCs & Cross-Border (US) RTOs – US Inversions – Canadian Issues

- Unless the Canadian resident shareholder has other unsheltered US-source income, the Canadian resident shareholder may not be in a position to fully monetize the US-withholding tax paid by way of crediting in Canada
- Canadian resident shareholder may be able to partially monetize the US withholding tax paid in the form of a deduction in computing income per subsection 20(12)
- Similar issues may arise for US shareholders domestically in the US, and issues of full monetization and denial may arise for non-Canada/non-US shareholders



## CPCs & Cross-Border (US) RTOs – US Inversions

- Inversions are not new, although the US rules have been expanded considerably in recent years and, in particular, via section 7874 of the *Internal Revenue Code*
- In circumstances where Canadian CPC does not earn any income (aside from exempt dividends from foreign affiliates) and does not intend to pay dividends, the consequences of an inversion may be manageable
  - The status of the Canadian CPC as a domestic US corporation for US federal income tax purposes could even prove beneficial insofar as it may facilitate a tax-free business combination for the US OpCo Shareholders participating in the RTO

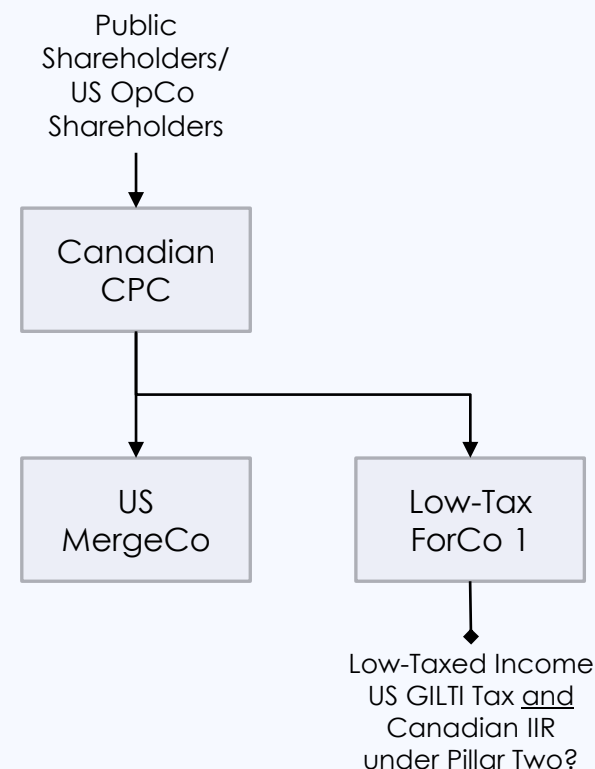
## CPCs & Cross-Border (US) RTOs – US Inversions

- For a brief period in and around 2013, inversions were deliberately triggered in the US real estate space whereby a publicly listed Canadian trust would complete a public offering and acquire a portfolio of US real properties of a US partnership in a manner that would cause the trust to be inverted and treated as a domestic US corporation, facilitating qualification as a US REIT for US federal income tax purposes and a familiar non-SIFT income trust for Canadian purposes

# CPCs & Cross-Border (US) RTOs – International Expansion

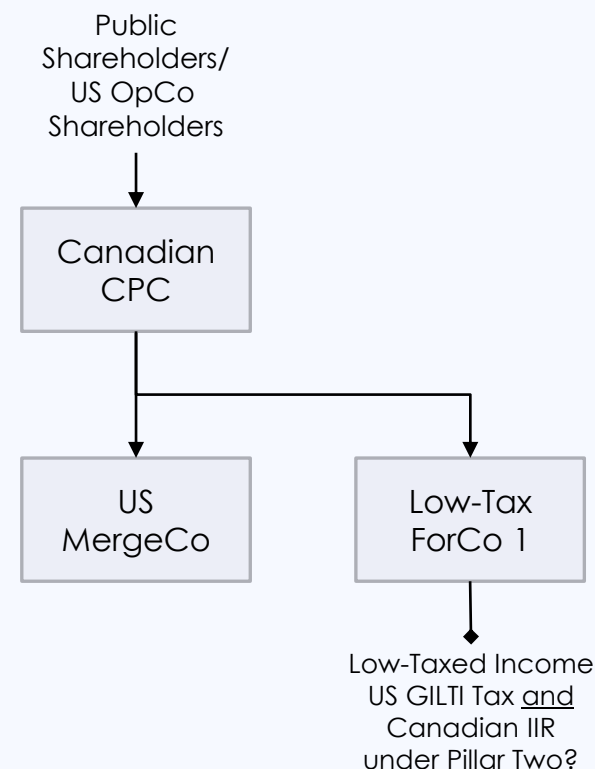
## Possible Pillar Two Issues:

- Where is Canadian CPC located for purposes of applying the income inclusion rule (IIR) under Pillar Two?
- If Canada has the right to apply the IIR under Pillar Two on the low-taxed income for Low-Tax ForCo 1 and the US applies its own minimum tax on that same income under its Global Intangible Low-Taxed Income (GILTI) regime:



## CPCs & Cross-Border (US) RTOs – International Expansion

- Will one regime take precedence over the other (and, if so, which)?
- If there is no clear ordering, what relief will be available in Canada on account of any US GILTI tax that might be paid at the level of Canadian CPC on the same income of Low-Tax ForCo 1 (and vice-versa)?
- There would still appear to be a “mismatch” in terms of the source of foreign taxation (e.g. US GILTI tax) and the source of foreign income (e.g. jurisdiction of Low-Tax ForCo 1)





# UPDATE ON TAX PROVISIONS IN TRANSACTIONAL AGREEMENTS

CARRIE AIKEN

# Representations and Warranties

- Representations: statements about past or existing facts
- Warranties: confirmations that existing or future facts are or will be true
- Allow the parties to identify and allocate business and legal risks
- Recent Developments
  - Section 160 risk
  - CEWS risk
  - Reportable Transactions
  - FAD representation and covenants

## Tax Indemnity Provisions

- General indemnity vs. tax specific indemnity
- Tax specific indemnities are not usually subject to baskets or caps
- Some SPAs will specify adjustments to indemnifiable amounts to account for tax benefits recognized by the indemnified party for suffering the loss or tax consequences to the indemnified party of receiving the indemnity payment

## Scope of Tax Indemnity

- Generally intended to cover “Taxes” and other damages that arise in respect of pre-closing tax periods and vendor pre-closing reorganizations
- Relevant definitions may include “Taxes”, “Damages”, “Loss” or “Liability”
- Standard definition of “Taxes” does not typically cover refundable items (e.g., SR&ED credits) or CEWS
- Consequential or indirect damages are generally covered by the indemnity unless expressly excluded or limited

## *Boliden Mineral AB v. FQM Kevitsa Sweden Holdings AB, 2021 ONSC 6844*

- Boliden sought indemnity from FQM under a purchase agreement (PSA) relating to the 2016 acquisition by Boliden of the shares of Kevitsa
- Kevitsa, a Finnish corporation, had tax losses from pre-closing tax periods
- Under Finnish law, tax losses after a change of control are forfeited, unless the Finnish tax authorities (FTA) grant a permit to use the losses after the acquisition
- Kevitsa applied for and was granted the permit in May 2017 and claimed the losses against income in 2017 and 2018 (“post-closing years”)
- 2010 reorganization of Kevitsa was reassessed, resulting in an increase to taxable income in pre- and post- closing years
- Taxes in post-closing years arose because the losses used to shelter income those years were shifted to shelter reassessed income in pre-closing years

## *Boliden Mineral AB v. FQM Kevitsa Sweden Holdings AB*

- FQM gave no specific assurance in PSA with respect to tax losses or the ability to use the losses after closing
- Boliden relied on the representation that “there are no grounds for the reassessment of Taxes of the Corporation” for seeking indemnification
- Definition of “Loss” in PSA included a consequential or indirect loss “to the extent that it is a reasonably foreseeable consequence of the event or circumstance constituting the ground for the applicable indemnification obligation”
- Tax indemnity covered “any Taxes required to be paid or remitted... with respect to any Pre-Closing Tax Period”

## *Boliden – Was there a breach of representation / warranty?*

- FQM argued that there was no breach of rep because it only covered known grounds for a reassessment as of the closing date
- Court held that there was a breach of rep:
  - The representation and warranty was absolute
  - There were no knowledge qualifiers
  - The parties were sophisticated and understood that a potential reassessment could arise after the SPA was entered into
  - The agreement placed the risk of possible reassessments on the vendor and not on the purchaser

## *Boliden – What was the scope of the indemnity obligation?*

- Boliden argued that the indemnity covered the increased taxes in both the pre-closing and post-closing years
- FQM argued that the indemnity only covered taxes in pre-closing periods and taxes in post-closing years were consequential losses that were not reasonably foreseeable



## *Boliden – What was the scope of the indemnity obligation?*

- Court found that the domino effect of the reassessment in the post-closing years was reasonably foreseeable and the taxes in those years were indemnifiable:
- Vendor knew about the tax losses and that they had value
- It was reasonable to expect that purchaser would (1) apply for (and be granted) a permit to use the losses, and (2) claim the losses in post-closing years because the company was profitable and taxable
- Indemnity did not contain an express temporal limitation and covered Taxes “with respect to” any Pre-Closing Tax Period

## *Boliden – What was the scope of the indemnity obligation?*

Ontario Superior Court of Justice held:

*Contrary to the position advanced by FQM, the applicants are not claiming for the “inability” to use tax losses carry forwards. They are claiming for taxes required to be paid, which flow directly from the FTA’s reassessment. The tax losses carried forward by Kevitsa post-closing were not lost, eliminated, or rejected by the Finnish tax authorities. Rather, the FTA reassessed and recognized income in Pre-Closing Tax Periods which resulted in a cascading effect of substantially higher taxes payable by Kevitsa. All of those additional taxes are payable in respect of the reassessment of Pre-Closing Tax Periods... There is no question this increased income tax cost is “with respect to” Pre-Closing Tax Periods, since it arises directly from reassessed income in those years.*

## Rep / Warranty Insurance in M&A

- Insurance product for managing undiscovered risks in a transaction
- Replace vendor's indemnification obligations for breach of representation and warranties
- Insurance may be useful in M&A deals where parties are unwilling or unable to provide protection under an indemnity (e.g., widely held targets, private equity vendors, vendors with limited resources)
- Insurance may also reduce or eliminate holdbacks on closing
- Covers standard tax representations and warranties, common tax risks (e.g., residency, status of corporations, etc.) and pre-closing tax indemnities

## Rep / Warranty Insurance in M&A

- Typically excludes:
  - Pre-closing reorganizations
  - Tax losses
  - Transfer pricing
  - SR&ED claims
  - Off-market or overly broad representations and warranties
  - Issues identified in due diligence
- Tax insurance may provide protection for specific identified risks (e.g., taxable Canadian property, withholding tax issues, permanent establishment issues)

## Insurance / Indemnification and Reportable Transactions

- Mandatory reporting regime in s. 237.3 for “reportable transactions”
- Proposed changes will broaden the application of the regime
- Taxpayers that realize a “tax benefit” as defined for purposes of the GAAR from a “reportable transaction”, and certain other persons, must report details of the transaction to the CRA
- A transaction is caught by the rules if it (a) is an “avoidance transaction” (being a transaction if one of the main purposes of the transaction or series of transactions is to obtain a tax benefit), and (b) has at least one out of three “hallmarks” of aggressive tax avoidance
- Definition and interpretation of the hallmark of “contractual protection” is concerning for tax insurance and tax indemnities

# Insurance / Indemnification and Reportable Transactions

Contractual protection is defined as:

(a) any form of insurance (other than standard professional liability insurance) or other protection, including, without limitation, an indemnity, compensation or a guarantee that, either immediately or in the future and either absolutely or contingently,

(i) protects a person against a failure of the transaction or series to achieve any tax benefit from the transaction or series, or

(ii) pays for or reimburses any expense, fee, tax, interest, penalty or similar amount that may be incurred by a person in the course of a dispute in respect of a tax benefit from the transaction or series

# Insurance / Indemnification and Reportable Transactions

- Definition of contractual protection is extremely broad
- Concern that it may cover:
  - Tax indemnity provisions and tax insurance products
  - Covenants for assistance in tax disputes
- Draft legislation adds an important carve-out from the definition of contractual protection for “insurance, protection or undertakings offered to a broad class of persons and in a normal commercial or investment context in which parties deal with each other at arm’s length and act prudently, knowledgeably and willingly”

## Insurance / Indemnification and Reportable Transactions

- The carve-out is only available if the protection is (1) offered to a “broad class of persons” and (2) in a “normal commercial or investment context”
- Who is a “broad class of persons”?
- Should the carve-out apply to typical share purchase indemnities for historic tax liabilities?
- Does the indemnity go beyond what is ordinary commercial practice?
- Department of Finance explanatory notes indicate the carve-out is intended to exclude contractual protection offered in the context of normal commercial transactions to a wide market



## Break Fees – *Glencore Canada Corporation v. The Queen*, 2021 TCC 63

- Tax Court held that fees received by Falconbridge on a failed merger were income
- Fees were calculated as 2.5% of transaction value and included:
  - Commitment fee of \$28.2M on execution of merger agreement
  - Break fee of \$73.3M payable on a failure to complete the merger
- Falconbridge was interested in DFR for its indirect interest in a valuable mineral deposit in Voisey Bay

## Break Fees – *Glencore Canada Corporation v. The Queen*

- Tax Court concluded that:
  - The acquisition of Voisey Bay was part of Falconbridge's strategy for earning income
  - Falconbridge was carrying on business when it negotiated the merger agreement
  - The fees were received by Falconbridge in the conduct of its business and were ancillary business income

# ***CURRENT CASES***

## **SPEAKERS:**

**Al Meghji**, Osler, Hoskin & Harcourt LLP, Toronto

**John Sorensen**, Gowling WLG (Canada) LLP, Toronto

**Matt Williams**, Thorsteinssons LLP, Toronto

## **YIN RAPPORTEUR:**

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## **MODERATOR:**

**Margaret Nixon**, Stikeman Elliott LLP, Toronto



# OUTLINE

## 1. GAAR

- *Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49
- *Deans Knight Income Corporation*, 2021 FCA 160 (under appeal to SCC)

## 2. Statutory Interpretation

- *Loblaw Financial Holdings Inc.*, 2021 SCC 51
- *Bank of Nova Scotia*, 2021 TCC 70
- Other Cases

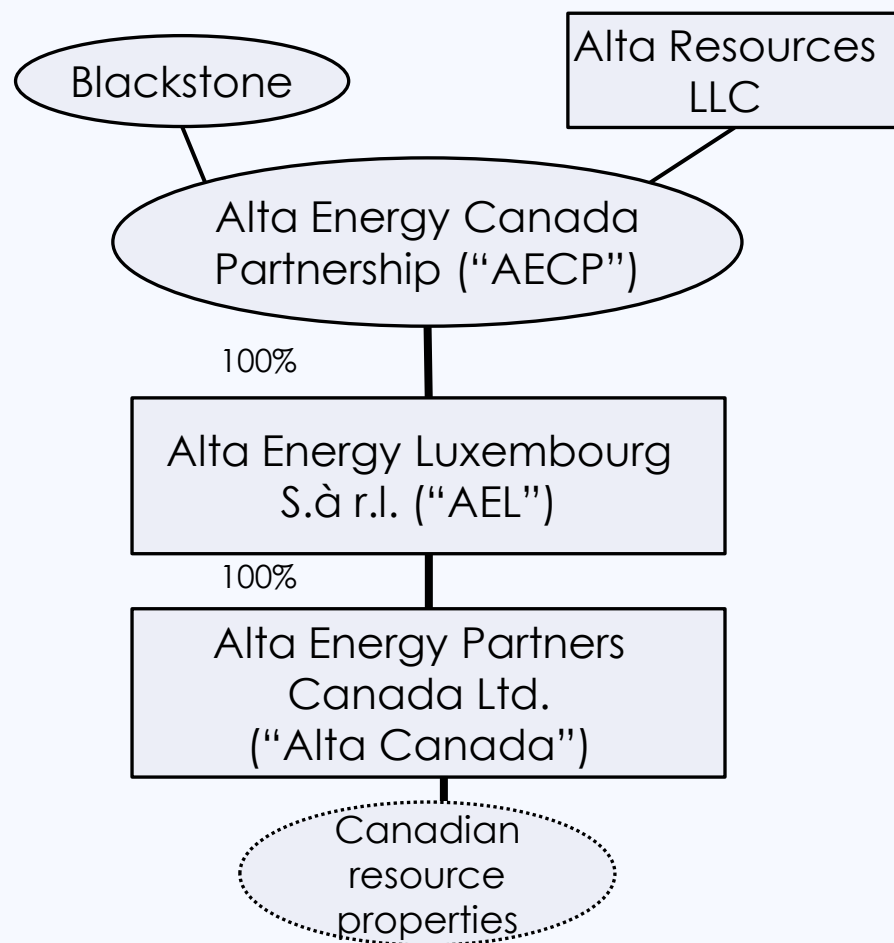
## 3. CRA Audit Powers

- Proposed legislative responses to recent cases
- *BMO Nesbitt Burns Inc.*, 2022 FC 157

## 4. Concluding Remarks

# 1. GAAR

## Alta Energy Luxembourg S.A.R.L., 2021 SCC 49



**Pre-restructuring**: Alta Canada owned by Alta Energy Partners LLC (Delaware LLC owned in turn by Blackstone and Alta Resources LLC)

