International TAX HIGHLIGHTS

Editor: Angelo Nikolakakis, EY Law LLP, Montreal (angelo.nikolakakis@ca.ey.com)

Volume 1, Number 3, November 2022

In This Issue

On August 9, 2022, the Department of Finance released *Legislative Proposals Relating to the Income Tax Act and the Income Tax Regulations*, which includes numerous measures relating to international taxation. Many of these measures, though not all of them, are addressed in this issue.

In particular, Cynthia Morin and Suhaylah Sequeira review the proposed changes to subsections 212(13.1) and (13.2) and related provisions, which address the application of part XIII tax in the context of payments made to and by partnerships, and of payments by non-residents. Michael Colborne and Nicholas McIsaac review proposed changes to certain "PUC reinstatement" provisions in subsection 212.3(9) that are part of the foreign affiliate dumping (FAD) regime.

We then move on to the foreign affiliate (FA) context proper, with Samantha D'Andrea reviewing proposed changes to the rollover rules for liquidations and dissolutions under subsections 88(3) and (3.3), as well as the "asset packaging" rule in regulation 5907(2.01). Continuing with the topic of non-recognition rules, David Bunn and Mark Dumalski review the proposed changes to the rollover restriction rule in subsection 85.1(4). Moving on to income inclusions, Silvia Wang and Clara Pham review the proposed changes to the deemed non-active business rules in paragraph 95(2)(b) and related provisions, and Audrey Dubois reviews the proposed changes to the moneylending business exception to the upstream loan rules in paragraph 90(8)(b).

We also cover some recent developments in international jurisprudence, with Chris Sheridan and Jeffrey Shafer reviewing the decision of the United Kingdom's First-Tier Tribunal in the *Burlington Loan Management DAC* case ([2022] UKFTT 290 (TC)), which involved the principal purpose test applicable to interest payments under the UK-Ireland income tax convention. Finally, Alex Pouchard and Paula Przybielska review a decision of the Luxembourg Administrative Tribunal holding that an interest-free loan should be characterized as informal capital rather than indebtedness, thereby denying any related deductions for notional interest expense.

With reference to interest expense, it should also be noted that on November 3, 2022 (the same day that the fall economic statement was released), the Department of Finance released revised legislative proposals to implement an excessive interest and financing expenses limitation. Unfortunately, this came too late to be covered in any detail in this issue, but readers will undoubtedly be interested to know that the revised proposals contain many significant changes. These include changes to the "excluded entity" and "excluded interest" definitions, the introduction of a new "exempt interest and financing expenses" definition in respect of qualifying infrastructure financing arrangements, changes to the rules on transfers of "excess capacity" and other attribute-sharing provisions (both in general and in respect of financial institutions), changes to the "group ratio" rules, the revision or introduction of various provisions to better integrate this regime with the FA regime, and changes to the anti-avoidance rules. These revisions are generally relieving in their effect and will be welcomed by taxpayers, as will the proposed deferral of the onset of the regime to taxation years beginning on or after October 1, 2023, which for calendar-year taxpayers moves it to 2024.

Finally, we note that we continue to await revised legislative proposals on hybrid mismatch arrangements (despite their possible retroactive application as of July 1, 2022), and that there continues to be a lack of clarity regarding the substance and the timing of the proposed implementation by Canada of the OECD's so-called pillar 1 and pillar 2 regimes. And for anybody interested in a career opportunity with the Tax Legislation Division of the Department of Finance, now might be a good time to apply. It seems that the very good people in that division could use all of the help they can get.

Angelo Nikolakakis
EY Law LLP, Montreal

In This Issue

CANADIAN TAX FOUNDATION
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Withholding Tax Obligations: Proposed Amendments to Subsections 212(13.1) and 212(13.2)

On August 9, 2022, the Department of Finance released draft legislative proposals regarding the application of part XIII tax when the payer or payee is a partnership. The proposals broaden the circumstances in which a partnership is deemed to be a person under subsection 212(13.1) and is therefore required to withhold part XIII tax on certain payments to non-residents, pursuant to subsection 212(1). The amended rules are expected to become effective sometime after September 30, 2022, the date on which the consultation period ends. No set effective date has been provided.

Withholding Tax Obligations: The Current Legislation

Partnerships

According to subsection 212(1), various payments made by a "person" resident in Canada to a non-resident "person" are subject to a 25 percent withholding tax (the rate may be reduced under an applicable tax treaty). Under the Act, the definition of "person" does not normally include a partnership; however, various provisions treat a partnership as a person for certain purposes of the Act. For example, subsection 96(1) requires a taxpayer to compute its income from a partnership as if the partnership were a separate person resident in Canada. Subsection 212(13.1) provides for a number of situations where a partnership is deemed to be a person for the purposes of part XIII tax.

More specifically, paragraph 212(13.1)(a) deems a partnership to be a person resident in Canada in respect of payments made by the partnership to non-residents when those payments are deductible in computing the partnership's Canadian-source income. Under this provision, the withholding tax obligations of a partnership are linked to the partnership's Canadian-source income.

When a partnership owns only foreign assets, such as shares of an FA, and does not have any Canadian-source income, the conditions of paragraph 212(13.1)(a) may not be met. In such circumstances, part XIII tax will not apply to payments made by the partnership that would, if they were made by a person resident in Canada, attract part XIII tax (even though such payments, if made through the allocation of the partnership income to its partners, may indirectly be deducted by persons resident in Canada). The CRA has confirmed this result in certain statements regarding interest paid by a partnership that did not have Canadian-source income; however, the CRA has also said that it may consider Canadian-resident partners of the partnership to have the obligation to withhold if the partners may be considered (according to the laws under which the partnership was formed, the terms and conditions of the partnership agreement, and the loan agreement) to be the payers of the interest on the debts of the partnership. (See CRA document nos. RCT-0246, November 12, 1980; 2003-0039231E5, May 25, 2004; and 2004-0072131C6, May 7, 2004.)

Non-Residents

The withholding tax obligations of non-resident persons are outlined in subsection 212(13.2). The current provision deems a non-resident person to be a person resident in Canada in respect of payments made to another non-resident person to the extent that those payments are deductible in computing the non-resident payer's Canadian-source income.

The current provision does not contemplate or specify the withholding tax obligations of non-resident persons that have made an election under section 216 of the Act. When a non-resident person makes such an election, it can file a part I income tax return as if it were a resident of Canada and can pay part I tax on the net income derived from the rental of real or immovable property in Canada (or from timber royalties), instead of paying a flat 25 percent withholding tax rate (or, possibly, a reduced rate under the applicable tax treaty) on the gross rental income.

Furthermore, when a payment made by a non-resident person to a partnership (other than a Canadian partnership) is deductible in computing the non-resident person's taxable income earned in Canada from a source that is neither a treaty-protected business nor a treaty-protected property, subsection 13(13.2) does not deem the non-resident person to be a person resident in Canada for the purposes of part XIII tax.

