

# FOREIGN AFFILIATE DUMPING RULES

## SPEAKERS:

**Stephanie Dewey**, McCarthy Tétrault LLP, Toronto

**Sam Li**, EY LLP, Toronto

## MODERATOR:

**Shaira Nanji**, Osler, Hoskin & Harcourt LLP, Calgary



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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