**Restructuring (2012)**: AEL and AECP created; Delaware LLC sells Alta Canada shares to AEL

- No capital gain realized; FMV = ACB

**2013**: Alta Canada shares sold to Chevron Canada

- ~\$380 million capital gain; AEL relied on Treaty

**CRA**: general anti-avoidance rule (GAAR) allows Canada to tax capital gain despite Article 13(4)(a) of the Treaty

- Lost at trial and appeal

## *Alta Energy Luxembourg S.A.R.L., 2021 SCC 49*

### **Majority:**

- “The principles of predictability, certainty, and fairness and respect for the right of taxpayers to legitimate tax minimization are the bedrock of tax law”
- GAAR does not apply (no misuse/abuse); capital gain not taxable in Canada
- Depth of AEL’s economic ties to Luxembourg are not relevant
- Policy of specific treaty provision at issue is clear from text (supported by context and purpose): to encourage foreign investment in Canada
- Dual nature of treaties as both statutory and contractual
- Deliberate choice not to limit treaty benefits to certain corporations using measures suggested by OECD that would have applied to AEL
  - “The GAAR was enacted to catch unforeseen tax strategies”

## *Alta Energy Luxembourg S.A.R.L., 2021 SCC 49*

### **Dissent:**

- “Multinational companies exploiting gaps and mismatches in international tax rules erode domestic tax bases and cost countries an estimated US\$100 to US\$240 billion in lost revenue annually”
- Treaty shopping is abusive where there is an absence of a “genuine economic connection with the state of residence”
- Purpose of all relevant articles read together “is to assign taxing rights to the state with the closest economic connection to the taxpayer’s income”
  - Majority: that is a purpose in the Treaty, but the business property exemption specifically at issue here has a different purpose



## *Deans Knight Income Corporation, 2021 FCA 160*

**Novel question:** Is object, spirit & purpose of acquisition-of-control element in s. 111(5) fully reflected in text of provision? If yes, GAAR inapplicable

**Novel answer:** control test means “**actual**” control rather than *de jure* or *de facto*

**Leave granted** March 10, 2022

**Forbes** (eventually renamed Deans Knight) had \$90M of non-capital losses & other deductions (Tax Attributes)

**Matco** offered plan to monetize Tax Attributes by way of Investment Agreement, with imposition of terms & plan for future Corporate Opportunity – but no acquisition of *de jure* control

## *Deans Knight*

**FCA:** considered only whether abuse of s. 111(5) under GAAR

Statutory limitations on losses after acquisition of control specific, but not complete or comprehensive scheme

Historic justification

1963 Ministerial pronouncement

1988 GAAR commentary

## *Deans Knight*

### **Object, Spirit & Purpose**

Actual control (by way of *de jure* control or otherwise) supplants effective control

Loss restrictions not comprehensive scheme reflected in text of provisions

### **Transactions Frustrated Purpose**

Investment Agreement gave Matco “actual control” over taxpayer & “corporate opportunity”, which would not realistically be rejected

## *Deans Knight*

### **Comments on Outcome**

Justification for break with *Duha Printers*

FCA approach invitation to SCC to revisit control

Questions to consider

## 2. STATUTORY INTERPRETATION

## *Loblaw Financial Holdings Inc., 2021 SCC 51*

**Loblaw Financial** incorporated Barbados subsidiary in 1992, renamed Glenhuron Bank & regulated by Central Bank of Barbados & under local law

**Activities** within definition of “international banking business”

From 1992 to 2000, Loblaw Group members **contributed capital** & interest-free **debt** to Glenhuron, including around \$500M from Loblaw Financial

Glenhuron’s activities made up of: (1) trading short term debt securities; (2) asset management (for fees); (3) intercorporate loans; (4) independent operator loans; (5) interest rate and cross-currency swaps; & (6) equity forwards

## Loblaw Financial

**FAPI** includes *inter alia* income from property which encompasses CFA's income from **investment business**

Investment business defined broadly & includes business carried on by affiliate, principal purpose of which to derive income from property (interest, dividends, rents, royalties or similar/substitutes), subject to exceptions

Case concerned whether “**financial institution**” (FI) **exception** in s. 95(1) definition of “investment business” met

## *Loblaw Financial*

### **FI exception**

1. **Type of FI** – CFA carries on business as foreign bank, trust co., credit union, insurer, or trader/dealer in securities/commodities
2. **Oversight by regulatory body** – CFA regulated under foreign law
3. **Threshold level of activity** – CFA employs more than five full-time employees or equivalent in active conduct of business
4. **Arm's length requirement** – CFA business not conducted principally with persons with whom CFA does not deal at arm's length



## *Loblaw Financial*

**Tax Court:** FI exception inapplicable – flunked arm’s length requirement based on **Barbadian** definition of “international banking business”

**Federal Court of Appeal:** applied usual definition of business – activities that occupy time, attention & labour for purpose of earning profit; hence only Glenhuron’s income-earning activities should be considered

Most lucrative business was conducted with arm’s length persons, thus Loblaw Financial fit within FI exception

**Supreme Court:** “The dispute in this case comes down to the meaning of the phrase ‘**business conducted principally with**’ within the arm’s length requirement, and specifically whether **providing corporate capital** and **exercising corporate oversight** amount to conducting business with a foreign affiliate.”

## *Loblaw Financial*

Raising capital necessary to any business, to **enable** business **to be conducted**;  
but contributing capital is **not conducting** said business

Corporate oversight **not** conducting business

Glenhuron's most lucrative activities generated 86% of income from dealings with  
**arms' length** parties, thus critical criterion met

But what's **really** interesting about *Loblaw Financial*?

## *Loblaw Financial*

Pendulum of statutory interpretation

Permutations of modern rule

TCP

Both cited in *Loblaw Financial*

Where the rubber hits the road is in determining the relative weight to be afforded to the text, context and purpose

Where the words of a statute are “precise and unequivocal”, their ordinary meaning will play a dominant role

In the taxation context, a “unified textual, contextual and purposive” approach continues to apply

## *Loblaw Financial*

In applying this unified approach, however, the particularity and detail of many tax provisions along with the *Duke of Westminster* principle ... lead us to focus carefully on the text and context in assessing the broader purpose of the scheme

This approach is particularly apposite in this case, where the provision at issue is part of the highly detailed and precise FAPI regime. If taxpayers are to act with any degree of certainty under such a regime, then full effect should be given to Parliament's precise and unequivocal words

## *Bank of Nova Scotia, 2021 TCC 70*

**Losses** carried back & **interest** under s. 161(7): when does interest clock stop?

2015 audit: proposed 2006 adjustment & request to carry back loss from 2008

161(7)(a) establishes interest on tax payable, ignoring deduction/reduction

161(7)(b) deemed payment date – 30 days after later of four possible dates

(ii) the day on which the taxpayer's ... return of income for that subsequent taxation year was filed (in this case 2008)

(iv) where, **as a consequence** of a request in writing, the Minister reassessed the taxpayer's tax for the year to take into account the deduction or exclusion, the day on which the request was made (in this case 2015?)

## Other Statutory Interpretation Cases

- *Robillard*, 2022 CCI 17
- *Canadian Imperial Bank of Commerce*, 2021 TCC 71 (under appeal)
- *Canada North Group Inc.*, 2021 SCC 30

### 3. CRA AUDIT POWERS

# Proposed Legislative Responses to Recent Cases

- *Cameco Corporation*, 2019 FCA 67
  - proposed amendments to para. 231.1(1)(c) – requirement to answer all proper questions
- *BP Canada Energy Company*, 2017 FCA 61
  - proposed s. 237.5 - reportable uncertain tax treatments
  - proposed s. 237.4 – notifiable transactions
  - proposed amendments to s. 237.3 – reportable transactions

How will the courts react to these amendments?



## *BMO NESBITT BURNS INC., 2022 FC 157*

Minister seeks production of unredacted Master Summary Pricing Model (MSPM).

BMONB argues MSPM constitutes tax accrual working papers (TAWPs) and that legal advice is revealed by what is being computed and how.

**Federal Court on Privilege:** “The MSPM reflects the operational implementation, outcome or end product of legal advice provided.” An end product is not privileged unless it discloses the “very legal advice” provided. BMONB has not established that the MSPM would disclose the legal advice provided.

## BMO NESBITT BURNS INC., 2022 FC 157

### OTHER ARGUMENTS:

1. Too late because audit is over? No time limit on use of section 231.1.
2. Although MSPM is to some extent a TAWP, it is relevant to a specific item under audit and does not impose an obligation to self-audit.
3. Tax Court Rules do not assist in the interpretation of the scope of the Minister's powers under section 231.1 of the *Income Tax Act*.

## 4. CONCLUDING REMARKS

Q&A

# ***INTEREST DEDUCTIBILITY AND HYBRID MISMATCH RULES***

## **SPEAKERS:**

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# EXCESSIVE INTEREST AND FINANCING EXPENSES LIMITATION (“EIFEL”)

## INTRODUCTION AND OVERVIEW

- Legislation released on February 4, 2022 to implement 2021 budget proposal to limit deduction for interest and financing expenses
- Regime intended to be consistent with recommendation of Action 4 report of OECD BEPS Action Plan
- Generally applicable for taxation years that begin on or after January 1, 2023 (subject to certain anti-avoidance rules)

# INTRODUCTION AND OVERVIEW

Who do the rules apply to?

- Any corporation or trust other than an “excluded entity”
- Excluded entities:
  - Small CCPCs
  - Members of related groups whose total “Interest and financing expenses” (IFE) less its “interest and financing revenues” (IFR) is less than \$250k
  - Corporations and trusts that individually and together with all eligible group entities carry on all business in Canada, that do not have foreign affiliates or non-resident specified shareholders or beneficiaries and that do not pay IFE to tax indifferent investors



# INTRODUCTION AND OVERVIEW

What do the rules do?

- Deny the deduction of IFE for a proportion of the IFE incurred (directly and not through a partnership)
- Proportion equal to excessive IFE divided by total IFE
- Excessive IFE being the IFE less permissible IFE less IFR (ignoring “absorbed capacity” and “received capacity”)
- Permissible IFE can be calculated in two ways (1) using the fixed “ratio of permissible expenses” (RPE) (30%) or (2) the group ratio, in each case multiplied by “adjusted taxable income” (ATI)

# INTRODUCTION AND OVERVIEW

## Reducing Excessive IFE With Excess Capacity

- Excessive IFE can be reduced with absorbed capacity and received capacity
- Absorbed capacity is negative amounts of excessive IFE from prior years
- Received capacity is negative amounts of excessive IFE transferred to an eligible group corporation from another eligible group corporation

# INTRODUCTION AND OVERVIEW

Is there anything else?

- Special rules for partnerships could result in income inclusion under s.12(1)(l.2) for partner's share of excessive IFE incurred by partnership
- Election to exclude from IFE and IFR interest paid between eligible group corporations
- Requirement to exclude from IFR amounts received from non-arm's length persons or partnerships
- "Restricted interest and financing expenses" can be carried forward 20 years
- Numerous anti-avoidance rules

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses

- Deductibility of IFE subject to potential denial under the EIFEL rules
- Added back in computing ATI
- Components of IFE
  - a. Interest, other than non-deductible interest and excluded interest
  - b. Other deductible financing costs – s.20(1)(e)(ii), s.20(1)(e)(ii.1), s.20(1)(e)(ii.2), s.20(1)(e.1), 20(1)(e.2) and s.20(1)(f)
  - c. Portion of CCA and resource pool deductions that is attributable to capitalised interest and financing costs - inclusion is for the year in which deduction is claimed, not for the year in which the expense was capitalised

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses (cont'd)

### ◦ Components of IFE (cont'd)

- d. Amounts paid or payable, or a loss or capital loss, under or as a result of an agreement or arrangement, where:
  - The amount is otherwise deductible (but not under s.20(1)(e)(i)) in computing income for the year, or in the case of a capital loss, if claimed as an offset to taxable capital gains in the year
  - The agreement or arrangement is entered into as or in relation to a borrowing, or other financing entered into, by the taxpayer, and
  - The amount can reasonably be considered to be part of the cost of funding of the taxpayer or NAL person

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses (cont'd)

### ◦ Components of IFE (cont'd)

- e. Expenses incurred in relation to derivatives in paragraph (d) (such as fees payable under the arrangement or costs incurred to enter into the arrangement)
- f. Lease financing amount, other than for excluded lease - imputes a financing cost to lessees in respect of their lease payments
- g. Pro-rata share of financing expenses of a partnership, less amounts specifically added back or denied under at-risk rules
- h. Portion of limited partnership loss deducted that is attributable to partnership's financing costs that was excluded in a prior year

Less: B - amounts received by the taxpayer under certain derivative arrangements described in paragraph (d) provided they are (i) included in income and (ii) reduce funding costs of the taxpayer or NAL person

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses (cont'd)

- Related anti-avoidance rules
- Proposed s.18.2(13) – very broad anti-avoidance rule for interest expenses
  - An amount that would otherwise not be included in interest and financing expenses must be so included if:
    - The amount arises in the course of a transaction or series, and
    - It can reasonably be considered that “one of the purposes” of the transaction is to cause the amount not to be included in interest and financing expenses

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Revenues

- IFR increases the amount of IFE deductible under the EIFEL rules
- IFR included in computing a taxpayers' excess capacity
  - a. Interest received, other than excluded interest, that is included in computing income
  - b. Guarantee fees received



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- c. Amounts received or receivable, or a gain as a result of an agreement or arrangement, where:
  - The amount is included in computing income for the year
  - The agreement or arrangement is entered into as or in relation to a loan made, or other financing provided, by the taxpayer, and
  - The amount can reasonably be considered to increase the taxpayer's return with respect to a debt obligation owing to the taxpayer

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Revenues (cont'd)

- d. Lease financing amounts received, other than on excluded lease
- e. Pro-rata share of financing revenues of a partnership

Less: (B) expenses and losses, including a capital loss to the extent it reduces a taxable capital gain, on derivatives that reasonably can be considered to reduce the taxpayer's return on a debt obligation owing to the taxpayer

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- Related anti-avoidance rules
  - Proposed s.18.2(12) - related party interest income exclusion
    - No amount receivable from a NAL person or partnership is included in interest and financing revenues, except to the extent that it is included in computing the interest and financing expenses of a taxable Canadian corporation or Canadian resident trust that is subject to tax under Part I

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- Related anti-avoidance rules (cont'd)
  - Proposed s.18.2(14) – very broad anti-avoidance for interest and financing revenues
    - Amount that would otherwise be interest and financing revenues must be excluded if:
      - The amount arises in the course of a transaction or series, and
      - One of the purposes of the transaction is to increase the taxpayer's interest and financing revenues in order to obtain a tax benefit

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Revenues (cont'd)

- Related anti-avoidance rules (cont'd)
  - Effect on borrowings by taxpayer to on-lend to another group entity, including foreign affiliates?
  - Effect on borrowings by taxpayer to on-lend to another Canadian entity that capitalize the interest expense?
  - Effect on loss consolidation transactions involving partnerships or trusts?

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses and Revenues – Observations

- Not clear if IFR includes deemed interest income (e.g., s.17, PLOI loans, etc.), and amounts included in income or foreign affiliate dividends for which s.113 deduction denied under proposed hybrid mismatch rules
- As currently drafted, IFE and IFR of taxpayer do not include FAPI interest expense or revenue, and are not excluded from the calculation of ATI
- Treatment of hedging gains in variable B of IFE definition

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Excluded Interest

- Two taxable Canadian corporations may jointly elect that one or more interest payments between them in a taxation year be “excluded interest”, where:
  - The Interest is paid or payable in respect of a debt owed by the payer corporation to the payee corporation throughout the period during which the interest accrued, and
  - The payee corporation is an eligible group corporation in respect of the payor corporation
- Intended to ensure the EIFEL rules do not negatively impact loss consolidation transactions but not limited to such transactions

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Excluded Interest (cont'd)

- Excluded interest is:
  - Not included in payer corporation's IFE
  - Not included in payee's IFR – limits ability to use such revenues to shelter payee's interest expense or increase payee's excess capacity
- As currently drafted, the excluded interest election is not available:
  - to partnerships, trusts or non-residents, or
  - for payments that are not interest



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Adjustable Taxable Income

- ATI is the basis for calculating a taxpayer's interest deductibility capacity ("tax-EBITDA")

A	+	B	-	C
Taxable income for the year		IFE (and RIFE from a prior year deducted in the current year)		IFR
<b>LESS</b> non-capital loss and net capital loss for the year		CCA claimed for the year		Foreign source income (if sheltered by foreign tax credits)
		Portion of the taxpayer's non-capital loss for another year (if this reasonably related to net interest and financing expenses deducted in that other year)		Share of income and taxable gains allocated to the taxpayer from a trust
		Part VI.1 tax deducted		Excess portion of interest and financing expense of a partnership  Other amounts of taxable income of the taxpayer not subject to tax under Part I

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Adjustable Tax Income – Observations

- Complex formulaic calculation which will require the calculation of taxable income as the starting point
- A portion of non-capital losses that do not relate to IFE in the year they arose (and all net capital losses) never increase ATI, even in the year they are utilized, leading to a reduction in ATI twice for these losses
- Dividends from other Canadian corporations and foreign affiliates are automatically excluded due to the starting point being taxable income

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Carry Forward Rules

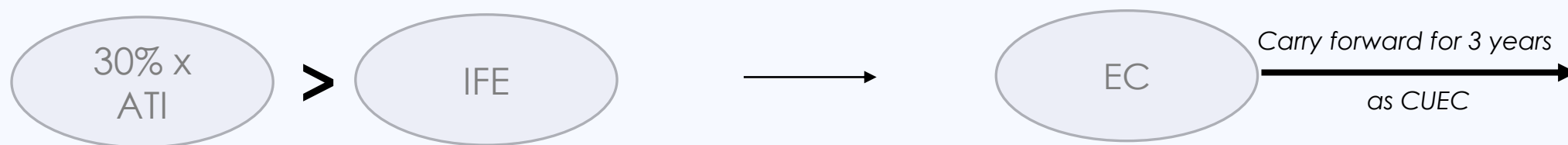
- Restricted Interest and Financing Expenses (“RIFE”)
  - Broadly arises where you do not have sufficient capacity in the year to deduct interest when compared with your actual interest and financing expenses for the period
  - Can be carried forward for 20 years
  - May be possible to deduct in a later period (within 20 years) if that period has an excess of capacity to deduct interest
- Broadly...