Proposed Amendments: Broadening Withholding Tax Obligations

Partnerships

Deeming Rules: Paragraph 212(13.1)(a)

The proposals amend paragraph 212(13.1)(a) to deem a partnership to be a person resident in Canada in respect of the portion of payments made by the partnership to a non-resident person that is deductible in computing a partner's share of the partnership's income or loss, to the extent that the partner's share is taxable under part I of the Act. A partner's share will be taxable under part I if the partner is a person resident in Canada or if the partner is a non-resident person and the share is included in the partner's taxable income earned in Canada or is income that results from a section 216 election. This amendment removes the link to Canadian-source income of the partnership and shifts the focus to the income of a member of the partnership that is subject to part I tax. This amendment thus ensures that part XIII tax applies to partnerships in a wider array of circumstances; it clarifies

that a partnership may have withholding tax obligations when making payments to a non-resident even if the partnership does not have Canadian-source income.

The proposed rules may also result in withholding tax obligations for foreign private equity entities that have one or more partners resident in Canada. For instance, a foreign private equity partnership with one or more partners that are resident in Canada may now have a withholding tax obligation on management fees paid to a non-arm's-length foreign manager if treaty relief is not available. The proposed rules may also affect tiered structures in which a foreign fund partnership, which owns subsidiary foreign partnerships and the subsidiary partnership, pays interest to the fund partnership with the objective of reducing foreign-country taxation. To the extent that one or more partners of the fund partnership are resident in Canada, there will be a withholding tax obligation.

Even if the withholding tax obligation would apply only to the portion of the partnership income that is allocated to the partner resident in Canada, the proposed rules are likely to create some complications for the foreign private equity partnerships. As currently drafted, the proposed rules do not provide relief for partners that are exempt from part I tax, and they may result in withholding tax obligations even when Canadian partners are dealing at arm's length with the payee or have de minimis standing in the private equity structure.

Interpretive Rules: Subsection 212(13.11)

The proposals further amend subsection 212(13.1) by adding subsection 212(13.11) so as to provide three interpretive rules for the purposes of paragraph 212(13.1)(a):

1) Paragraph 212(13.11)(a) provides that if a partnership pays or credits an amount to another partnership (other than a Canadian partnership), the other partnership is deemed to be a non-resident person in respect of that amount. This rule ensures that payee partnerships with non-resident members are captured as non-resident persons under paragraph 212(13.1)(a).
2) Paragraph 212(13.11)(b) provides a lookthrough rule for tiered partnerships that ensures that paragraph 212(13.1)(a) is applied at the appropriate member level, which is the top-tier level.
3) Paragraph 212(13.11)(c) clarifies that a person's membership interest in a partnership, for the purposes of paragraph 212(13.1)(a), includes that person's interest to the extent that it is held directly or indirectly through another partnership.

Non-Residents: Subsection 212(13.2)

Subsection 212(13.2) extends the application of withholding tax under part XIII of the Act if a payment made by a non-resident person to another non-resident person is deducted against the payer's taxable income earned in Canada.

The amendments to subsection 212(13.2) are twofold. First, subsection 212(13.2) will apply to a non-resident person that makes a payment to a partnership other than a Canadian partnership. In such circumstances, the provision will deem the non-resident payer to be a person resident in Canada and the partnership to be a non-resident person. Second, the provision will apply when a non-resident has filed an election under section 216. This second amendment broadens the provision so that it is not tied to the existence of the payer's Canadian-source income.

It is worth noting that the proposals also amend subsection 212(13.3) so as to deem an authorized foreign bank to be a person resident in Canada for the purposes of subsection 212(13.1), paragraph 212(13.11)(a), and subsection 212(13.2), to the extent that the bank holds a membership interest in a partnership in the course of its Canadian banking business.

The proposals also amend paragraph 212(13.1)(b) for the sake of consistency with the proposed rules in paragraph 212(13.11)(a) and subsection 212(13.2).

Part XIII Tax Where the Payer Is a Partnership

Under the current legislation, paragraph 212(13.1)(b) deems a partnership, other than a Canadian partnership, to be a non-resident person in respect of amounts credited or paid to the partnership from a person resident in Canada. Accordingly, part XIII tax currently applies to payments from a person resident in Canada to a non-resident partnership. Because of the introduction of paragraph 212(13.11)(a) and the amendments to subsection 212(13.2), paragraph 212(13.1)(b) has also been amended.

Following the amendment, the deeming rule will no longer apply when the payer is a partnership or non-resident person deemed to be a person resident in Canada under either paragraph 212(13.1)(a) or paragraph 212(13.2)(b).

Concluding Observations

The proposed amendments to subsections 212(13.1) and 212(13.2) broaden the potential application of withholding tax obligations under part XIII. In particular, amendments to paragraph 212(13.1)(a) broaden the scope of the provision to include partnerships that do not have Canadian-source income; this should prevent the avoidance of Canadian withholding tax through the use of "shell" partnerships with non-Canadian-source income. Non-residents that have filed a section 216 election will have withholding tax obligations on payments made to other non-residents, and on payments made to partnerships other than Canadian partnerships. These amendments, as currently drafted, may also have adverse impacts on the structuring of private equity funds if one

or more Canadian partners are involved. It will be interesting to see whether the Department of Finance will consider a de minimis rule or an arm's-length requirement in order to help address the complexity involved in complying with the proposals.

Cynthia Morin and Suhaylah Sequeira
PwC LLP, Toronto

Proposed Amendments to Subparagraph 212.3(9)(b)(ii)

Proposed amendments to the Income Tax Act released by the Department of Finance on August 9, 2022 included a proposed change to the foreign affiliate dumping (FAD) rules in section 212.3—specifically, to the PUC reinstatement rule in subsection 212.3(9).

The PUC reduction rules in paragraph 212.3(2)(b) and subsection 212.3(7), along with the deemed dividend rule in paragraph 212.3(2)(a), are cornerstones of the FAD rules. In simplified terms, paragraph 212.3(2)(b) reduces the PUC of a class of shares of a corporation resident in Canada (CRIC) in circumstances where the PUC was increased by reason of an investment in an FA—for example, where shares of an FA are transferred to the CRIC in consideration for CRIC shares (thus giving rise to PUC in an amount equal to the value of the non-resident corporation's shares). Similarly, subsection 212.3(7)—a rule that provides relief from the deemed dividend rule in paragraph 212.3(2)(a), which is generally applicable where property is transferred to a CRIC to facilitate investment by the CRIC in an FA—reduces PUC where all required elements are present.

There are two circumstances in which subsection 212.3(9) reinstates the PUC of a class of CRIC shares that was reduced by a prior application of paragraph 212.3(2)(b) or subsection 212.3(7) as a consequence of an investment described in paragraphs 212.3(10)(a) to (f) (for example, an investment involving shares of and loans to FAs, or shares of Canadian corporations more than 75 percent of the value of which was derived from FAs). One circumstance is outlined in subparagraph 212.3(9)(b)(i), which describes a reduction of the PUC of the class of CRIC shares in a situation where shares of an FA (or certain Canadian-resident corporations) that gave rise to a prior reduction of PUC are distributed as payment of a PUC distribution. Subparagraph 212.3(9)(b)(ii) prescribes the other circumstance, which in general terms is a situation where a CRIC receives property (that is, sale proceeds and certain other transactions) "that can be traced to the investment that resulted in the prior reduction of PUC of shares of [the CRIC]" (*Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations*, August 2022, clause 42).