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Carry Forward Rules (cont'd)

- Excess Capacity ("EC")
  - Broadly arises where you have an excess of capacity in the year to deduct interest when compared with your actual interest and financing expenses for the period – i.e. "headroom" on deductibility
  - Can be carried forward from the preceding 3 years as Cumulative Unused Excess Capacity ("CUEC")
  - Can be transferred to other eligible group corporations through a joint election
  - There are ordering rules which require a company to automatically use its own cumulative unused excess capacity in a later year if it has an interest restriction in that later year (i.e. using it as absorbed capacity before receiving capacity from other entities)
  - If the group ratio election is made for a year, the excess capacity for that year is deemed to be nil
- Broadly...



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Carry Forward Rules – Observations

- The current draft rules require the same Canadian tax reporting currency in each group entity in order for two (or more) entities to transfer capacity amongst group members (or to share in the group ratio allocation)
- Financial institutions cannot transfer excess capacity (nor make the group ratio election)
- Loss restriction events result in the expiry of cumulative unused excess capacity - this may be a concern where there is a change of control above Canada, although the debt profile of Canada itself may not change as a result of the change of control
- The rules include transitional provisions for the “pre-regime” years to enable taxpayers to carry forward up to 3 years of excess capacity into the regime

# GROUP RATIO RULE

## Overview

- Intended to allow for deductible IFE in excess of fixed ratio based on third party interest expense of the consolidated group
- Elective regime that replaces excess capacity mechanism
  - Capacity calculated at group level and allocated among group members
- Legislative framework
  - s.18.21(1) – Definitions
  - s.18.21(2) – Conditions for application
  - s.18.21(3) – Allocation of group ratio amount
  - s.18.21(4) – Use of accounting terms
  - s.18.21(5) – Single member group

# GROUP RATIO RULE

## Conditions for Application (s.18.21 (2))

1. Must have a consolidated group (subject to single entity rule in s.18.21 (5))
  - Consolidated group defined as ultimate parent and all entities that are fully consolidated in that parent's consolidated F/S
  - Cannot apply regime to consolidated subgroup (i.e. a group that does not include the ultimate parent)
  - Consolidated group can have foreign parent(s), foreign sister(s)/brother(s) and/or foreign affiliates
2. Each related or affiliated Canadian corporation and trust in the consolidated group (i.e., each "Canadian group member"):
  - Must be a taxable Canadian corporation or trust resident in Canada
  - Must have the same taxation year as the ultimate parent of the consolidated group
  - Must have the same tax reporting currency

## GROUP RATIO RULE

### Conditions for Application (s.18.21(2)) (cont'd)

3. Cannot have a “relevant financial institution” as a Canadian group member
  - Bank, insurance corporation, mutual fund corporation or trust, etc.
  - Broadly defined
4. Must have audited consolidated F/S prepared based on acceptable accounting standards – IFRS or Canadian/US/certain other jurisdiction GAAP
5. Each Canadian group member must jointly elect



## GROUP RATIO RULE

### Computation/Allocation of Group Ratio Amount (s.18.21(3))

- Group ratio amount can be allocated among each Canadian group member on a discretionary basis
- Allocation is made as part of joint election
- Total of allocated amounts cannot exceed lesser of:
  - “Group ratio” of consolidated group X aggregate ATI of all Canadian group members;
  - “Group net interest expense” of the consolidated group; and
  - Total ATI of Canadian group members

## GROUP RATIO RULE

Computation/Allocation of Group Ratio Amount (s.18.21(3)) (cont'd)

- Computation of group ratio
  - Group net interest expense (“GNIE”) divided by group adjusted net book income (“GANBI”)
- Decreasing proportionate capacity for ratios exceeding 40%

## GROUP RATIO RULE

Computation/Allocation of Group Ratio Amount (s.18.21(3)) (cont'd)

- GNIE:
  - “Specified interest expense” of consolidated group minus “specified interest income” of consolidated group
  - Adjusted for amounts to/from “specified non-members” (non-consolidated entities that nonetheless have a significant connection with the group (non-arm’s length or 25% votes or value))

## GROUP RATIO RULE

### Computation/Allocation of Group Ratio Amount (s.18.21(3)) (cont'd)

- GNIE (cont'd):
  - “Specified interest expense”
    - Total of consolidated interest expense, capitalized interest, and guarantee or similar fees, plus same amounts for equity-accounted entities; less any dividends included in the foregoing
    - Dividends excluded on the basis that shares of corporations may be treated as debt for financial reporting purposes
  - “Specified interest income” involves similar calculation

## GROUP RATIO RULE

Computation/Allocation of Group Ratio Amount (s.18.21(3)) (cont'd)

- GANBI:

- Consolidated net income

- +/- specified interest expense/revenue

- +/- income tax expense/recovery

- + book depreciation

- +/- gains and losses from disposition of fixed assets

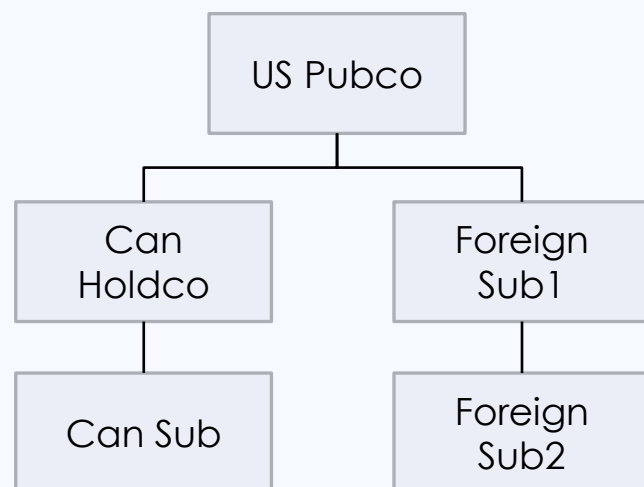
- +/- charges for fixed asset impairment

## GROUP RATIO RULE

### Issues and Observations

- Potential distortions for accounting-based income/expenses
  - e.g., stock-based comp, unrealized FX gains/losses
- Identification of possible consolidated group(s)
- Group ratio not available for non-residents, even if subject to Part I tax in Canada

## Group Ratio Rule – Example



### Facts

- US Pubco has audited F/S that consolidate its Canadian and foreign subsidiaries
- Financial information:

	Consolidated F/S Amounts	Legal entity	
		Can Holdco	Can Sub
Consolidated net income	1,000	N/A	N/A
Taxable income	N/A	-	200
Interest expense	500	-	95
Capitalized interest	10	-	-
Interest income	10	-	2
Income tax expense	150	N/A	N/A
Depreciation	20	-	5

## Group Ratio Rule – Example

Facts	Consolidated F/S Amounts	Legal entity	
		Can Holdco	Can Sub
Consolidated net income	1,000	N/A	N/A
Taxable income	N/A	-	200
Interest expense	500	-	95
Capitalized interest	10	-	-
Interest income	10	-	2
Income tax expense	150	N/A	N/A
Depreciation	20	-	5

Computation of group ratio			
GNIE			
Specified interest expense			
Consolidated interest expense	510		
Specified interest income			
Consolidated interest income	(10)		
	500	A	
GANBI			
Consolidated net income	1,000		
Specified interest expense	500		
Specified interest income	(10)		
Depreciation	20		
	1,510	B	
Group ratio [A / B]	33.1%		
Allocation of group ratio			
Can Holdco	Nil	(Cannot exceed ATI of Can Holdco)	
Can Sub			
ATI	298	(200 + 95 - 2 + 5)	
Group ratio	33.1%		
Maximum deductible amount	99		
IFE deduction limited to:	95	(Actual amount incurred)	



## Example – Carry Forward Rules

### Facts

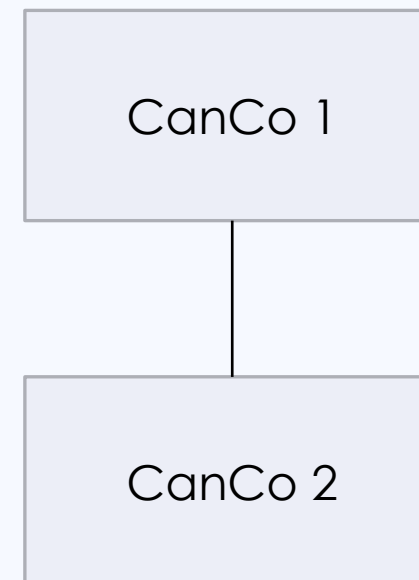
- There are two eligible group corporations – CanCo 1 and CanCo 2 – which are not financial institutions

### CanCo 1

- CanCo 1 has RIFE brought forward from 2023 of \$10m and no brought forward excess capacity for years preceding 2023
- CanCo 1 is assumed to have IFE of \$15m per year
- CanCo 1's based deduction capacity changes year-on-year as shown

### CanCo 2

- CanCo 2 has no IFE or ATI for 2024 through to 2026
- In 2027 and 2028, it incurs IFE of \$20m
- CanCo 2 has no ATI of its own in 2027 and has base deduction capacity in 2028 of \$10m



## Example – Carry Forward Rules (cont'd)

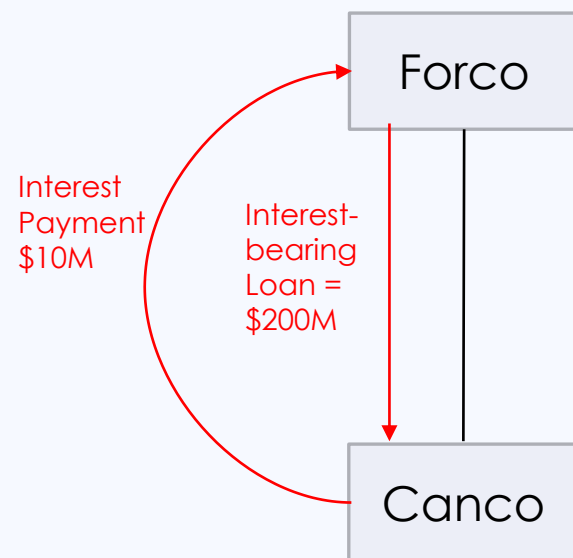
	CanCo 1 (2024)	CanCo 1 (2025)	CanCo 1 (2026)	CanCo 1 (2027)	CanCo 1 (2028)
RIFE brought forward (C)	\$10m	-	-	-	-
RIFE permitted to be deducted in current year	(\$10m)	-	-	-	-
RIFE carried forward	-	-	-	-	-
<b>Current year facts:</b>					
Base deduction capacity (Fixed ratio x ATI) (A)	\$50m	\$35m	\$5m	\$30m	\$nil
IFE (B) – assumed \$15m per taxation year	\$15m	\$15m	\$15m	\$15m	\$15m
<b>Permissible interest deduction in the current year:</b>					
Current year IFE permitted to be deducted (i.e. sufficient capacity)	\$15m	\$15m	\$5m	\$15m	-
Absorbed capacity utilized	-	-	\$10m	-	\$15m
RIFE permitted in current year	\$10m	-	-	-	-
<b>Current year deduction allowed for IFE</b>	<b>\$25m</b>	<b>\$15m</b>	<b>\$15m</b>	<b>\$15m</b>	<b>\$15m</b>
<b>Cumulative unused excess capacity:</b>					
Cumulative unused excess capacity brought forward (from prior 3 years)	-	\$25m	\$45m	\$35m	\$30m
Excess capacity for current year (A-B-C)	\$25m	\$20m	-	\$15m	-
Transferred capacity (by 18.2(4) election) to CanCo 2	-	-	-	(\$20m)	(\$10m)
Absorbed capacity (utilized)	-	-	(\$10m)	-	(\$15m)
<b>Cumulative unused excess capacity carried forward</b>	<b>\$25m</b>	<b>\$45m</b>	<b>\$35m</b>	<b>\$30m</b>	<b>\$15m</b>

## Example – Carry Forward Rules (cont'd)

	CanCo 2 (2027)	CanCo 2 (2028)
RIFE brought forward (C)	-	-
RIFE permitted to be deducted in current year	-	-
RIFE carried forward	-	-
<b>Current year facts:</b>		
Base deduction capacity (Fixed ratio x ATI) (A)	-	\$10m
IFE (B) – assumed \$15m per taxation year	\$20m	\$20m
<b>Permissible interest deduction in the current year:</b>		
Current year IFE permitted to be deducted (i.e. sufficient capacity)	-	\$10m
Absorbed capacity utilized	-	-
Transferred in capacity (by 18.2(4) election) from CanCo 1	\$20m	\$10m
RIFE permitted in current year	-	-
<b>Current year deduction allowed for IFE</b>	<b>\$20m</b>	<b>\$20m</b>
<b>Cumulative unused excess capacity memo:</b>		
Cumulative unused excess capacity brought forward (from prior 3 years)	-	-
Excess capacity for current year (A-B-C)	-	-
Transferred out capacity (by 18.2(4) election)	-	-
Absorbed capacity (utilized)	-	-
<b>Cumulative unused excess capacity carried forward</b>	<b>-</b>	<b>-</b>

Through transferring capacity from CanCo 1, CanCo 2 achieves a full deduction for its IFE in 2027 and 2028, even though its base deduction capacity is below its IFE in both years

## Example – Interaction with Thin Capitalization rules



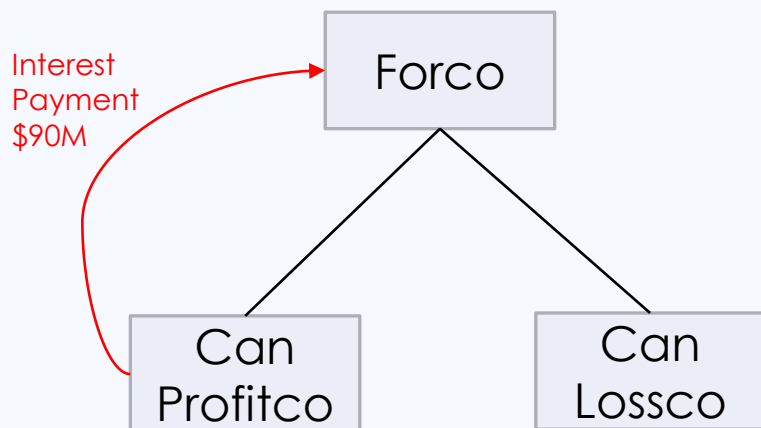
### Facts

- Canco's equity amount for the year = \$100M
- Canco's taxable income (before interest payment) = \$20M
- Canco's interest expense paid to Forco = \$10M

### Implications

- Interest denied (and deemed dividend) under s.18(4) = \$2.5M
- IFE = \$10M - \$2.5M = \$7.5M
  - Ratio of permissible expenses = 30% (40% initially)
  - 18.2(2) = no deduction to the extent of the proportion of  $(A - (B + C + D + E)) / A$ , where:
    - $A = 7.5M$
    - $B = 30\% \times 20M = 6M$
    - $C = 0$
    - $D = 0$
    - $E = 0$
    - 1.5M/7.5M of interest denied under 18.2(2), i.e., \$1.5M of interest denied

## Example – Loss Consolidation and Excluded Interest



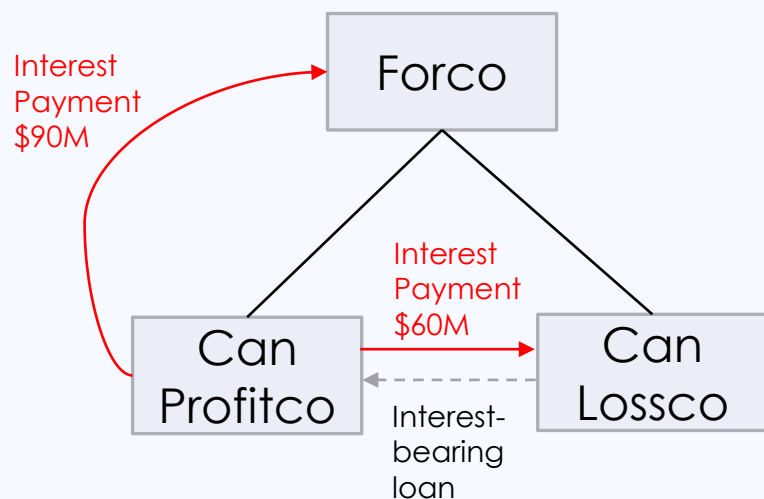
### Facts

- Can Lossco's loss (generated from business activities) = \$60M
- Can Profitco's taxable income (before interest payment) = \$300M
- Can Profitco's interest expense paid to Forco = \$90M
- Assume s.18(4) do not limit deduction of interest expense paid to Forco due to Can Profitco having sufficient equity amount

### Implications

- Ratio of permissible expenses = 30% (40% initially)
- 18.2(2) = no deduction to the extent of the proportion of  $(A - (B + C + D + E)) / A$ , where:
  - $A = 90M$
  - $B = 30\% \times 300M = 90M$
  - $C = 0$
  - $D = 0$
  - $E = 0$
  - 0/90 of interest denied under 18.2(2) (i.e., none denied)

## Example – Loss Consolidation and Excluded Interest



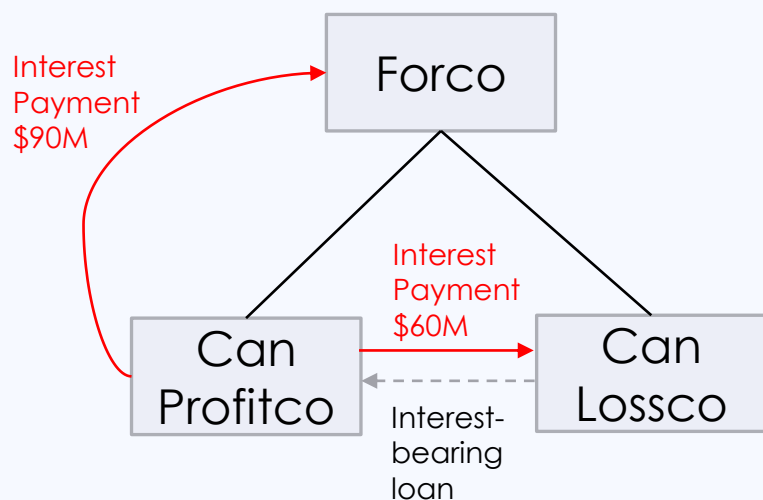
### Facts

Same facts as previous slide, but implement preferred share debt loop where Can Lossco makes interest-bearing loan to Can Profitco to subscribe for Can Lossco preferred shares with a dividend rate that slightly exceeds interest rate on interest-bearing loan. Can Profitco pays 60M interest to Can Lossco on interest-bearing loan.

### No Excluded Interest Election

- Can Lossco's excess capacity =  $G - H \times I$ 
  - $60M - 30\% \times 60M = 42M$
- 42M transferred to Can Profitco under 18.2(4)
  - Requires an election to transfer
- 18.2(2) = no deduction to the extent of the proportion of " $(A - (B + C + D + E)) / A$ ", where:
  - $A = 90M + 60M = 150M$
  - $B = 30\% \times 300M = 90M$
  - $C = 0$
  - $D = 42M$
  - $E = 0$
  - 18/150 of interest denied under 18.2(2)

## Example – Loss Consolidation and Excluded Interest



### Excluded Interest Election

- 60M is not considered IFE of Can Profitco and IFR of Can Lossco
- Can Lossco's excess capacity =  $G - H \times I$ 
  - $0 - 30\% \times 0 = 0$
- Can Profitco's adjusted taxable income = \$240M
- 18.2(2) = no deduction to the extent of the proportion of " $A - (B + C + D + E) / A$ ", where:
  - $A = 90M$
  - $B = 30\% \times 240M = 72M$
  - $C = 0$
  - $D = 0$
  - $E = 0$
  - 18/90 of interest denied under 18.2(2)
  - 60M interest paid to Can Lossco is not subject to the limitation in 18.2(2)

# APPLICATION TO PARTNERSHIPS

Corp A

20%

Partnership  
ABC

Taxable Income = \$70  
IFE = \$30  
IFR = \$0

IFE = \$100  
IFR = \$25  
Income = \$50

Corp A

IFE = \$30 + \$20 = \$50

IFR = 0 + \$5 = \$5

ATI = \$70 + \$10 + \$50 - \$5 = \$125

**Excessive IFE Proportion** =  $\$(50 - (.3)(125) - 5) / 50$

= 15%

Denied Interest  
18.2(2)

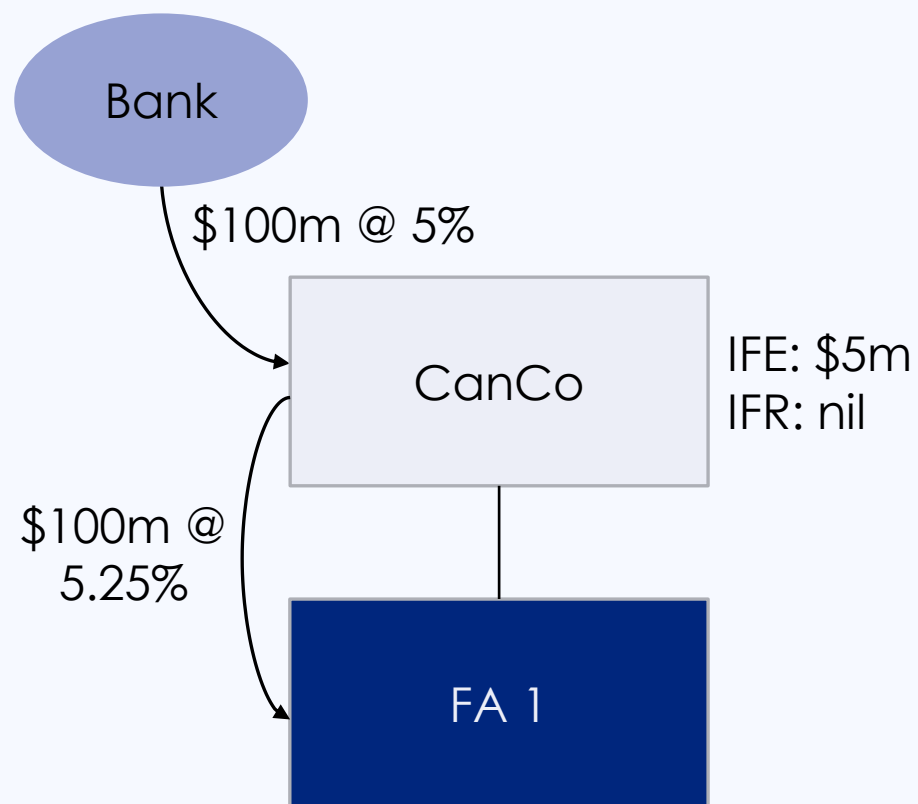
=  $.15 \times 30 = \$4.50$  → Both amounts added to

12(1)(1.2) inclusion

=  $.15 \times 20 = \$3.00$  → RIFE



## Example – Back-to-Back Loan With a Foreign Affiliate



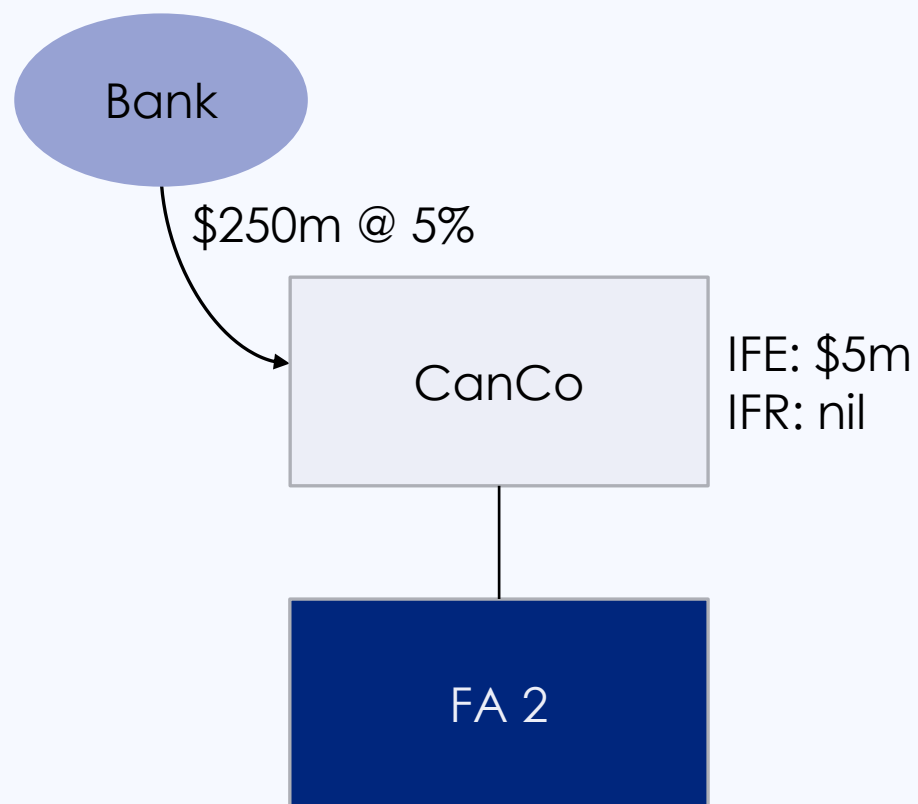
### Facts

- CanCo has a wholly-owned foreign affiliate, FA1
- CanCo borrows \$100m from an external lender, with an interest rate of 5%, to finance FA1 with debt, with an interest rate of 5.25% - leading to net interest income in CanCo of \$250k

### Observations

- There is no indication currently as to how the EIFEL rules are expected to apply to FA1 itself as a foreign affiliate
- For CanCo, as the rules are currently drafted, 18.2(12) provides a broad exclusion from including interest income in interest and financing revenues from a related entity (which is not a Canadian entity). Depending on the EBITDA-capacity, this could lead to a denial of interest, even though CanCo is in a net interest income position economically.

## Example – CanCo Borrows to Fund Acquisition of FA shares



### Facts

- CanCo borrows \$250m to acquire the shares of a new foreign affiliate, FA2
- The external loan bears interest at a rate of 5%, leading to an interest expense of \$12.5m for CanCo

### Observations

- Subject to EBITDA-capacity in CanCo, or other Canadian group entities, CanCo may be subject to an interest restriction on the borrowing to acquire FA2's shares and may need to consider the most tax-efficient holding entity to acquire future FAs

# ANTI-HYBRID RULES

# ANTI-HYBRID RULES

## Overview

- Proposed legislation released April 29, 2022, first of two legislative packages
- Intended to neutralize deduction/non-inclusion outcomes associated with:
  - Three types of hybrid mismatch arrangements
  - Foreign deductions for notional interest expense
- Rules proposed to apply effective July 1, 2022, with submissions requested by June 30, 2022 (1 day before effective date!)
- Proposed legislation for second package to follow, with rules to apply no earlier than 2023

# ANTI-HYBRID RULES

## Key Elements

- Definitions – s.18.4(1)
- Interpretational rule – s.18.4(2)
  - Rules explicitly intended to implement and be consistent with chapters 1 and 2 of BEPS Action 2 Report, as amended
- Primary rule – s.18.4(3)/(4)
  - Denial of Canadian deduction to the extent it exceeds foreign/Canadian income inclusion
  - Mismatch amount determined under s.18.4(6)(a)/18.4(7)(a)
  - s.18.4(8) – No double counting of income inclusion
  - s.18.4(9) – Deeming rule for notional interest expense on debt

## ANTI-HYBRID RULES

### Key Elements (cont'd)

- Secondary rule – s.12.7
  - Canadian income inclusion where foreign deduction exceeds Canadian/foreign income inclusion
  - s.12.7(1) – Definitions by reference to s.18.4(1)
  - s.12.7(2)/(3) – Operative rules
  - Mismatch amount determined under s.18.4(6)(b)/18.4(7)(b)
  - s.18.4(8) – No double counting of income inclusion

# ANTI-HYBRID RULES

## Key Elements (cont'd)

- Types of hybrid mismatch arrangements – s.18.4(10)-(15)
  - s.18.4(10)/(11) – Hybrid financial instrument arrangements
  - s.18.4(12)/(13) – Hybrid transfer arrangements
  - s.18.4(14)/(15) – Substitute payment arrangements
- Supporting rules – 18.4(16)-(19)
- Anti-avoidance rule – 18.4(20)
  - Potentially applies where one of the main purposes of a transaction/series is to avoid the application of the rules or to limit the consequences of the rules

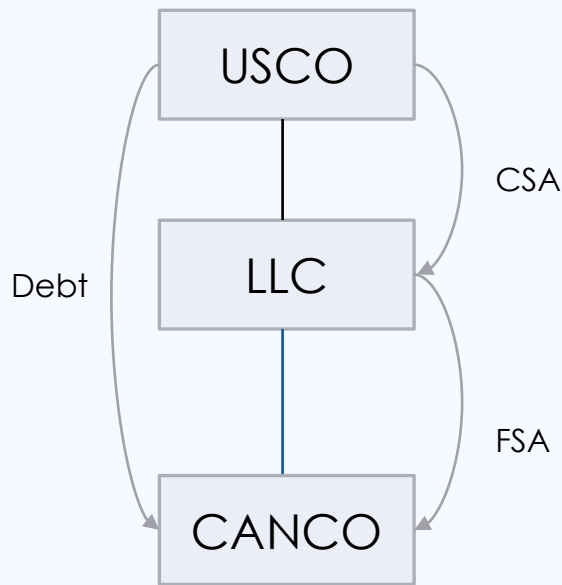
## ANTI-HYBRID RULES

### Key Elements (cont'd)

- Relief for no awareness/benefit under structured arrangement – s.18.4(5)
- Relief for foreign income inclusion – s.20(1)(yy)
  - Allows a deduction where deduction previously denied under primary rule and taxpayer subsequently demonstrates that an amount has been included in foreign income
- Dividend deduction denial rule – s.113(5)
  - s.113 deduction denied to the extent dividend is deductible in foreign jurisdiction
- Deemed dividend/WHT – s.214(18)
  - Denied interest under primary rule deemed to be a dividend subject to Canadian WHT

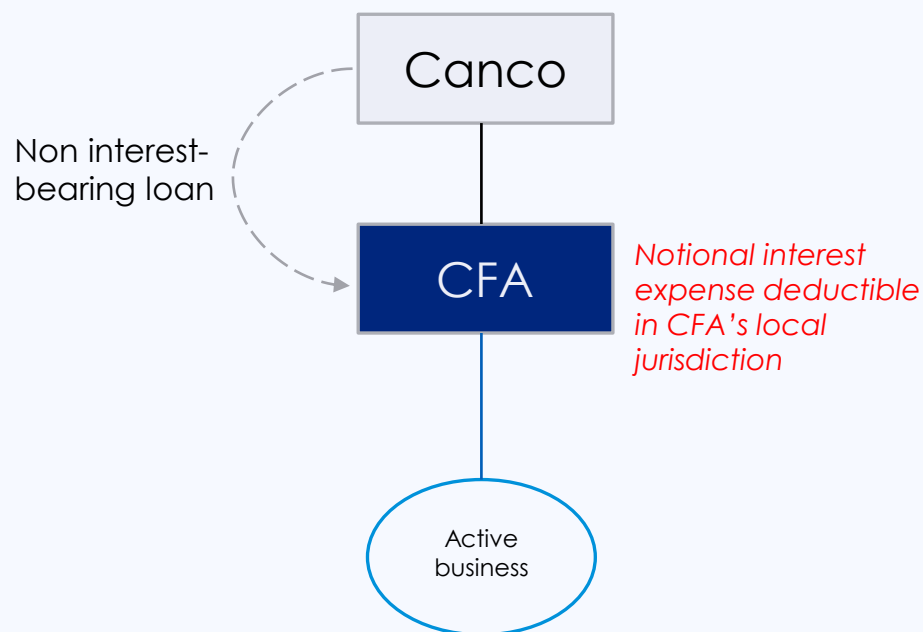


## Example – Inbound Hybrid Debt



- Typical inbound hybrid debt arrangement with loan, forward subscription agreement and capital support agreement (or guarantee)
- Deduction for interest in Canada, no inclusion in US so payment of interest gives rise to a deduction/ non-inclusion mismatch under s.18.4(6)(a)
- Other conditions in s.18.4(10) are satisfied so s.18.4(11) applies
- No deduction for payment to the extent of the hybrid mismatch amount under s.18.4(4) and that amount is deemed to be payment of a dividend under s.214(18)

# Example – Notional Interest Expense



## Assumptions

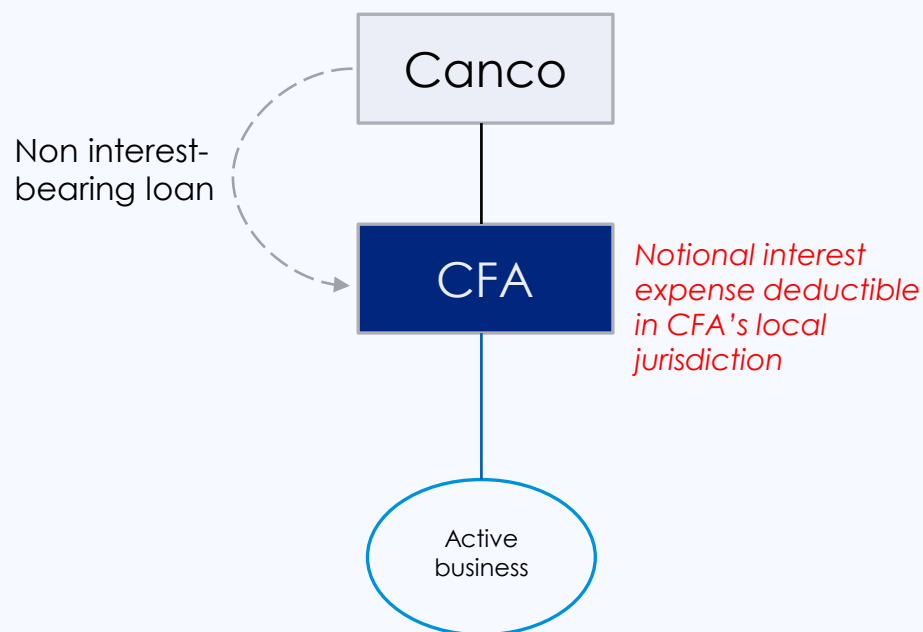
- Canco (a taxable Canadian corporation) makes a non-interest bearing loan to a CFA; CFA uses the borrowed money to earn income from an active business
- CFA is a resident in a jurisdiction that, through the operation of its transfer pricing rules (or otherwise), allows CFA to deduct an amount of notional interest expense for tax purposes corresponding to the rate of interest that would be charged by an arm's length party
- There is no corresponding income inclusion in Canada, as a result of the exceptions provided in s.17(8) and s.247(7)