The amount of the PUC increase (that is, reinstatement) for a particular class of shares provided by subsection 212.3(9) is the lesser of two amounts. The first is the amount determined under paragraph 212.3(9)(a), which is generally the amount by which (1) the total of all amounts previously deducted pursuant to paragraph 212.3(2)(b) and subsection 212.3(7) in determining PUC exceeds (2) the total amounts previously reinstated to the PUC of the class. The second amount is determined under either subparagraph 212.3(9)(b)(i) or subparagraph 212.3(9)(b)(ii), as applicable in the circumstances.

The August 9, 2022 package proposed to amend subparagraph 212.3(9)(b)(ii). As noted above, this rule applies to determine an amount for the purposes of the reinstatement calculation in subsection 212.3(9) where a CRIC receives property in certain circumstances that can be traced to the investment that resulted in the prior PUC reduction in respect of a class of CRIC shares. More particularly, the amount computed under subparagraph 212.3(9)(b)(ii) is computed by a formula. In essence, the formula limits the PUC increase to the amount that is equal to the product of (1) the FMV of property received in the relevant circumstances by the CRIC or Canadian-resident corporations not dealing at arm's length with the CRIC (the description of A in the formula) and (2) a fraction, the numerator of which is the net PUC amount determined under paragraph 212.3(9)(a) (the description of B in the formula) and the denominator of which is the amount determined under paragraph 212.3(9)(a) in respect of all classes of CRIC shares and all corporations that do not deal at arm's length with the CRIC (the description of C in the formula).

Under current law, the FMV of property received by a CRIC is included in the description of A in the formula in subparagraph 212.3(9)(b)(ii) if it was received in any of the following circumstances:

- It was received as proceeds of the disposition of shares acquired by the CRIC—that is, FA shares described in paragraph 212.3(10)(a), or certain Canadian-resident corporation shares described in paragraph 212.3(10)(f), or shares in respect of a contribution of capital described in paragraph 212.3(10)(b)—that gave rise to a prior PUC reduction under the rules. However, an amount will not be included in the description of A if it constitutes either (1) shares of another FA received as consideration for the disposition, and either the "closely connected business" rule in subsection 212.3(16) or the reorganization exception in subsection 212.3(18) applies to exempt the acquisition of shares from the FAD rules; or (2) proceeds from the disposition of shares to a CRIC that is exempted from the rules by reason of subsection 212.3(16) or (18): clause (A) of the description of A, subparagraph 212.3(9)(b)(ii).

- It was received as a reduction of PUC or a dividend on shares acquired by the CRIC (again, as above—FA shares described in paragraph 212.3(10)(a), or certain Canadian-resident corporation shares described in paragraph 212.3(10)(f), or shares in respect of a contribution of capital described in paragraph 212.3(10)(b)) or as a reduction of PUC or dividends of FA shares substituted for such shares: see clause (B) of the description of A, subparagraph 212.3(9)(b)(ii). There is no restriction for such amounts received in respect of shares to which the FAD rules did not apply by reason of subsection 212.3(16) or (18).
- Where the investment that gave rise to the prior reduction of PUC under the rules was an investment in a debt obligation or amount owing described in paragraph 212.3(10)(c) or (d) or subparagraph 212.3(10)(e)(i), it was received on the repayment of, or as proceeds of disposition of, a debt or amount owing or interest on the amount owing. An amount will not be included in the description of A if the amount arose as a consequence of either of the following circumstances: (1) the debt was acquired by another FA of the taxpayer, to the extent of the portion of the FMV of the property received in relation to an investment described in paragraphs 212.3(10)(a) to (f), which is exempted from the application of the rules by subsection 212.3(16) or (18); or (2) the amount received is proceeds from a disposition to a CRIC, the acquisition of which by the latter is exempted from the rules by reason of subsection 212.3(16) or (18). It is noteworthy that these two restrictions do not apply to amounts received as payments of interest on such debts: see clause (C) of the description of A, subparagraph 212.3(9)(b)(ii).

In addition to reorganizing the architecture of the rule and correcting a non-substantive typographical error in clause (B) of the description of A in the formula, the proposed amendments extend the restrictions for amounts received in respect of shares to which the FAD rules did not apply by reason of subsection 212.3(16) or (18), such that the restrictions apply to all circumstances, including situations where amounts are received as a reduction of PUC or a dividend on shares acquired by the CRIC, or as interest on certain debts. More particularly, the proposals would restructure the description of A such that the transactions and events currently set out in clauses (A) to (C), outlined above, are renumbered as subclauses (A)(I) to (III), respectively, and the restrictions that deny the PUC reinstatement in all circumstances described above are consolidated in clause (B). The circumstances in which the proposed amended rules would apply, but in which the current rules do not apply, appear to be rare. One example is a situation where the PUC of the CRIC was initially reduced pursuant to an investment by way of a loan to an FA, as described in paragraph 212.3(10)(c). Under the current rules, a payment of interest "in kind" on that loan, by way of the issuance of shares in the FA, would result in a PUC reinstatement pursuant to subclause (C)(II) of the description of A in subparagraph 212.3(9)(b)(ii). This would be the case even if the acquisition of the shares of the Canadian-resident corporation was exempt from subsection 212.3(2) by virtue of subsection 212.3(16) (it would otherwise be considered an investment under paragraph 212.3(10)(a)). However, there appear to be few other instances in which the amendments would have practical application.

Michael Colborne and Nicholas McIsaac
Thorsteinssons LLP, Toronto

Packing and Unpacking Proposed Amendments

On August 9, 2022, the Department of Finance released draft legislation, along with explanatory notes, regarding technical amendments to the Income Tax Act and Income Tax Regulations. This article will address the proposed amendments to subsection 88(3.3) (the FA suppression election) and to regulation 5907(2.01), which concerns FA asset-packaging transactions.

Amendments to Subsection 88(3.3): FA Suppression Election

Subsection 88(3.3), commonly referred to as the suppression election, allows a taxpayer to reduce the capital gain that would otherwise be realized on the disposition of a share of a liquidating affiliate, upon a qualifying liquidation and dissolution, by electing a lower amount of proceeds of disposition (and, in consequence, a lower cost base going forward) on a particular distributed capital property of the liquidating affiliate.

Proposed subsection 88(3.3) reads as follows:

> For the purposes of paragraph (3)(a), if the liquidation and dissolution is a qualifying liquidation and dissolution of the disposing affiliate and the taxpayer would, in the absence of this subsection and, for greater certainty, after taking into account any election under subsection 93(1), realize a capital gain (the amount of which is referred to in subsection (3.4) as the "capital gain amount") from the disposition of a disposed share, the taxpayer may elect, in accordance with prescribed rules, that distributed property that was, immediately before the disposition, capital property (*that is a share of the capital stock of another foreign affiliate of the taxpayer*) of the disposing affiliate be deemed to have been disposed of by the disposing affiliate to the taxpayer for proceeds of disposition equal to the amount claimed (referred to in subsection (3.4) as the "claimed amount") by the taxpayer in the election. [Emphasis added.]

Under the proposed amendment, the distributed capital property for which the suppression election can be used is

limited solely to shares of another FA of the taxpayer. This amendment is expected to substantially reduce the effectiveness of the suppression election.

In the explanatory notes to the August 9 proposals, Finance indicated that the proposed amendment was drafted because of Finance's concern that the current rules allow the accrued gain from the acquisition of shares or debt of a Canadian-resident corporation to be (1) deferred indefinitely while still allowing a Canadian-resident corporation to have use of the underlying property, or (2) eliminated altogether through a reorganization of the Canadian-resident corporation following the dissolution. Arguably, an alternative response to Finance's concern could have been a requirement that the capital property be foreign capital property. In its current form, the proposed amendment to subsection 88(3.3) seems to cover more dispositions than was intended.

The amendment to subsection 88(3.3) applies in respect of dispositions that occur on or after August 9, 2022.

Amendments to Regulation 5907(2.01)(a): Packaging of Assets for Sale and Surplus Recognition

Finance proposed two amendments to regulation 5907(2.01)(a).

Regulation 5907(2.01) overrides the non-recognition rules in regulations 5907(5.1) and 5907(2)(f) and (j). When an FA's assets are packaged for sale and the conditions set out in regulation 5907(2.01)(a) are met (including the disposition to an arm's-length person, within 90 days, of the shares of another FA received as consideration for the packaged assets), the non-recognition rules should not apply to the transfer, and surplus recognition on any unrealized value on the packaged assets should be allowed.

The first amendment to regulation 5907(2.01)(a) adds a requirement that the shares received by the disposing affiliate as consideration for the packaged assets be shares of the receiving affiliate. Proposed regulation 5907(2.01)(a)(i) states that "the only consideration in respect of the particular disposition is one or any combination of (i) shares of the capital stock of the other affiliate, and. . . ."

The second amendment relaxes the requirements for the "consideration received" in regulation 5907(2.01)(a); this is, we believe, a response to an issue raised in a 2014 CRA income tax ruling. In CRA document no. 2014-0550451E5 (April 22, 2015), the CRA confirmed that "consideration received" by the disposing affiliate for the purposes of regulation 5907(2.01) included the assumption of the disposing FA's debt by the receiving FA. Because regulation 5907(2.01)(a) previously required that the only "consideration received" be the shares of another FA, the transfer would not meet the requirements of regulation 5907(2.01)(a), and, therefore, the non-recognition rules could apply.

Proposed regulation 5907(2.01)(a) allows the consideration received to include "the assumption by the other affiliate of a debt or other obligation owing by the particular affiliate that arose in the ordinary course of the business of the particular affiliate to which the affiliate property relates."

The extension of the "consideration received" rule to debt arising in the ordinary course of the disposing affiliate's business is a welcome expansion of the rules.

In sum, these amendments, which apply in respect of dispositions that occur on or after August 9, 2022, support taxpayers in the packaging of FA assets, but they limit their unpacking.

Samantha D'Andrea
EY Law LLP, Montreal

Proposed Amendments to Subsection 85.1(4)

Proposed legislation, released on August 9, 2022, seeks to expand the scope of subsection 85.1(4)—an anti-avoidance rule relating to transfers of FA shares under subsection 85.1(3)—in order to address certain perceived gaps in the existing legislation. Parallel amendments are also proposed for the similar anti-avoidance rule in subsection 87(8.3), which applies to so-called triangular foreign mergers. The discussion below focuses only on subsection 85.1(4).

In general, subsection 85.1(3) allows a taxpayer to transfer, on a rollover basis, shares of a first-tier FA of the taxpayer ("the first affiliate") to another corporation that is, immediately following the transfer, an FA of the taxpayer ("the second affiliate"), provided that the consideration received by the taxpayer includes shares of the second affiliate. It is a commonly used provision that facilitates tax-deferred reorganizations of directly held FAs.

Without an appropriate safeguard, the provision could be used in unintended ways. For example, the capital gain that would otherwise be realized on the outright sale of a directly held FA could be deferred by the initial transfer of the shares of the first affiliate, on a rollover basis, to a second affiliate, which would then sell the shares of the first affiliate to a subsequent acquiror. Provided that the shares of the first affiliate are excluded property, the capital gain realized by the second affiliate could be deferred offshore as hybrid surplus until the proceeds are repatriated to Canada. Subsection 85.1(4) addresses this concern by denying rollover treatment under subsection 85.1(3) in situations where all or substantially all of the property of the first affiliate is excluded property at the time of the initial transfer and the transfer is part of a series of transactions undertaken for the purpose of selling the first affiliate to a subsequent acquiror who is dealing at arm's length with the taxpayer, with a limited exception for subsequent

acquirors that are FAs of the taxpayer in which the taxpayer has a qualifying interest.

Given that subsection 85.1(4) has generally been viewed as an adequate safeguard, it is somewhat surprising that the draft technical amendments include a proposal to expand the scope of the provision. The key changes are discussed below.

Purpose Test

The existing language in subsection 85.1(4) requires the initial transfer to be part of a series of transactions undertaken for the purpose of selling the shares of the first affiliate to a subsequent acquiror. The proposed amendments eliminate the purpose test and simply require the initial transfer to be part of a series of transactions that includes another disposition of the shares of the first affiliate or certain other properties that derive a portion of their value from the shares of the first affiliate. The elimination of the purpose test is potentially significant, given the possible breadth of what can constitute a series of transactions, and the uncertainty that this can produce for taxpayers. This is especially so because of the expanded scope of subsequent acquirors and subsequent dispositions under the proposed amendments, as discussed below. At a minimum, the new wording places a significant burden on taxpayers to carefully consider the meaning of the term "series" as established under common law and expanded by subsection 248(10). In this context, some limited comfort may be gleaned from the jurisprudence, which clarifies that for two events to be part of the same series, one needs to be undertaken "because of" or "in relation to" another, and the connection between the events needs to be closer than an extreme degree of remoteness or a mere possibility (see, for example, *OSFC Holdings Ltd. v. The Queen*, 2001 FCA 260 and *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63). Nevertheless, reliance on such positions is at best unappealing, given that it requires taxpayers to prove a negative when defending against assertions made by tax authorities who undertake audits with the benefit of hindsight.

Subsequent Acquirors

Currently, rollover treatment is denied only where the subsequent acquiror is an arm's-length person, other than an FA of the taxpayer in which the taxpayer has a qualifying interest. Under the proposed amendments, rollover treatment is denied where the subsequent acquiror is either an arm's-length person or a non-arm's-length non-resident person, other than a controlled FA of the taxpayer (within the narrower meaning in section 17, which requires the FA to be controlled by the taxpayer and other non-arm's-length Canadian residents).