## Analysis

The deduction in respect of a notional interest expense in the debtor jurisdiction gives rise to a deduction/non-inclusion mismatch under proposed s.18.4(6)(b) by operation of the deeming rules in proposed s.18.4(9)

- Proposed s.18.4(9)(a): debtor deemed to make a payment under the debt to the creditor equal to the deductible amount, and
- Proposed s.18.4(9)(b): deems the deductible amount to be in respect of the payment
- Proposed s.18.4(9)(c): does not apply in this case as Canco does not have an income inclusion in respect of the debt because of s.17(8) and s.247(7).
- Proposed s.18.4(9)(d): deems the mismatch to meet the causal condition in proposed s.18.4(10)(d)
- Other conditions in proposed s.18.4(10) are met

## Example – Notional Interest Expense (cont'd)



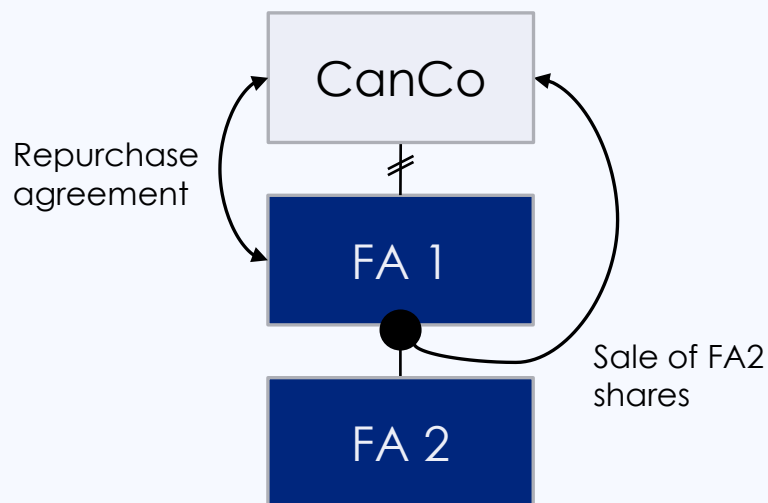
### Result

- The deemed payment is considered to arise under a hybrid financial instrument arrangement and proposed s.18.4(11) applies
- “Hybrid mismatch amount” = deductible amount in respect of the notional interest expense on the debt included in computing Canco's income per proposed s.12.7(3)

### Observations

- Proposed s.18.4(9) reflects a departure from the recommendations in the BEPS Action 2 Report
- Deductible amount is determined as if “foreign expense restriction rules” did not apply
- A “foreign expense restriction rule” is foreign tax rule that either has an effect, or is intended to have an effect, that is substantially similar to s.18(4) or proposed s.18.2(2); or implements Pillar Two
- “Notional interest expense” is not defined
- Explanatory Notes states: “A notional interest expense is one that does not have corresponding legal obligation to pay interest. Thus s.18.4(9) can apply, for example, where a country allows a debtor a deduction in respect of a low- or non-interest bearing debt as if the debtor had paid interest at a market rate”

## Example – REPO Transaction – Hybrid Transfer Arrangement

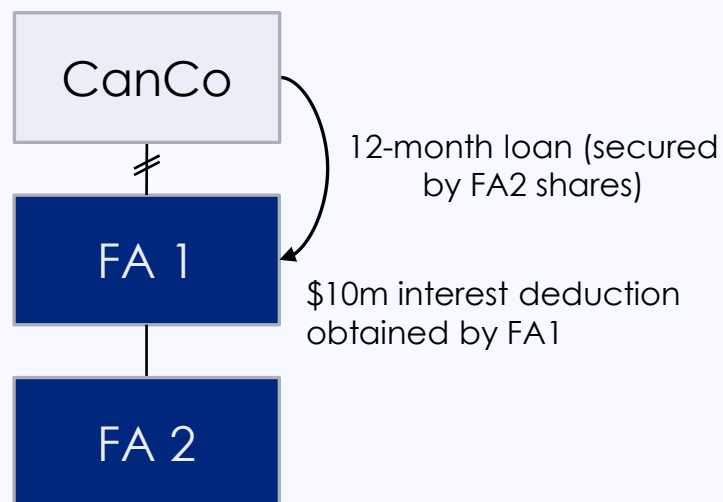


### Facts

- FA1 sells shares (may be preferred shares) of FA2 to CanCo for \$100m
- The FAs are both tax resident in Country X, a tax-treaty territory
- At the same time as the FA2 share sale, FA1 enters into an agreement to repurchase the FA2 shares from CanCo exactly one year later for \$110m (reduced by any dividends paid during the year)
- During the year FA2 pays a \$10m dividend which CanCo is entitled to receive as legal shareholder of FA2
- At maturity, FA1 repurchases the FA2 shares for the agreed price of  $\$110\text{m} - \$10\text{m} = \$100\text{m}$

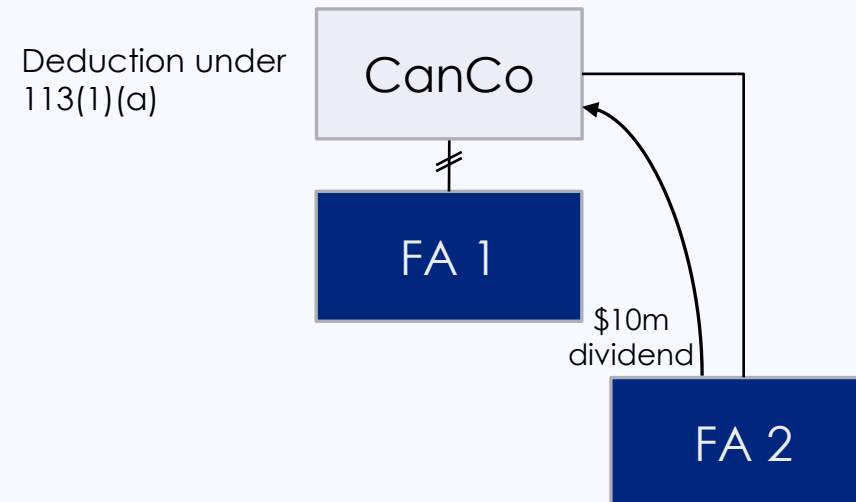
## Example – REPO Transaction – Hybrid Transfer Arrangement (cont'd)

### Country X Tax Treatment



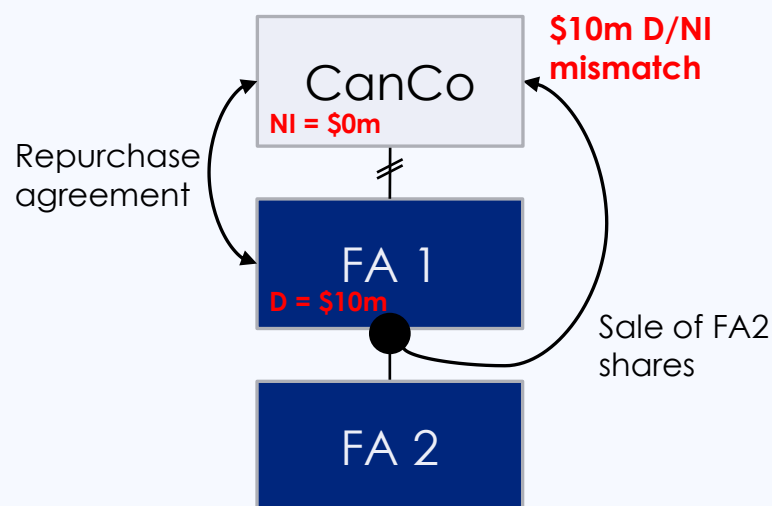
- Country X treats the series of transactions as a 12-month loan from CanCo to FA1, secured by the FA2 shares, on the basis that the substance of the overall arrangement is a financing arrangement between FA1 and CanCo
- Country X treats FA1 as the continued owner of FA2 shares and FA1 obtains a \$10m interest deduction in respect of the secured loan

### Canada Tax Treatment



- Canada treats the FA2 shares as being beneficially owned by CanCo during the year, as a result:
  - The \$10m dividend received is treated as taxable income in accordance with s. 90(1)
  - A deduction for the dividend received is obtained through s.113(1)(a) on the basis that FA2 is paying the \$10m dividend out of its exempt surplus

## Example – REPO Transaction – Hybrid Transfer Arrangement (cont'd)



### Application of the Hybrid Mismatch Rules

- The conditions of proposed 18.4(12) are met – i.e. the dividend paid arises under a **hybrid transfer arrangement** because:
  - There is a **transfer arrangement** involving the transfer of FA2 shares (which constitute a **financial instrument**)
  - The dividend is a **payment** arising under the transferred instrument
  - FA1 (transferor) does **not deal at arm's length** with CanCo (transferee)
  - A **deduction/non-inclusion mismatch** arises under 18.4(6) due to the \$10m interest deduction obtained by FA1 (**D**), but **no Canadian ordinary income** arises due to the 113(1)(a) deduction (**NI**) – the amount of the mismatch is \$10m
- As the \$10m interest expense deduction is a **foreign deduction component**, the conditions of 12.7(2) for the application of 12.7(3) are met. As a result, 12.7(3) includes **\$10m in CanCo's income**
- There is no denial of the s. 113(1)(a) dividend deduction
- **Note:** if Country X denies a deduction in respect of "interest" under its hybrid mismatch rules, there would be no D/NI mismatch as defined in 18.4(6) and no resulting 12.7(3) income inclusion

# RECENT CANADIAN AND INTERNATIONAL DEVELOPMENTS

## SPEAKERS:

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**Christopher Montes**, Felesky Flynn LLP, Calgary





## OUTLINE

1. Update on OECD/G20 International Tax Proposals
2. Update on International Tax Proposals in the US
3. Examples regarding Application of International Tax Proposals
4. 2022 Budget Potpourri
5. Questions



# UPDATE ON OECD/G20 INTERNATIONAL TAX PROPOSALS

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

# OECD/G20 Tax Proposals - Pillar One

137 of the 141 members of the OECD/G20 Inclusive Framework have agreed on certain key parameters of the two-pillar approach to international tax reform.

Pillar One is intended to shift taxing rights over certain large multinational corporate groups from residence jurisdictions to market jurisdictions

OECD has released public consultation documents on nexus and revenue sourcing (on Feb 4, 2022), tax base determinations (on Feb 18, 2022), scope of Amount A (on Apr 4, 2022), extractives exclusion (on Apr 14, 2022), and the regulated financial services exclusion (on May 6, 2022), all on a “without prejudice” basis. These documents “do not reflect final or consensus views” among members of the Inclusive Framework

- Amount A: 25% of residual profit (i.e. profit in excess of 10% of revenue, based on adjusted financial accounting income) will be allocated to market jurisdictions with nexus, using a revenue-based allocation key.
- Amount B: intended to simplify the application of the arm's length principle to baseline marketing and distribution activities

## OECD/G20 Tax Proposals - Pillar One

Pillar One will apply to about 100 of the world's largest MNEs (generally, groups with global revenues over EUR 20 billion, and pre-tax profit margins over 10% with a prior period test and an average test). Pillar One will include exclusions for Extractives and Regulated Financial Services.

Implementation of Pillar One will require removal of all Digital Services Taxes (DST) and other similar measures, but there is considerable uncertainty as to whether Pillar One will be adopted in the US (and other countries)

Canada is moving ahead with its alternative DST (payable on revenue earned in 2022 and subsequent taxation years) if Pillar One is not successfully adopted by the end of 2023. This may lead to retaliatory tariffs by the U.S.

The Canadian DST would apply to entities/groups with global revenue of at least EUR 750 million in a calendar year not earlier than 2022, and more than \$20 million of in-scope revenue from Canadian users.

## OECD/G20 Tax Proposals - Pillar Two

Pillar Two is intended to ensure that large multinational enterprises pay a minimum tax of 15% on income arising in each jurisdiction.

Model Rules were released by the OECD on Dec 20, 2021. Commentary to the Model Rules and illustrative examples were published on March 14, 2022.

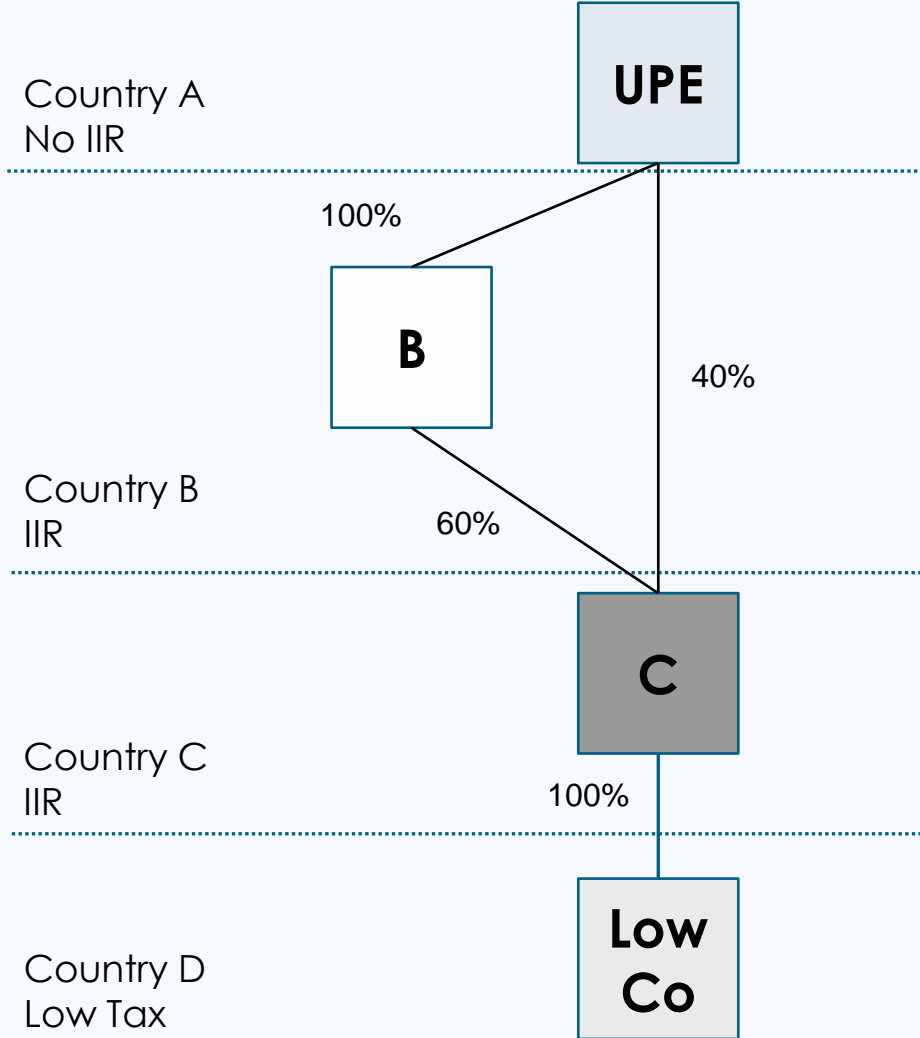
Pillar Two applies to multinational groups with more than EUR 750 million in consolidated revenues (in at least two of the four previous fiscal years), with exclusions for government entities, international and non-profit organizations, and pension, investment or real estate funds

Effective tax rate in each jurisdiction will be calculated based on adjusted financial accounting income and adjusted accounting tax expense (with a recapture mechanism)

The excess of 15% over the effective tax rate in a jurisdiction (i.e. the “top-up tax percentage”) applies to income less a substance-based exclusion equal to 5% of tangible assets and payroll costs in the jurisdiction (with a higher percentage during a transitional period).

## OECD/G20 Tax Proposals - Pillar Two

- “Qualified Domestic Minimum Top-up Taxes” (QDMTT) paid to a local jurisdiction can be credited against minimum tax liability under Pillar Two.
- Otherwise, primary rule is the Income Inclusion Rule (IIR), which is applied on a “top-down” basis (starting from the ultimate parent entity)
- A backstop to the IIR is the UTPR, which applies to low-taxed income not subject to the IIR. UTPR requires an adjustment that increases the tax of an entity in a jurisdiction in an amount sufficient to result in the appropriate top-up tax being paid by the group. The UTPR top-up tax amount is allocated to implementing jurisdictions based on relative percentages of employees and tangible assets.
- Most countries are expected to implement QDMTTs, which will decrease the amount of any additional revenue collected under the IIR and UTPR.



## Pillar Two Example: Top-Down Approach of the IIR

No IIR at the UPE level (since Country A has no IIR).

B Co's allocable share of IIR from Low Co is 60%.

C Co collects no IIR Top-Up Tax because its Intermediate Parent Entity, B Co, owns a Controlling Interest in C Co and applies the IIR.

Remaining 40% of Top-Up Tax to be collected through the UTPR.

**Hierarchy**: Local income tax → [local QDMTTs / CFC taxes in parent jurisdiction] → IIR → UTPR

## OECD/G20 Tax Proposals - Pillar Two

- A proposed EU Directive to implement Pillar Two by December 31, 2023 was vetoed by Poland on April 5, 2022. Poland's stated reason for opposing the directive was that both Pillar One and Pillar Two should be implemented together as a package (which is unlikely to occur). Next meeting is scheduled for May 24, 2022.
- There are proposals in the US (the BBBA and the Biden Administration's Budget for FY2023) to amend its GILTI and BEAT regimes to align with Pillar Two.
- Canada intends to implement Pillar Two, along with a domestic minimum top-up tax that would apply to Canadian members of MNEs that are within the scope of Pillar Two. The IIR and domestic minimum top-up tax would come into effect in 2023, the UTPR would come into effect no earlier than 2024. A public consultation is ongoing (with submissions due July 7, 2022).