Expanding the scope of subsequent acquirors to include non-arm's-length non-resident persons is presumably intended to address a concern that subsection 85.1(3) could be used as a means of moving a directly held FA out from under Canada on a tax-deferred basis. To illustrate, assume that a non-resident corporation (NRco) owns all of the shares of a Canadian corporation (Canco), which in turn owns all of the shares of two FAs (FA1 and FA2), and assume, furthermore, that there is a desire to transfer the shares of FA1 from Canco to NRco. Under current law, if Canco were to transfer the shares of FA1 to FA2 for additional shares of FA2, and FA2 were then to sell the shares of FA1 to NRco, subsection 85.1(4) would have no application, because the subsequent acquiror (NRco) is not an arm's-length person. Under the proposed amendments, the initial transfer would be within the scope of subsection 85.1(4) because the subsequent acquiror (NRco) is a non-arm's-length non-resident person.

Similarly, narrowing the carve-out for subsequent FA acquirors so as to include only FAs that are controlled by the taxpayer and other non-arm's-length Canadian residents, as opposed to FAs in which the taxpayer has a qualifying interest (generally 10 percent ownership of the affiliate based on votes and value), is intended to limit the opportunity to transfer a directly held FA out from under Canada. However, abandoning a "votes and value" test in favour of a test of voting control may open up opportunities to transfer the economics associated with the ownership of an FA out from under Canada, if not to establish de jure control—a result that is presumably unintended.

Subsequent Dispositions

Under existing law, subsection 85.1(4) applies in situations where a share of the first affiliate that is transferred to the second affiliate is disposed of on a subsequent disposition. Under the proposed amendments, this application is expanded to include situations where certain other property is disposed of on a subsequent disposition. The types of property that fall within the scope of this amendment include any property that is substituted for the share of the first affiliate, as well as any other property any of the FMV of which is derived, directly or indirectly, from the share of the first affiliate. The purpose of these changes is to prevent a taxpayer from avoiding subsection 85.1(4) by structuring the subsequent disposition as an indirect disposition of the shares of the first affiliate—for instance, by transferring the shares of the first affiliate to a second affiliate, which, in turn, transfers the shares of the first affiliate to a third affiliate, after which the second affiliate sells the shares of the third affiliate to a subsequent acquiror. Conceptually, this makes sense. However, the drafting of the "indirect" concept is extremely broad. For instance, it seems that the transfer of a first affiliate from a Canadian corporation to a second affiliate followed by an outright sale of the second affiliate by the Canadian corporation is caught by the proposed amendments, even though the subsequent disposition in this case is taxable in Canada without any opportunity for deferral. Similarly, it appears that the transfer of a first affiliate from a Canadian corporation to a second affiliate,

followed by an outright sale of the Canadian corporation by its shareholder(s), is caught by the amendments, because the FMV of the shares of the Canadian corporation is derived, in part, from the underlying shares of the first affiliate. Presumably this is unintended; it would seem appropriate to consider only subsequent dispositions by FAs of the taxpayer.

Furthermore, it seems that the broad drafting of the "indirect" concept could lead to other inappropriate results. For instance, in the example above, if all of the shares of the first affiliate are transferred to the second affiliate for 100 shares of the second affiliate, and then to the third affiliate for 100 shares of the third affiliate, after which a single share of the second affiliate is sold to a subsequent acquiror, it would seem that rollover treatment is denied for all of the shares of the first affiliate because the single share of the second affiliate that is disposed of to the subsequent acquiror derives a portion of its FMV from each underlying share of the first affiliate. This is an unexpected result, because it would seem appropriate to deny rollover treatment only on a proportionate basis.

Once again, the expanded wording requires taxpayers to place greater reliance on the position that subsequent dispositions are not part of the same series.

Excluded Property

As noted above, subsection 85.1(4) is aimed at preventing the inappropriate deferral of tax in respect of gains on the shares of an FA that qualify as excluded property at the time of their subsequent disposition by another FA. Under current law, excluded property status is tested, indirectly, by considering whether all or substantially all of the property of the first affiliate is excluded property at the time of the initial transfer. Under the proposed amendments, excluded property status is considered to exist if either of the following two tests is met: (1) all or substantially all of the property of the first affiliate is excluded property at the time of the initial transfer, or (2) the shares of the first affiliate are excluded property at the time of the subsequent disposition. The addition of the second test addresses a concern that a first affiliate with property that includes non-excluded property could be transferred to a second affiliate, purified, and then sold to a subsequent acquiror at a time when the shares of the first affiliate qualify as excluded property. At the same time, there could be situations where all or substantially all of the property of the first affiliate is excluded property at the time of the initial transfer, but the shares of the first affiliate, or any other shares that derive their value from those shares, are not excluded property at the time of the subsequent disposition. In such cases, the initial transfer would be denied rollover treatment even though the subsequent disposition gives rise to FAPI. Given that the relevant test for deferral is whether the shares of the first affiliate are excluded property at the time of the subsequent disposition, it is not clear why the test at the time of initial transfer was retained along with the new test at the time of the subsequent disposition, rather than the initial test simply being replaced with the new test, which appears to be the more relevant and appropriate one.

Conclusion

While there are valid concerns underlying the proposed amendments to subsection 85.1(4), the drafting of the proposed amendments introduces a number of potential issues and pitfalls of which taxpayers need to be aware. We hope that some of these issues will be addressed before the proposed amendments are passed into law.

David Bunn
Deloitte LLP, Toronto

Mark Dumalski
Deloitte LLP, Ottawa

The Amended Service FAPI Rule: New Relief Available

In August 2022, the Department of Finance released draft legislation to amend and expand the service foreign accrual property income (FAPI) rule in paragraph 95(2)(b), thus providing welcome relief to taxpayers. This article provides an overview of the amendments, and it explores whether further consideration is warranted to ensure that their intended result is achieved.

Paragraph 95(2)(b) stipulates that the provision of certain services by an FA of a taxpayer is deemed to be a separate business, other than an active business, carried on by the FA, and any income from that business is deemed to be income from a business other than an active business and, as such, FAPI. Specifically, clause 95(2)(b)(i)(B) targets amounts paid in consideration for such services that are deductible in computing the FAPI of an FA of the taxpayer. The purpose of clause 95(2)(b)(i)(B) is to prevent taxpayers from converting FAPI expenses that would be deductible for one FA into active business income of another FA.

In the proposed legislation, new subsection 95(3.03) provides an exception to existing subparagraph 95(2)(b)(i). In order for the exception to apply, all of the conditions set out in subsection 95(3.03) must be met. These conditions are largely analogous to those in clause 95(2)(a)(ii)(D), which recharacterizes income from property as income from an active business. The conditions that must be met for the exception in subsection 95(3.03) to apply include the following:

a) Throughout the taxation year of the particular affiliate, the taxpayer has a qualifying interest in respect of the particular affiliate, or the particular affiliate is a controlled foreign affiliate (CFA) of the taxpayer.
b) The particular affiliate provides the services to another FA (the "second affiliate") of the taxpayer in

respect of which the taxpayer has a qualifying interest throughout the year.

c) The amounts paid or payable by the second affiliate in consideration for the services are for expenditures incurred by the second affiliate for the purpose of earning income from property.

d) The property referred to in paragraph 95(2)(c) is excluded property of the second affiliate that is shares of the capital stock of a corporation that is an FA of the taxpayer ("third affiliate") in respect of which the taxpayer has a qualifying interest.

e) The second affiliate and the third affiliate are subject to income tax in a foreign country for each of their taxation years that end in the year.