# UPDATE ON INTERNATIONAL TAX PROPOSALS IN THE US

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES



## The American Jobs Plan: The 2023 Biden Administration's Revenue Proposals

- On March 28, 2022, the Biden Administration released its 2023 Budget as part of the American Jobs Plan.
- The United States Treasury introduced several new international tax proposals that build upon the Build Back Better Act (the “BBBA”) which was passed by the US House of Representatives in November 2021 but stalled in the US Senate.
- The Budget treats the BBBA as enacted, with its revenue estimates scored against the BBBA as the baseline.

## The American Jobs Plan: The 2023 Biden Administration's Revenue Proposals (continued)

- The US Congress will return from its spring recess amid speculation that Democrats may make one last attempt to pass pared-down budget reconciliation legislation before the August recess.
- However, there are mixed signals about a post-BBBA reconciliation bill, with some senators suggesting a package would need to come together by Memorial Day. Among the complicating factors are differences between Senators Kyrsten Sinema's (D-AZ) and Joe Manchin's (D-WV) tax positions (e.g., Senator Sinema opposes tax rate increases) and uncertainty over whether both Senators Manchin and Sinema want an agreement.

## From the Fact Sheet - “The American Jobs Plan”

- Increase the corporate tax rate to 28%
- Increase the rate on global intangible low-taxed income (“GILTI”) to 21%, calculates it on a country-by-country basis and eliminates the 10% return on tangible assets
- Encourage other countries to adopt strong minimum taxes on corporations
- Deny deductions to foreign corporations on payments that could allow them to strip profits out of the United States if they are based in a country that does not adopt a strong minimum tax
- Replace an ineffective provision in the 2017 tax law that tried to stop foreign corporations from stripping profits out of the United States

## From the Fact Sheet - "The American Jobs Plan" (continued)

- Make it "harder for U.S. corporations to invert"
- Deny companies expense deductions for offshoring jobs and provides a credit for expenses for onshoring
- Eliminate the deduction for foreign-derived intangible income
- Impose a 15% minimum tax on corporations based on "book income"
- Eliminate tax preferences for fossil fuels
- Strengthen business tax enforcement

## A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017

- The corporate tax rate was changed from a tiered tax rate ranging from 15% to as high as 39% depending on taxable income to a flat 21%.
- The Act also changed the US from a global to a territorial tax system with respect to corporate income tax with the introduction of the provisions of section 245A.
- One-time repatriation tax of profits in overseas subsidiaries is taxed at 8% (15.5% for cash) creating the concept of “previously taxed earnings and profits” or “PTEP”.

## A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- The introduction of “Global Intangible Low-Taxed Income” or “GILTI” calculated as the total active income earned by a US taxpayer’s foreign subsidiaries that exceeds 10% of the taxpayer’s depreciable tangible property (referred to as the “Qualified Business Asset Investment” or “QBAI”). A corporation (but not other businesses) can generally deduct 50% of the GILTI and claim a foreign tax credit for 80% of foreign taxes paid or accrued on GILTI.
  - Therefore, if the foreign tax rate were zero, the effective US tax rate on GILTI would be 10.5% (half of the regular 21% corporate rate because of the 50% deduction provided by way of section 250); if the foreign tax rate were 13.125% or higher, there would be no US tax after the 80% credit for foreign taxes.

## A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- The introduction of “Base Erosion And Anti-abuse Tax” or “BEAT” which targets large US corporations (i.e., those with gross receipts of more than \$500 million, averaged over the prior three years) that make deductible payments, such as interest, royalties, and certain service payments, to related foreign parties.
- The BEAT only applies to a corporation that makes more than 3% of its total deductible payments to related foreign parties
- The BEAT is a minimum tax add-on: A US corporation calculates its regular US tax, at a 21% rate, and then recalculates its tax at a lower BEAT rate after adding back the deductible payments. If the regular tax were lower than the BEAT, then the corporation must pay the regular tax plus the amount by which the BEAT exceeds the regular tax.
- The BEAT rate was 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and beyond.

## A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- The introduction of “Foreign-Derived Intangible Income” or “FDII” which is designed to reduce the tax rate on foreign-derived sales and service income to 13.125%, rather than the regular 21% to encourage US corporations to export more goods and services and locate more intangible assets in the United States. The FDII computation is complicated but it is intended to approximate income from the sale of goods and services abroad attributable to US-based intangible assets such as patents, trademarks, and copyrights.
- The reduced tax rate is again facilitated by way of the introduction of section 250 which provides for a 37.5% deduction (which results in a permanent tax benefit and 13.125% effective tax rate as compared to a 21% corporate rate) for tax years beginning after December 31, 2017 and before January 1, 2026 after which the deduction is reduced to 21.875%, resulting in an effective tax rate of 16.406%.



## A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- As with the provisions of the new law related to GILTI, the law approximated the income attributable to a US firm's intangible assets by the income that exceeds a 10% deemed return on its depreciable tangible property (again, the QBAI); the share of the excess income allocated to the sale of goods and services abroad is taxed at a reduced rate.

## Increased Corporate and GILTI Rates

- The Budget would raise the corporate tax rate to 28% from the BBBA baseline (and current) rate of 21%.
- Early drafts and policy outlines of the BBBA included a similar rate increase, which was later dropped following opposition from Senator Kyrsten Sinema.
- The House-passed BBBA then included a 15% corporate alternative minimum tax (“CAMT”), largely viewed as a substitute for the corporate rate increase from a revenue perspective. Thus, the FY23 Budget would increase the corporate rate while maintaining the CAMT from the BBBA.

## Increased Corporate and GILTI Rates (continued)

- The Budget would also increase the GILTI rate to 20%. For comparison, the GILTI rate under current law is 10.5%, or 13.125% after the 20% GILTI foreign tax credit ("FTC") haircut, for tax years beginning before December 31, 2025.
- The corporate and GILTI rate increases would apply to tax years beginning after December 31, 2022. For an earlier tax year ending after December 31, 2022, a blended corporate rate would apply equal to 21% plus 7% multiplied by the portion of the tax year that takes place in the 2023 calendar year.

## Replacement of BEAT with UTPR

- The Budget would repeal the BEAT and replace it with a UTPR that is consistent with the Pillar Two Model Rules, which include the Undertaxed Profits Rule (“UTPR”) and the Income Inclusion Rule (“IIR”).
- The technical aspects of the Budget's UTPR proposal align closely with those in the Pillar Two Model Rules published on December 20, 2021.
- Under the Budget, both domestic corporations that are part of a foreign-parented multinational group and domestic branches of foreign corporations would be denied US tax deductions to the extent necessary to collect the hypothetical top-up tax required for the financial reporting group to pay an effective tax rate of at least 15% in each foreign jurisdiction in which the group has profits (i.e., the UTPR Top-up Tax).

## Replacement of BEAT with UTPR

- As contemplated in the Pillar Two Model Rules, both US-parented and foreign-parented multinationals operating in low-tax jurisdictions (with financial reporting groups' global annual revenue of \$850 million or more in at least two of the prior four years) would fall within the UTPR's scope. The Budget explicitly states, however, that the UTPR would not apply to income that is subject to an IIR that is consistent with the Pillar Two Model Rules, including income subject to GILTI; as such, the UTPR would generally not apply to US-parented multinationals.

## Replacement of BEAT with UTPR (continued)

- The Budget also includes a domestic minimum top-up tax that would apply to preclude the imposition of UTPR by other countries. This top-up tax would equal the excess of (a) 15% of the financial reporting group's US profit (determined using the same rules as under the UTPR to determine the group's profit for a jurisdiction), over (b) all the group's income tax paid or accrued with respect to US profits (including federal and state incomes taxes, CAMT, and creditable foreign income taxes incurred with respect to US profits).
- Consistent with the OECD Pillar Two proposal, the Budget's UTPR proposal would take effect in 2024.

## Onshoring and Offshoring Rules

- The Budget would create a new general business credit for onshoring expenses, while disallowing deductions for offshoring expenses. In each case, the relevant expenses are solely those incurred in relocating a trade or business to or from the United States, respectively, and do not include capital expenditures or costs for severance pay and similar assistance to displaced workers.
- The onshoring credit would equal 10% of relevant expenses incurred when onshoring a trade or business to the United States. The Budget states that "onshoring" means reducing or eliminating a trade or business conducted outside the United States and starting, expanding, or otherwise moving the same trade or business within the United States, provided US jobs increase.

## Onshoring and Offshoring Rules (continued)

- The offshoring rule would disallow deductions for relevant expenses incurred when offshoring a trade or business from the United States. "Offshoring" for this purpose means reducing or eliminating a trade or business conducted inside the United States and starting, expanding, or otherwise moving the same trade or business outside the United States, provided US jobs decrease.
- The Budget states that a US shareholder could not deduct an offshoring expense against its subpart F or GILTI inclusion, implying that a CFC or a US person could incur the relevant expense.
- The onshoring and offshoring rules would apply to expenses paid or incurred after the date of enactment.



## Some Observations

- The Budget's proposal to increase the corporate (and thus GILTI) rate would be expected to pose additional tax liabilities on taxpayers on top of increases expected from the BBBA's move toward country-by-country GILTI and FTC regimes, among other BBBA changes.
- These increases are also in addition to the CAMT, which some had viewed as a substitute for the rate increases; a higher corporate rate could, however, reduce the likelihood that some taxpayers are subject to the CAMT.
- Taxpayers looking to restructure their global operations may have significant interest in the Onshoring and Offshoring rules, though the scope of each proposal is uncertain, pending further word from the Administration or draft legislative text.

## Some Observations (continued)

- Because it maintains the BBBA proposals, the Budget does not propose to repeal the deduction for FDII.
  - This contrasts with President Biden's FY2022 Budget, released in May 2021, proposing to repeal FDII in its entirety. This may have implications on the current review of FDII by the OECD's Forum on Harmful Tax Practices ("FHTP"), which is assessing whether FDII is considered a harmful tax practice. The FHTP previously stated in August 2021, based on last year's Budget, that the FDII regime is "in the process of being eliminated" and that "[t]he United States has committed to abolish this regime." The elimination of this from the Budget raises the question of whether the FHTP will look to revisit the review of FDII.

## Some Observations (continued)

- The Budget also does not propose changing the anti-inversion rules of Section 7874, which the House-passed BBBA did not propose to amend. Senate Finance Committee drafts, as well as the Administration's FY22 Budget, proposed expanding the scope of transactions that are "domestic entity acquisitions" and reducing the Section 7874 ownership percentage thresholds, among other changes. The Administration has not communicated that it intends to drop these proposals altogether, so they could re-emerge in later policy outlines or draft texts.
- The Budget proposes to replace BEAT with the UTPR. The proposal would conform the US rules to the Pillar Two agreement, a clear sign of the Administration's support for implementing Pillar Two around the world.

## Some Observations (continued)

- The Budget's proposed adoption of a domestic minimum tax appears to respond to criticism that a foreign government's adoption of the IIR and UTPR would result in foreign countries gaining tax revenue that arises from US profits — a domestic minimum tax would instead tax those profits in the United States first and preclude application of the IIR and UTPR by other countries.

## Some Observations (continued)

- Critics also note that adopting a minimum tax on US profits under Pillar Two would eliminate certain job-creating incentives (particularly those arising from general business credits, which are non-refundable credits and treated less favorably than refundable credits for Pillar Two purposes).
  - Although the Budget alludes to the possibility of rules that would allow US taxpayers to benefit from "US tax credits and other tax incentives that promote US jobs and investment," no further details are provided. The United States would presumably have to balance the desire to preserve certain tax incentives without them triggering the types of low-tax outcomes that the United States is seeking to end under Pillar Two.

## Some Observations (continued)

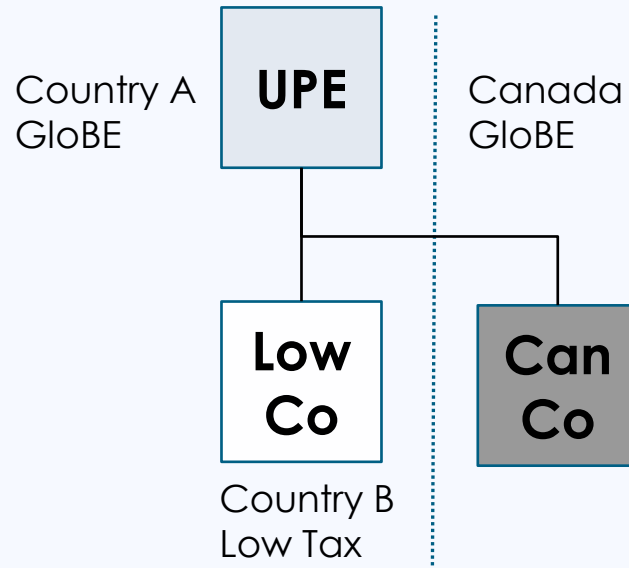
- The US adoption of the Pillar Two Model Rules would require numerous and novel changes to the Code:
  - the proposal would require the use of financial accounting principles (similar to the CAMT, which is presumed adopted as part of the BBBA, although with very different adjustments) to determine the taxable base,
  - the introduction of rules for determining foreign taxes that fundamentally differ from the existing US FTC rules,
  - the Budget would require deferred taxes to be considered in the computation of foreign taxes, and also allow for a broader scope of foreign taxes to be treated as income taxes, and
  - The definition of Cost of Goods Sold may need be modified for purposes of the CAMT (i.e., the UTPR) as it was for purposes of the BEAT.

# EXAMPLES REGARDING APPLICATION OF INTERNATIONAL TAX PROPOSALS

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

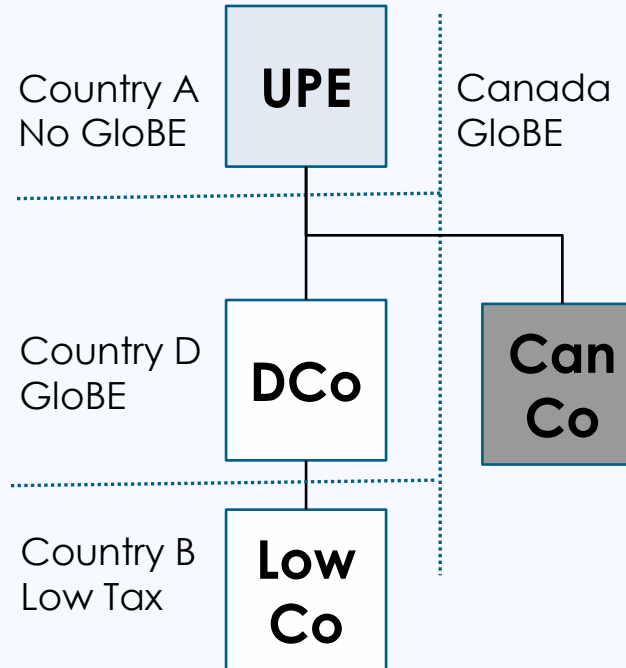
## Pillar Two: Who Needs To Pay? Small Changes – Big Impact – No Nexus Required

### Scenario 1:



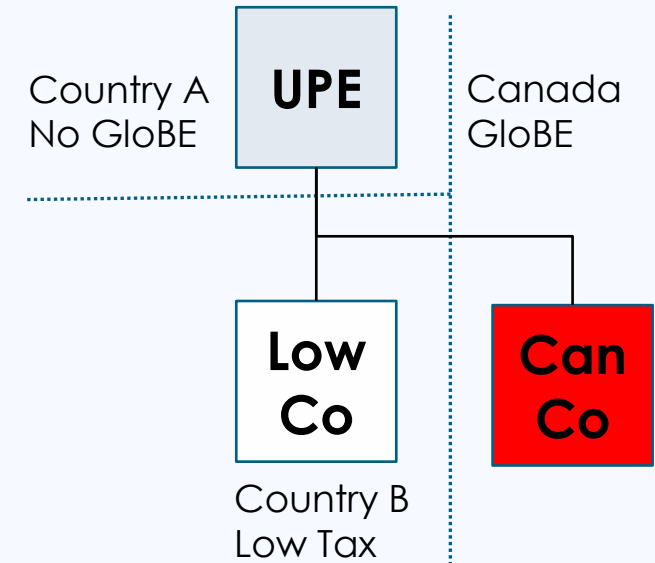
Top-Up Tax attributable to LowCo payable in Country A (UPE) under IIR

### Scenario 2:



Top-Up Tax attributable to LowCo payable in Country D under IIR

### Scenario 3:

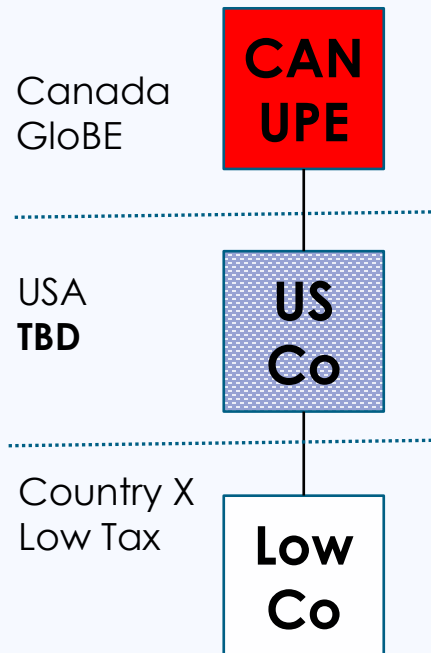


Top-Up Tax attributable to LowCo payable in Canada under UTPR

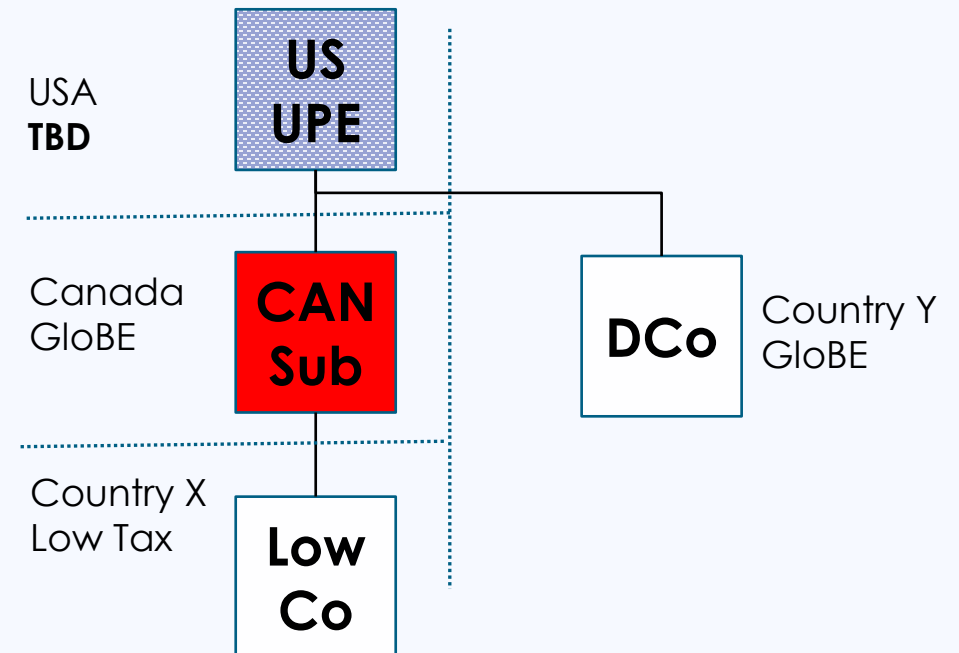


## Pillar Two: Additional Examples -- Canadian MNE and US MNE with CanSub

### Canadian MNE with US Subsidiary:



### US MNE with Canadian Subsidiary:



## Pillar Two: Example 4.1.5-1 – Imposition of Top-up Tax in Loss Year

- Salt in the Wound – March 2022 commentary confirms the possibility of Top-Up Tax if there is a difference between the GloBE tax base and the local tax base, even if there is no net GloBE income for a jurisdiction
- Assume a \$20 book to tax difference (e.g., due to a capital gains exemption);
- Company otherwise in a loss position
- Pillar 2 proposes an immediate cash tax of \$3 (even if NOLs never get used)!