The policy intent of proposed subsection 95(3.03) is not explicitly stated in the explanatory notes. However, it is thought to address the fact pattern set out in the comfort letter issued by the Department of Finance on December 23, 2016. The comfort letter provided a factual situation where an FA ("FA 1") of a taxpayer provides management services to another FA of the taxpayer ("FA Opco") that carries on an active business. FA Opco is held by a third FA of the taxpayer ("FA Holdco") and other arm's-length parties. The management fee received by FA 1 in consideration for the services it provides to FA Opco is paid by FA Holdco instead of FA Opco, because the other shareholders of FA Opco are unwilling to bear the fee. Because FA Holdco does not carry on an active business, the service fee paid by FA Holdco is deductible in computing FA Holdco's income from property, which results in foreign accrual property losses (FAPLs). Existing clause 95(2)(b)(i)(B) would otherwise apply to deem the service income earned by FA 1 to be FAPI. Finance stated that to the extent that the conditions generally analogous to those in clause 95(2)(a)(ii)(D) are satisfied, clause 95(2)(b)(i)(B) should not apply to recharacterize the service fee as FAPI to FA 1. Arguably, the rationale for Finance's position is that, if the management fee were paid by FA Opco, it would have been deductible in computing FA Opco's active business income, and paragraph 95(2)(b) would not have applied.

Proposed subsection 95(3.03), however, seems to require that the payee FA provide services to the payer FA (as described in (b) and (c) of the conditions listed above) instead of to a third FA. Therefore, the comfort letter's fact pattern may not meet the conditions of proposed subsection 95(3.03) because, in that fact pattern, the payee FA did not provide services directly to the payer FA. Rather, the services were rendered to a third FA, the shares of which were excluded property of the payee FA, presumably for the purpose of maintaining the third FA's active business. Should subsection 95(3.03), therefore, be extended to situations where the payer FA directly or indirectly holds the excluded property shares of the FA that receives the services? The proposed legislation, while a welcome addition, seems to have a relatively limited scope: it appears to apply only to services provided by an FA to a second affiliate to support the second affiliate's holding company function in respect of its investments that are shares of a third affiliate (which are excluded property). Variables A and D in the definition of "FAPI" in subsection 95(1) and regulation 5907(2.7) have, as a result, been amended to provide that any FAPLs of the payer FA otherwise resulting from the service payments are eliminated and deducted in computing that FA's earnings from an active business, with a view to ensuring symmetry in the treatment of the payer and payee affiliates.

It will be interesting to see whether and how Finance will further expand the scope of the proposed exception in subsection 95(3.03) to encompass the situation that likely prompted the amendment.

Finally, clause 95(2)(b)(i)(B) has also been amended to ensure that service income is included in the payee affiliate's FAPI only in proportion to the taxpayer's participating percentage in the payer affiliate's income. For this purpose, the participating percentage is to be read as though it applies to all FAs, not just CFAs. This change provides a fairer result when clause 95(2)(b)(i)(B) is being applied, because service fees are included in the payee's FAPI only in proportion to the taxpayer's economic interest in the payer's income.

Silvia Wang and Clara Pham
RSM Canada LLP, Toronto

Upstream Loans: Limitation on the Scope of the Moneylending Business Exception

On August 9, 2022, the Department of Finance released legislative proposals that include technical amendments to specific international tax measures. One of these amendments is to the moneylending business exception in paragraph 90(8)(b) of the "upstream loan" rules, which has been narrowed so as to apply only to arm's-length moneylending businesses.

Under the upstream loan rules, which were introduced in 2011, an upstream loan made by an FA of a Canadian taxpayer to a specified debtor must be included in the income of the relevant taxpayer to the extent that an equivalent dividend could not have been paid tax-free under the FA surplus regime. Upstream loans were broadly used by Canadian multinationals as a tool to prevent or defer the payment of Canadian tax on the repatriation of funds to Canada where insufficient underlying foreign tax was paid with respect to taxable surplus, with a view to circumventing the cost of foreign withholding tax on dividends or to sidestepping certain foreign corporate-law limitations on dividend payments.

These rules, including the exceptions to their application, are similar to the shareholder loan rules in subsection 15(2), but the two sets of rules are mutually exclusive (subsection 90(6) does not apply if subsection 15(2) applies). New paragraph 90(8)(b) is aligned with the proposed changes to subsection 15(2.3) that were introduced in the same legislative package of August 2022.

Subsection 90(8) provides four general exceptions to the application of subsection 90(6), one of which—paragraph (b)—carves out an indebtedness that arose in the ordinary course of the creditor's business or a loan that was made in the ordinary course of the creditor's ordinary business of lending money, if bona fide arrangements were made, at the time the indebtedness arose or the loan was made, for repayment within a reasonable time. The first item (unaffected by the proposals) generally deals with trade accounts receivable, while the latter is in respect of loans made in a business of lending money.

Submissions were made a decade ago suggesting amendments to this exception, because it was considered to be too narrow in its application and because it did not take into account situations in which the creditor acquires existing loans and receivables as opposed to originating them. (See the Joint Committee submission Re: October 24, 2012 Notice of Ways and Means Motion/Bill C-48, the Technical Amendments Act, 2012.) However, the proposals are going in the opposite direction from what these submissions recommended.

Furthermore, the amendments represent a clean break from past rulings positions issued by the CRA that confirmed, in the context of subsection 15(2.3), that this exception applied to internal financing arrangements. (See, for example, CRA document nos. 2006-0191881R3, 2007; 2007-0238971R3, 2007; and 2007-0244561R3, 2007.) The CRA generally acknowledged the application of its subsection 15(2) interpretations in relation to the upstream loan rules.

The proposals would amend paragraph 90(8)(b) to narrow the moneylending business exception to predominantly arm's-length lenders, while the trade receivables exception would remain intact. The proposed amendment to paragraph 90(8)(b) provides that if, at any time during which the loan is outstanding, less than 90 percent of the aggregate outstanding amount of the loans of the business is owing by borrowers that deal at arm's length with the lender/creditor, the exception does not apply and the "specified amount" in respect of the loan or indebtedness made by the FA to a "specified debtor" should fall under the general rule in subsection 90(6) and be included in the taxpayer's income.

In the explanatory notes, Finance states that "internal or 'captive' " moneylenders within a corporate group will not be able to benefit from this exception, which is intended to apply only to arm's-length lending. Considering that the exception allows less than 10 percent of the aggregate amount of loans outstanding to be with non-arm's-length parties, the moneylending business exception has not been completely eradicated. Its scope, however, appears to be limited: only a very small percentage of the overall loans portfolio can be made on an ongoing basis to a specified debtor without falling within the ambit of the rules.

It is noteworthy that a specific set of rules already exists to exclude from the application of subsection 90(6) upstream deposits (for example, indebtedness) that are made to eligible Canadian banks with the exception in paragraph 90(8)(d), read in combination with subsection 90(8.1). Subsection 90(6) should not apply to a loan or other form of indebtedness made by an eligible bank affiliate to an eligible Canadian bank if 90 percent of all of the upstream deposits that the eligible Canadian bank owes to the eligible affiliate does not exceed the affiliate's excess liquidity for the year. The 2014 explanatory notes regarding this exception indicated that subsection 90(8.1) "is consistent with the policy of the excess liquidity proposals in new subsections 95(2.43) to (2.45)."

The tightening of the exception in paragraph 90(8)(b) will undoubtedly limit the structuring options for intragroup financing companies. Also, given the proposed rules, a company whose purpose is to rely on the moneylending business exception for an FA creditor will need to calculate the percentage that represents the moneylending to entities within its group, *during all of the time in which the loan is outstanding*. The pressure on the taxpayer to rely on such an exception appears high when significant loan portfolios are in place with arm's-length and non-arm's-length borrowers, and balances vary on a daily basis. This difficulty is similar to the difficulty involved in applying the upstream loan rules to certain cash-pooling arrangements. By contrast, the application of the upstream deposits rule to banks uses monthly averages.

The proposals would also add subsection 90(8.01), which is an interpretive provision applicable to partnerships to determine whether the borrower and the creditor are dealing at arm's length.

The amendments discussed above are applicable to loans made after 2022; however, they also apply to any portion of a particular loan made before 2023 that remains outstanding on January 1, 2023 as if that portion were a separate loan that was made on January 1, 2023 in the same manner and on the same terms as the particular loan. As a result, taxpayers may be required to take remedial action in respect of pre-existing upstream loans.

Audrey Dubois
KPMG LLP, Montreal

UK First-Tier Tribunal Declines To Apply a Specific Anti-Avoidance Rule: Requisite Purpose Was Lacking

The recent decision of the United Kingdom's First-Tier Tribunal in *Burlington Loan Management DAC v. HMRC* ([2022] UKFTT 290 (TC)) considered a specific anti-avoidance rule in a tax treaty, and the case may provide a foretaste of the sorts of disputes that will arise under the principal purpose test in article 7 of the multilateral instrument (MLI).

Background

SAAD Investments Company Ltd. ("SAAD"), a Cayman company, had an interest-bearing debt claim against Lehman Brothers International (Europe) ("Lehman UK"), a UK company. Following the full discharge by Lehman UK's administrators, in September 2016, of the principal amount of the debt, SAAD retained the right to receive the interest payable in respect of the claim, amounting to £90 million. SAAD was not entitled to any treaty relief in respect of the debt claim and would have been subject to UK statutory withholding tax of 20 percent had Lehman UK paid SAAD the interest.

In February 2018, SAAD's liquidators sold the right to receive interest to Burlington Loan Management DAC ("Burlington"), an Irish company, for an amount equal to 92 percent of the amount of the interest owing. In July 2018, Lehman UK's administrators discharged the amount of the outstanding interest in full, paying 80 percent of the interest to Burlington and withholding 20 percent of the interest in compliance with their UK withholding tax obligations. Burlington applied to HM Revenue & Customs (HMRC) for a refund of the amount withheld in reliance on article 12(1) of the double taxation treaty between the United Kingdom and the Republic of Ireland, which provides relief from UK tax on interest derived and beneficially owned by an Irish resident. HMRC denied Burlington's claim on the basis that article 12(5) of the treaty applied; this provision denies the benefit of article 12(1) if "it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of [article 12 of the treaty] by means of that creation or assignment." Burlington appealed to the First-Tier Tribunal, which held that HMRC had not discharged its burden of proving that article 12(5) applied in the circumstances.

The Tribunal's Reasons

HMRC argued that Burlington was aware that the seller was likely to incur UK withholding tax if it retained the debt claim; this awareness accounted for the significant discount at which Burlington offered to purchase the debt claim (paragraph 156). Thus, according to HMRC, one of Burlington's main purposes must have been to generate a profit from that discount in reliance on its exemption from UK withholding tax under article 12(1).

The tribunal disagreed with HMRC, finding instead that Burlington's sole purpose was to realize a profit (paragraph 176). The tribunal accepted that Burlington was aware of its ability to benefit from article 12(1) of the treaty, but the tribunal found that ability to be merely a component in the calculation of the purchase price that Burlington was willing to pay; that ability did not form any part of Burlington's purpose in acquiring the debt claim. It was merely part of the "scenery" in which Burlington made its offer (paragraph 174).

HMRC had also argued that SAAD must have known, on the basis of the offer price, that the purchaser was eligible for the benefits of a treaty. Therefore, according to HMRC, one of SAAD's main purposes had been to take advantage of article 12(1) by assigning the debt for a price that reflected the purchaser's exemption and thereby realizing more than it would have if it had held onto the asset (paragraph 157).

Again, the tribunal disagreed. It found that SAAD's sole purpose had been to realize the claim for the best possible price and that it had agreed on that price in principle before even inquiring about the identity or the tax residence of the end purchaser (paragraph 187). Although SAAD had subsequently become aware of Burlington's identity and the precise legal basis for its withholding tax exemption before finalizing the transaction (which the tribunal held to be a precondition for engaging article 12(5)), the tribunal declined (paragraphs 193-95) to find that SAAD, as a result of this awareness, had achieved one of its main purposes by taking advantage of article 12(1). The tribunal distinguished, in the process, between (1) situations where a person sells a debt claim outright for a purchase price that reflects the existence in the market of parties that are able to benefit from tax attributes that they do not themselves enjoy, and (2) situations that anti-avoidance provisions such as article 12(5) were intended to address, which typically involve the retention, by the resident of the non-treaty jurisdiction, of some indirect economic interest in the debt claim that allows that resident to take advantage of the treaty benefit indirectly (paragraphs 196-200).

Discussion

The tribunal's conclusion that article 12(5) does not apply in these circumstances seems well founded. It is comforting, in particular, to read the tribunal's commercially sensible conclusion that an anti-avoidance rule that denies treaty benefits on the basis of a taxpayer's purposes is not engaged merely because a taxpayer has knowledge of its tax position, including its entitlement to treaty benefits, and relies on that knowledge to determine the price at which it is willing to make an investment.

One troubling aspect of this case is the tribunal's willingness to consider SAAD's purpose as relevant to the article 12(5) analysis. The tribunal ultimately rejected HMRC's arguments

that one of SAAD's main purposes was to take advantage of article 12(1), and it did suggest that article 12(5) was intended to apply only to transactions involving conduits or treaty shopping; however, its conclusion on this point was grounded in the specific facts. The tribunal may have left the door open to the perverse possibility that a taxpayer's ability to access a treaty benefit will depend on an unrelated taxpayer's purpose in entering into a transaction. This would be an inappropriate outcome, and it could result in similarly situated taxpayers being taxed differently because they acquired assets from counterparties with differing purposes—a consideration that should be entirely irrelevant to the analysis.