Local Tax		GloBE	
Income	100	Income	100
		Capital gain excluded under local law	20
Expenditure	(220)	Expenditure	(220)
Total Profit (Loss)	(120)	Total Profit (Loss)	(100)
Tax (Tax benefit)	(18)	Expected Adjusted Covered Taxes Amount	(15)

## Pillar Two: Tax Credits – What the Left Hand Giveth the Right Hand Taketh? (Article 3.2.4)

- “Qualified Refundable Tax Credit” means a refundable tax credit designed in a way such that it must be paid as cash or available as cash equivalents within four years from when a Constituent Entity satisfies the conditions for receiving the credit under the laws of the jurisdiction granting the credit. A tax credit that is refundable in part is a Qualified Refundable Tax Credit to the extent it must be paid as cash or available as cash equivalents within four years from when a Constituent Entity satisfies the conditions for receiving the credit under the laws of the jurisdiction of the credit. A Qualified Refundable Tax Credit does not include any amount of tax creditable or refundable pursuant to a Qualified Imputation Tax or a Disqualified Refundable Imputation Tax.

Qualified Refundable Tax Credit	Non-Qualified Refundable Tax Credit
<ul style="list-style-type: none"><li>• Treated as income for purposes of GloBE Rules<ul style="list-style-type: none"><li>• Included in ETR denominator and not treated as reducing taxes in the year the refund/credit is claimed</li></ul></li></ul>	<ul style="list-style-type: none"><li>• Excluded from income for purposes of GloBE Rules, <u>but</u> treated as a reduction to Covered Taxes in the period the refund/credit is claimed (i.e., reduction to numerator of ETR computation)</li></ul>

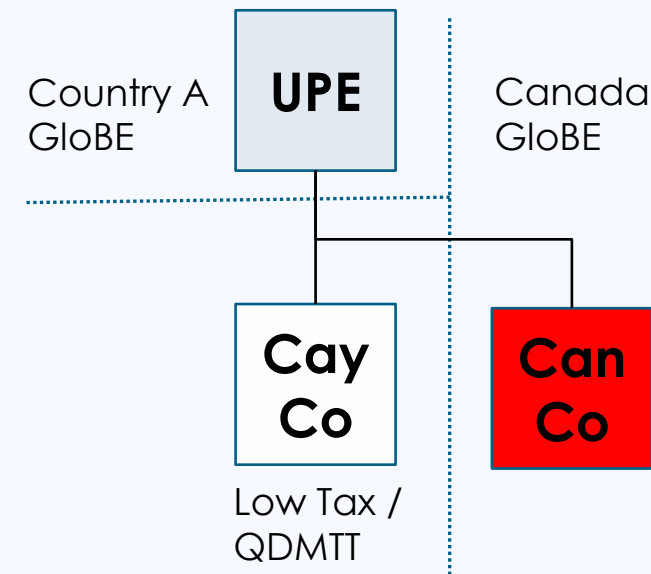
## Pillar Two: Canadian Patent Boxes – An Opportunity for Canada?

- Budget 2022:

### Review of Tax Support to R&D and Intellectual Property

The Scientific Research and Experimental Development (SR&ED) program provides tax incentives to encourage Canadian businesses of all sizes and in all sectors to conduct R&D. The SR&ED program has been a cornerstone of Canada's innovation strategy. The government intends to undertake a review of the program, first to ensure that it is effective in encouraging R&D that benefits Canada, and second to explore opportunities to modernize and simplify it. Specifically, the review will examine whether changes to eligibility criteria would be warranted to ensure adequacy of support and improve overall program efficiency.

As part of this review, the government will also consider whether the tax system can play a role in encouraging the development and retention of intellectual property stemming from R&D conducted in Canada. In particular, the government will consider, and seek views on, the suitability of adopting a patent box regime in order to meet these objectives.



# 2022 BUDGET POTPOURRI

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

1. Interest Coupon Stripping
2. FAPI Amendments
3. Application of GAAR to unused Tax Attributes
4. Exchange of Information on Digital Economy Sellers
5. Transfer Pricing Proposals

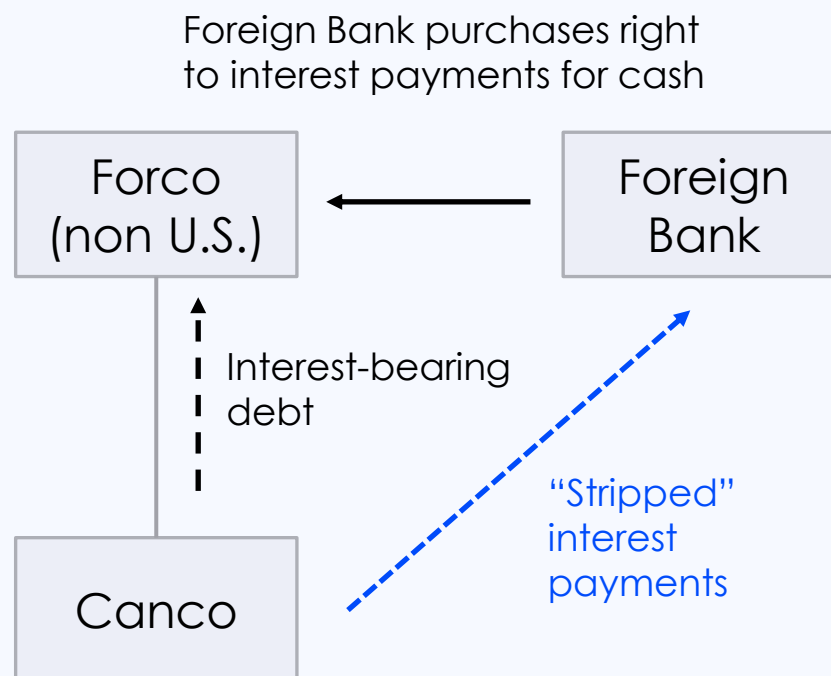
## Interest Coupon Stripping

Budget proposal targets structures designed to eliminate or reduce Canadian withholding tax that would be payable on inter-group financing.

Entitlement to interest/coupons on related party debt is separated from the entitlement to the repayment of principal. The right to receive the stripped coupons is then sold to an arm's length purchaser.

ITA 212(1)(b)(i)(B) was introduced in the 2011 Budget to defeat coupon strip planning as a means to avoid the application of Part XIII altogether, but certain coupon stripping structures are not caught.

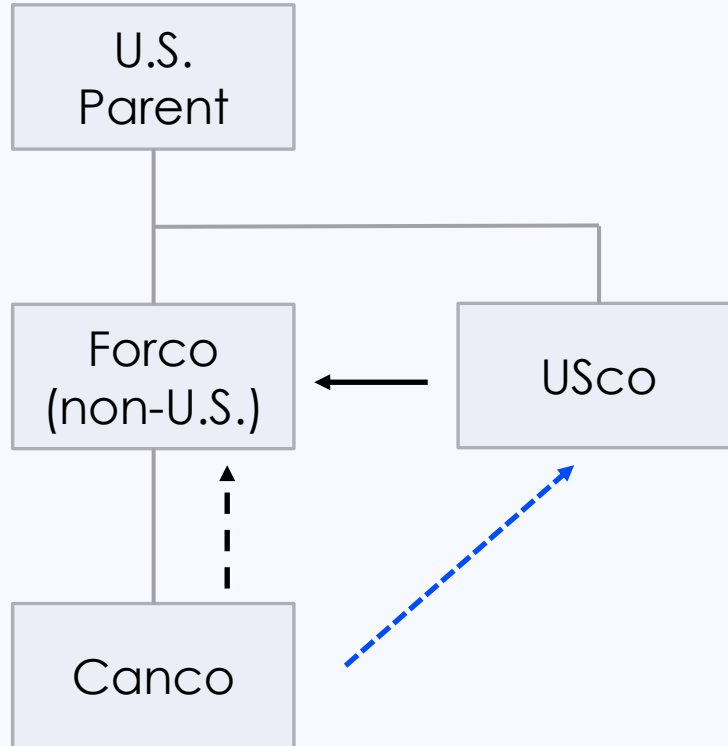
## Coupon Strip Example – ITA 212(1)(b)(i)(B)



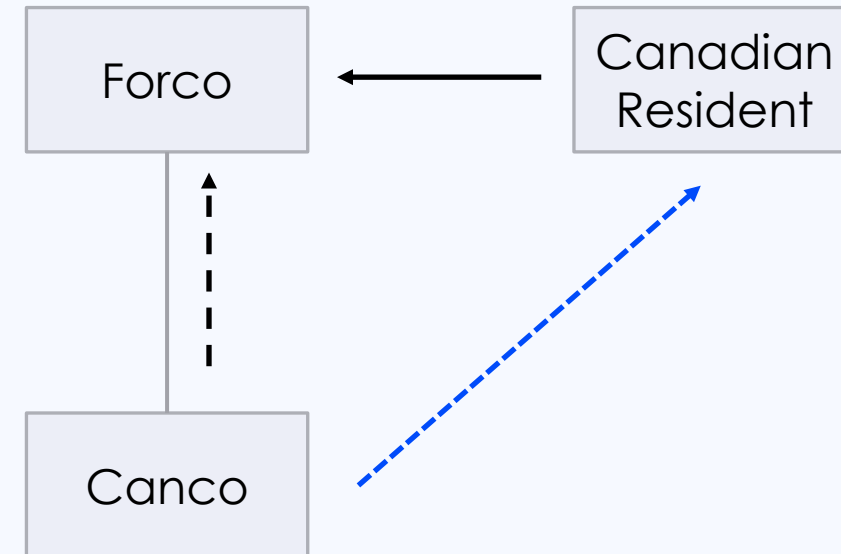
ITA 212(1)(b)(i)(B) imposes withholding tax on interest paid “in respect of a debt or other obligation to pay an amount to a person with whom the payer is not dealing at arm’s length”.



## Coupon Strip Examples – 2022 Budget



Interest payments to USco are exempt from Canadian withholding tax under Article XI of the *Canada-U.S. Treaty*.



Interest payments to Canadian Resident are not subject to Canadian withholding tax.

## Budget Proposal – Interest Coupon Stripping Arrangements

New ITA 212(21) and 212(22) introduce a new specific anti-avoidance rule applicable where a taxpayer pays interest to a person in respect of a debt or other obligation owed to another person where:

- (a) the other person (the “**non-arm’s length creditor**”) is either a non-resident with whom the payer is not dealing at arm’s length or a partnership that is not a Canadian partnership; and
- (b) the Part XIII tax payable in respect of the payment is less than the amount of Part XIII tax that would have applied if the payment had been made to the non-arm’s length creditor.

Exception for certain publicly offered debt obligations.

## Budget Proposal - Consequences

If the rule applies, the payer is deemed to make an interest payment to the non-arm's length creditor.

The amount of deemed interest is  $A \times (B-C)/B$  where:

A = the amount of the actual interest payment

B = the Part XIII tax rate that would apply to an interest payment to the non-arm's length creditor

C = the Part XIII tax rate applicable to the actual interest payment

## Effective Date

Proposal to apply to interest accrued on or after April 7, 2022 (Budget day).

One-year grandfathering available to payments in respect of debts incurred before Budget day if (i) the coupon holder and the non-arm's length creditor deal at arm's length and (ii) the right to the coupons was acquired under an agreement or arrangement entered into before Budget day.

For grandfathered arrangements, rule will apply to interest that accrues on or after April 7, 2023.

## Tax Deferral Using Foreign Corporations

“Foreign accrual property income” (FAPI) earned in a controlled foreign affiliate (CFA) is included in a taxpayer’s income in the year earned by the affiliate.

The FAPI regime includes provisions to avoid double taxation by allowing for a deduction against FAPI inclusions in respect of “foreign accrual tax” (FAT) applicable to the FAPI in question multiplied by the taxpayer’s “relevant tax factor” (RTF).

Foreign affiliate dividends-received deduction in ITA 113 is also based in-part on the dividend recipient’s RTF.

## Tax Deferral Using Foreign Corporations

RTF is intended to calibrate to the rate that would have applied had the income been earned in Canada.

- For corporations, RTF is 4 (reflecting an assumed tax rate of 25%)
- For all other taxpayers RTF is 1.9 (reflecting an assumed tax rate of 52.63%)

CCPCs are subject to a substantially higher corporate tax rate on undistributed investment income than non-CCPCs. However, corporate RTF does not differentiate between tax rates applicable to CCPCs and other corporations, leading to a potential deferral benefit for CCPCs.

Deductible FA dividends can give rise to GRIP, allowing for ultimate distribution as eligible dividends.

## CFA Deferral Example

Ontario CCPC earning \$100 undistributed investment income directly is subject to \$50.17 (50.17%) corporate tax.

Ontario CCPC earning the same \$100 investment income through a CFA, assuming 20% foreign tax rate, achieves deferral under existing rules as follows:

FAPI inclusion = \$100

FAT deduction =  $\$20 \times 4 = \$80$

Net FAPI inclusion = \$20

Total tax = \$30.34 (\$20 foreign tax plus \$10.34 Canadian tax on net FAPI).

## Budget Proposal – Tax Deferral Using Foreign Corporations

Budget proposes to eliminate potential deferral advantage associated with CCPCs earning investment income through CFAs and FAs by applying the RTF currently applicable to individuals to CCPCs (and “substantive CCPCs”).

To preserve integration, Budget proposes accompanying amendments to add an amount to the CCPC (or substantive CCPC)’s capital dividend account (CDA). New CDA inclusion will replace GRIP inclusion of amounts in respect of inter-corporate dividend deductions for hybrid surplus and taxable surplus dividends.



## Budget Proposal – Application of GAAR to Tax Attributes

Legislative override of 2018 FCA decision in *1245989 Alberta Ltd* (a.k.a. *Wild*).

*Wild* involved a corporate reorganization designed to achieve a step-up on the PUC of shares held by an individual; step-up was achieved without triggering ITA 84.1 by relying on automatic PUC averaging under corporate law.

TCC held that the transaction amounted to a misuse or abuse of section 84.1.

FCA overturned TCC decision on the basis that there could not be a misuse or abuse of section 84.1 before the increased PUC was used to realize an unintended tax benefit – in this case the tax-free extraction of corporate surplus.

## Budget Proposal – Application of GAAR to Tax Attributes

Budget concern that *Wild* decision with respect to unused tax attributes runs counter to the policy of the rule in ITA 152(1.11) that allows the CRA to determine the amounts of tax attributes where the GAAR applies to a transaction.

Budget proposes to amend the GAAR to allow it to apply to transactions that affect tax attributes that have not yet become relevant to the computation of tax.

Corresponding amendments to notice of determination rule apply to any notice of determination issued after Budget day, even in respect of pre-Budget transactions.

## Budget Proposal – Application of GAAR to Tax Attributes

Budget proposes to amend the definition of “tax benefit” to include a reduction, increase or preservation of an amount that could at a subsequent time (i) be relevant for the purpose of computing an amount payable under the ITA or a refund of an amount under the ITA, and (ii) result in a tax benefit (as defined before the Budget change).

Corresponding change to the definition of “tax consequences”.