The tribunal's reasoning may have been driven by article 12(5)'s particular focus on the purpose of "any person"—an emphasis lacking, perhaps, in most other anti-avoidance rules. (Notably, the principal purpose test in article 7 of the MLI does not refer to the purpose of "any person.") It is to be hoped that subsequent cases will not endorse this reasoning, at least not with respect to provisions that lack a specific reference to "any person."

Chris Sheridan and Jeffrey Shafer
(with thanks to Jessica Charendoff)
Blake Cassels & Graydon LLP, Toronto

The Luxembourg Tax Authorities Challenge Interest-Free Loans: Is It a Call for Action?

Introduction

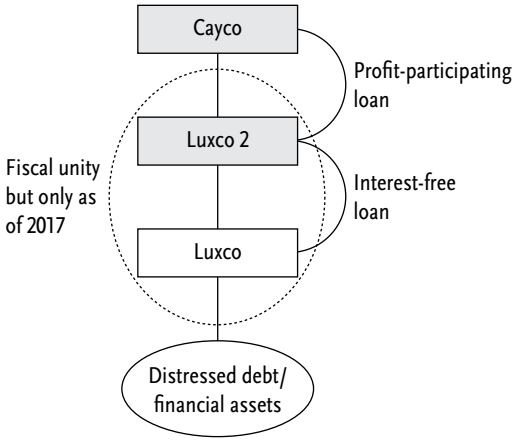
On September 23, 2022, the Luxembourg Administrative Tribunal confirmed, with decision 44902, the Luxembourg tax authorities' position on financing in the form of an interest-free loan (IFL) that is granted to a Luxembourg company by its sole shareholder: such financing is to be treated as a hidden capital contribution (equity). This treatment entails, inter alia, the non-deductibility of notional interest expenses on the IFL as well as the non-deductibility of the IFL for the purposes of net wealth tax.

The Facts of the Case

On April 29, 2016, the Cayman sole shareholder ("Cayco") of a Luxembourg company ("Luxco 2") provided funds via a profit-participating loan (PPL) to its Luxembourg subsidiary, which in turn, on the same date, granted an IFL to its fully owned Luxembourg subsidiary ("Luxco"). Luxco then invested in debt instruments. (See the accompanying figure.)

The IFL legal agreement was not executed until December 19, 2016, some months after the funds were provided to Luxco, with retroactive effect from April 29, 2016.

The two Luxembourg companies entered into a fiscal unity as of January 1, 2017. Typically, as part of a fiscal unity, the income at the Luxco level is offset with a deduction on the PPL at the Luxco 2 level. In the absence of fiscal unity, the income at the Luxco level would have been fully taxable without a deduction on the PPL save for a notional deduction on the IFL. For the 2016 tax year, Luxco deducted an amount of notional interest expense on the IFL in its tax return. Notional interest income at the level of Luxco 2 (though not relevant to the case) would be taxable, but offset with an expense on the PPL. The Luxembourg tax authorities, in the assessment of Luxco for 2016, denied the company's notional interest deduction on the IFL.



Simplified structure for illustrative purposes.

The Luxembourg Administrative Tribunal focused on analyzing the terms of the IFL, in particular the "limited recourse clause" and a "conversion option." According to the tribunal, the interaction of certain clauses in the IFL agreement actually removed any obligation on the borrower to repay the funds, leading the tribunal to conclude that the intention of the lender (who was, at the same time, the sole shareholder) was to provide its subsidiary with equity rather than to act as a lender.

The fact that the IFL provided for the possibility, at the option of the lender who was also the sole shareholder, of the contribution of part or all of the IFL in exchange for shares at a predetermined ratio was held by the tribunal to be a further indication of a hidden capital contribution.

Other features that, according to the tribunal, should generally be considered in a debt-versus-equity analysis were the lack of an interest rate, the absence of protection against a repayment default, the allocation of the funding to long-term assets, the lack of guarantees, and the excessive debt-to-equity ratio, along with the general circumstances in which the financing was granted.

The Substance-over-Form Approach and the Qualification of IFLs

The tribunal decided to recharacterize the financing as equity on the basis of the "substance over form" principle, which

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IFA Canada
Canadian Tax Foundation
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
ISSN 2816-4415 (Online)

looks at an arrangement's economic rationale rather than its legal aspects alone. In other words, the Luxembourg tax authorities will not be bound by the legal construct of a transaction. Rather, they will consider the economic reality of a transaction in order to apply the tax treatment appropriate for that reality.

From a tax point of view, an arrangement that is a debt in appearance can carry the characteristics of equity. On the basis of the "substance over form" approach and the principle, from article 40 of the Luxembourg Income Tax Law, that the tax balance sheet follows the commercial balance sheet (*principe de l'accrochement du bilan fiscal au bilan comptable*), an IFL will also be considered to be a debt instrument for Luxembourg tax purposes on a case-by-case basis to the extent that the instrument has debt characteristics.

In summary, according to the tribunal, the real content of an economic transaction is relevant for the application of the tax law, and it must be identified. Thus, where the intention behind the transaction (given the terms of the instrument and related circumstances) is that of a shareholder investing in its subsidiary rather than that of a lender (who expects a return and repayment of the funds), the loan is to be recharacterized as hidden capital.

The Tax Consequences of Recharacterizing an IFL as Equity

On the evidence of the case at hand, the tax consequences of recharacterizing an IFL as hidden capital are the following:

- Any dividend distribution from Luxco to Luxco 2 would result in the disallowance of the yield accrued on the PPL issued by Luxco 2, because the PPL will be considered to be financing the participation in Luxco (which includes the IFL as equity), not a receivable. This result is arrived at through the application of the tax rules according to which expenses in relation to exempt income, such as dividends, may not be deducted—a way to avoid, indirectly, double non-taxation.
- There is no deduction of notional interest for income tax purposes.
- The IFL is non-deductible for net wealth tax purposes.

Conclusion

The specific facts of the case may have played a role in the Luxembourg tax authorities' decision to challenge the loan, but the tribunal's statements are not applicable only to the specific circumstances and facts of the case, the activity of the entity involved in the case, or the absence of a fiscal unity.

The tribunal's decision confirms the need for companies (1) to consider whether a shareholder that is also a creditor of the company behaves like a creditor when granting a loan, and (2) to take the economic features of this behaviour into account. This principle applies outside the context of IFLs; companies must give it careful consideration when financing their corporate structures through either debt or equity, because such financing is normally motivated by strategic business decisions that trigger different tax consequences.

The tribunal's decision may still be appealed. Nonetheless, taxpayers should review the terms and conditions of their Luxembourg IFLs to ensure that these loans are not at risk of being characterized as equity.

Alex Pouchard and Paula Przybielska
EY Luxembourg