Amendment to ITA 152(1.11) provides for determination of any amount that is, or could at a subsequent time be, relevant for purposes of computing income, taxable income...

## Exchange of Information - Digital Economy Platform Sellers

On July 3, 2020 OECD published *Model Rules for Reporting by Platform Operators in the Sharing and Gig Economy* (the “**Model Rules**”). The Model Rules impose reporting obligations on operators of digital platforms that provide accommodation, transport and other personal services (“**Basic Scope**”).

On June 22, 2021 OECD published the *Multilateral Competent Authority Agreement on Automatic Exchange of Information on Income Derived through Digital Platforms* (“**DPI MCAA**”), together with an optional extension to the Model Rules to cover digital platforms providing for the sale of goods and rental of means of transportation (“**Extended Scope**”).

## Exchange of Information - Digital Economy Platform Sellers

The DPI MCAA provides a framework for automatic exchange of information collected from digital platform operators by competent authorities based on three options:

- Exchange of information collected under the Basic Scope
- Exchange of information collected under the Extended Scope
- Decline to exchange information, but express interest in receiving information from other jurisdictions.

Other jurisdictions, including the EU, UK and Australia have announced intention to implement the Model Rules or a similar framework.

## Exchange of Information - Digital Economy Platform Sellers

Budget 2022 announces that Canada also proposes to implement the Model Rules.

Canada intends to implement Extended Scope (including reporting in respect of sales of goods and rental of means of transportation).

Automatic exchange of information proposed in the Budget to be limited to exchange with jurisdictions with reciprocal exchange rules in place.

## Exchange of Information - Digital Economy Platform Sellers

Reporting rules will apply to platform operators (“**reporting platform operators**”) who are:

- Resident in Canada
- Not resident in Canada or a partner jurisdiction that facilitate relevant activities by sellers resident in Canada or with respect to rental of immovable property located in Canada

“Partner jurisdiction” means a jurisdiction that has implemented similar reporting requirements on platform operators and has agreed to exchange information with the CRA.

## Exchange of Information - Digital Economy Platform Sellers

Platform is broadly defined in the Model Rules; includes software, websites, apps.

Exclusions for software that exclusively facilitates:

- processing of compensation (e.g. payment processors)
- mere listing or advertising (e.g. classified ads boards)
- transfer of users to another platform (e.g. online aggregators)

A platform operator is defined in the Model Rules as an entity that contracts with sellers to make all or part of a platform available.



# Exchange of Information - Digital Economy Platform Sellers

## Reporting Platform Operators:

- Entities engaged in contracting, directly or indirectly, with sellers to make the software that runs a platform available for sellers to be connected to other users; or
- Entities collecting compensation for the relevant activities facilitated through the platform.

## Exemptions

- Platform operators that demonstrate that their business model does not allow sellers to profit
- Platform operators that demonstrate that the platform does not have reportable sellers
- Platform operators for which the total prior year compensation for relevant activities is less than €1 million, and that elect to be excluded

## Exchange of Information - Digital Economy Platform Sellers

Reportable sellers are active users registered on the platform to provide services or sell goods.

Exclusion for certain sellers who represent low compliance risk:

- Governmental entities
- Public companies
- Large hotel accommodation providers
- Very small sellers

## Exchange of Information - Digital Economy Platform Sellers

Reporting platform operators required to complete due diligence procedures to identify reportable sellers and jurisdictions of residence.

Proposed to apply to calendar years beginning after 2023, with the first reporting and exchange of information to take place in early 2025 with respect to the 2024 calendar year.

## Budget Proposals – Transfer Pricing Consultation

Budget confirms the Department of Finance's continuing intention to proceed with the transfer pricing consultation announced in Budget 2021.

Budget 2021 had announced a consultation on Canada's transfer pricing rules in light of the FCA decision in *Cameco*. (SCC denied leave to appeal in February of 2021.)

Consultation materials indicating how Finance proposes to address concerns with *Cameco* expected in the coming months.

# QUESTIONS?



# CRA ROUNDTABLE

## SPEAKER:

**Yves Moreno**, Canada Revenue Agency, Ottawa

## MODERATORS:

**Kim Brown**, McCarthy Tétrault LLP, Vancouver

**Michael Kande**v, Davies Ward Phillips & Vineberg LLP,  
Montréal



## Question 1: Meaning of “Habitual Abode” in Canadian Tax Treaties

As you know, Canada's extensive treaty network contains residency “tie-breaker” provisions – usually in Article IV:2 of most of the treaties. For example, in the Canada-US treaty, the residency “tie-breaker” rule is indeed in Article IV:2. Paragraph (b) of the provision states:

*“...if the Contracting State in which he has his centre of vital interests cannot be determined, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;”*

Can the CRA comment on its views of what an habitual abode is of an individual and what factors the CRA reviews to make a determination?

## **Question 2: Apportionment of a Royalty Payment for the Purposes of Subparagraph 212(1)(d)(vi)**

Should the application of the exception in subparagraph 212(1)(d)(vi) be based on an apportionment of a royalty payment between copyrights and trademarks agreed to by arm's length parties to a mixed contract?



## Question 3: Meaning of “Goods” in Paragraph 95(3)(b)

Consider a situation where marketing services are provided by a wholly-owned foreign affiliate (“FA”) of a corporation resident in Canada (“Canco”) in respect of the sale of residential condominiums located in Canada.

The residential condominiums are owned either by Canco or entities that do not deal at arm’s length with Canco.

The following is assumed:

- Canco and non-arm’s length entities are subject to Canadian tax in relation to income earned on the sale of the residential condominiums; and
- Reasonable consideration is paid for the provision of the marketing services and that these costs are deductible against income earned in Canada.

Does real estate inventory, such as residential condominiums, held for sale in the regular course of business, qualify as “goods” for purposes of paragraph 95(3)(b)?

## Question 4: PLOI Late-Filed Penalties and Administrative Relief

Where subsection 15(2) or the foreign affiliate dumping rules under section 212.3 would otherwise apply to an amount owing to a corporation resident in Canada (CRIC) or certain partnerships, subsections 15(2.11) and 212.3(11) allow for a pertinent loan or indebtedness (PLOI) election to be filed in respect of that amount. Where there is more than one amount owing between the two parties, the CRA has indicated in technical interpretation 2014-053454117 that a separate PLOI election is required for each amount owing, notwithstanding that a taxpayer may prepare and file a single written communication containing each such PLOI election. At the May 26, 2016 IFA CRA Roundtable, the CRA stated (2016-0642031C6) that, based on the language of subsections 15(2.13) and 212.3(13), the late-filing penalty calculations must be applied separately for each amount that is elected to be a PLOI. However, the CRA also stated

## Question 4: PLOI Late-Filed Penalties and Administrative Relief

that it was exploring whether an administrative position could be taken to aggregate certain amounts for purposes of the PLOI election late-filing penalty calculation.

Could you please provide an update on the status of this review?

## Question 5: Surplus Account Maintenance

At the 2019 IFA Conference, the CRA commented on the requirement to prepare detailed surplus account calculations to support a deduction under subsection 113(1). It was also mentioned that in situations where calculations are not provided, it is the CRA's general practice to deny any deduction under subsection 113(1).

Given that surplus account calculations are relevant in various situations, and in order to give better clarity to taxpayers, can the CRA provide additional guidance on the required documentation and on the best practices to adopt in respect of the preparation of surplus account calculations?

## Question 6: Exempt Earnings and Residency Information

A corporation resident in Canada (Canco) receives a dividend from a wholly-owned foreign affiliate (FA). Canco claims a full deduction under paragraph 113(1)(a) in respect of the dividend. Canco prepares a complete calculation of the FA's exempt surplus account.

FA is incorporated in a country (Country A) with which Canada has entered into a comprehensive agreement for the elimination of double taxation on income (the "Treaty"). FA has been carrying on an active business in Country A since its incorporation. The Treaty includes a dual residency tie-breaker rule based on the place of incorporation. Canco considers the FA to be a resident in Country A for purposes of the Treaty.

Should Canco maintain any other information, in addition to the surplus calculation, to support a deduction claimed under paragraph 113(1)(a)?

## Question 7: Compliance Requirements for Taxpayer Owning Cryptocurrencies and Situs of Cryptocurrencies

Section 233.3 imposes the requirement for a “specified Canadian entity” to disclose its ownership of any “specified foreign property” on CRA form T1135 - Foreign Income Verification Statement. This obligation generally arises in respect of a taxation year if the total cost of such property exceeds \$100,000 at any time during that taxation year. “Specified foreign property” includes (among other things) “funds or intangible property, or for civil law incorporeal property, situated, deposited or held outside Canada.”

In a technical interpretation issued in April 2015 (CRA document no. 2014-0561061E5), the CRA took the position that cryptocurrency constitutes funds or intangible property and would be specified foreign property of a person or partnership to the extent that it is situated, deposited or held outside of Canada and is not used or held exclusively in the course of carrying on an active business.

## Question 7: Compliance Requirements for Taxpayer Owning Cryptocurrencies and Situs of Cryptocurrencies

In the context of the 2021 APFF Financial Strategies and Instruments Roundtable held on October 7, 2021, the CRA was asked to provide its view on the situs of cryptocurrency (CRA document no. 2021-089602). At that time, the CRA responded that the question of where a cryptocurrency is located, deposited or held within the meaning of section 233.3 was under review.

Could the CRA provide an update?

## Question 8: Foreign Entity Classification

In Income Tax Technical News No. 38 (Sept. 22, 2008), the CRA updated its two-step approach to foreign entity classification and also confirmed how the CRA would classify a number of specific foreign entities. Given the CRA's recent announcements on the classification of certain US LLPs and the introduction of anti-hybrid mismatch rules in countries like Luxembourg, which may apply depending on how Canada treats a particular Luxembourg entity for tax purposes (e.g., a Luxembourg special limited partnership), will the CRA publish and maintain an online list of foreign entities that the CRA has classified for reference purposes?



## Question 9: Subsection 247(4) – Contemporaneous Documentation and COVID-19

Canada's contemporaneous documentation ("CD") rules in subsection 247(4) require the completion of CD meeting statutory requirements within six months of the end of the relevant taxation year, a shorter time limit than is found in the analogous rules of most of Canada's G7 contemporaries (typically one year). Meeting the required standard involves finding suitable comparables and determining appropriate transfer pricing methodologies and documenting the various relevant items within the statutory six-month deadline from year-end. Many taxpayers are finding it particularly challenging to meet the CD standards set out in subsection 247(4) in a COVID-19 environment, due to significant business disruptions that make finding genuine comparables harder and staff shortages that reduce taxpayers' capacity for generating and documenting this analysis.

## Question 9: Subsection 247(4) – Contemporaneous Documentation and COVID-19

Has the CRA considered providing relief to taxpayers making good faith efforts to produce satisfactory CD within the six-month time limit comparable to administrative relief for other cross-border COVID-related tax issues previously announced (e.g., permanent establishment status, residency, etc.)? The binary nature of subsection 247(4) compliance (i.e., one either meets the standard and gets the resulting penalty protection, or does not and gets no protection) makes this an area where administrative relief is particularly necessary for affected taxpayers.

## Question 10: Changes to Corporate Residence Approach

It was raised at the 2021 United Nations climate change conference (COP26) that the corporate residency rules are not only out of date in the age of video conferencing but potentially also not in sync with Environmental, Social and Governance (ESG) concerns. In particular, too much focus on the location of board meetings encourages both waste of time and energy in that motivated taxpayers will simply fly where they need to and distracts from ensuring board composition is based on good governance. In light of the developments of the last two years is the CRA considering changes to its approach to corporate residency?

## Question 11: Employee Equity Incentive Notice Requirements Under New Non-Qualified Securities Rules

Under the recent amendments to the employee stock options rules in section 110, if a non-resident corporation agrees to issue securities to its Canadian employees or employees of a Canadian subsidiary, the new non-qualified securities rules in section 110 will generally apply if the issuer is a specified person because the \$500 million gross revenue threshold is exceeded.

Under these new rules, the employee deduction under paragraph 110(1)(d) is subject to the \$200,000 annual vesting limit and in certain cases an issuer may be eligible for a deduction under paragraph 110(1)(e) in respect of the non-deductible portion of the benefit realized by the employee. These rules also contain employee and Minister of National Revenue notice requirements in subsection 110(1.9).

## Question 11: Employee Equity Incentive Notice Requirements Under New Non-Qualified Securities Rules

“If a security to be issued or sold under an agreement between an employee and a qualifying person is a non-qualified security, the employer of the employee shall (a) notify the employee...and (b) notify the Minister...”

If the employer does not comply with the notice requirements, then no employer deduction can be claimed because of subparagraph 110(1)(e)(vi).

If a non-resident corporation (or any other specified person) issues restricted stock units to an employee that can only be settled for shares, and therefore are effectively treated as section 7 stock options with no exercise price, and the shares to be issued are non-qualified securities, one could argue that in policy terms, the non-resident corporation should not have to comply with the notice requirements in subsection 110(1.9) because

## Question 11: Employee Equity Incentive Notice Requirements Under New Non-Qualified Securities Rules

no deduction can be claimed under paragraph 110(1)(e). However if the non-resident corporation does not comply with the notice requirements, there is arguably a risk of penalty under the general non-compliance provision in subsection 162(7).

The question: Will the CRA provide administrative relief to the subsection 110(1.9) notice requirements if no amount is deductible under 110(1)(d) or (e)?

## Question 12: Principal Purpose Test

Could CRA please comment on the following:

1. (1) The number of matters in which CRA has recommended applying the principal purpose test (PPT) and examples of situations in which it has done so. Please also indicate if GAAR is being applied.
2. (2) Has CRA received any PPT ruling requests?

## Question 13: Current Statistics on Mutual Agreement Procedures

Could the CRA give current statistics on Mutual Agreement Procedures (MAPs)?



## Question 14: Partnership and Subsection 90(3) Election

A distribution made by a foreign affiliate of a taxpayer in respect of a share of its capital stock will be a qualifying return of capital pursuant to subsection 90(3) where the following conditions are met: (i) the distribution is a reduction of the paid-up capital of the foreign affiliate in respect of the share, (ii) the distribution would otherwise be deemed under subsection 90(2) to be a dividend paid or received on the share, and (iii) an election is made in respect of the distribution in accordance with prescribed rules.

Assume the following facts (see figure 1):

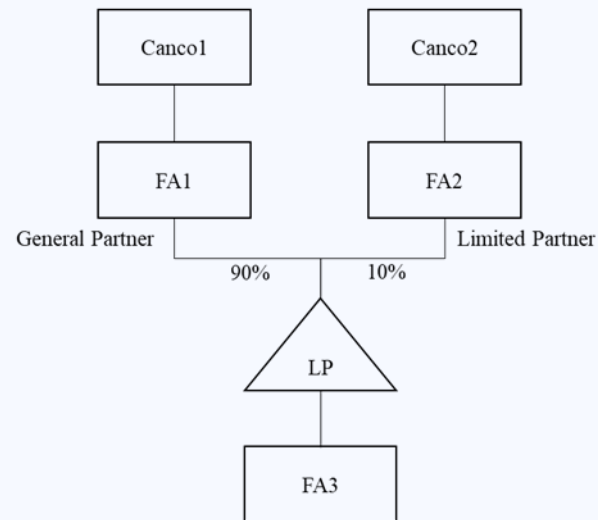
- 1) A Canadian corporation (Canco1) owns 100% of a foreign affiliate (FA1);
- 2) A related Canadian corporation (Canco2) owns 100% of a foreign affiliate (FA2);
- 3) LP is a partnership for purposes of the Act;
- 4) FA1 is the general partner of LP, is the only member that has authority to act for LP and has a 90% partnership interest in LP;

## Question 14: Partnership and Subsection 90(3) Election

- 5) FA2 is a limited partner of LP and has a 10% partnership interest in LP;
- 6) LP owns 100% of a foreign affiliate (FA3);
- 7) Canco1 and FA1 each has a taxation year ending November 30; each of Canco2, FA2 and FA3 has a taxation year ending December 31; LP has a fiscal period ending December 31; and
- 8) On July 1, 2021 FA3 reduced its paid-up capital and made a distribution to LP (the “**Distribution**”).

## Question 14: Partnership and Subsection 90(3) Election

Figure 1



## Question 14: Partnership and Subsection 90(3) Election

FA3 is a foreign affiliate of LP, and for purposes of (*inter alia*) section 90 is a foreign affiliate of both Canco1 and Canco2 pursuant to subsection 93.1(1).

Our questions are:

- (i) Would the CRA agree that only LP is required to make a subsection 90(3) election in respect of the Distribution?
- (ii) If a joint election is required to be made, or is made, by LP, Canco1 and Canco2, can LP file the election on behalf of itself, Canco1 and Canco2?
- (iii) Would the election, if a joint election, be required to be filed by the earliest of the filing-due dates for Canco1 and Canco2 for their taxation years that include December 31, 2021?

# FINANCE ROUNDTABLE

## SPEAKERS:

**Trevor McGowan**, Department of Finance, Ottawa

**Peter Repetto**, Department of Finance, Ottawa

## MODERATORS:

**Phil Halvorson**, EY LLP, Toronto

**Kim Maguire**, Bennett Jones LLP, Vancouver



# OUTLINE

1. Status of Proposed Legislation and Consultations
2. Discussion of Specific Proposed Rules
3. Update on Pillars 1 and 2

## Status of Proposed Legislation and Consultations

1. Proposed Legislation
2. “Modernizing” GAAR Consultation
3. Transfer Pricing Consultation

## Specific Proposed Rules

1. Excessive interest and financing expenses limitation rules (EIFEL)
2. Hybrid mismatch arrangement rules
3. Mandatory disclosure rules



## Update on Pillars 1 and 2

