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IFA CANADA NEWSLETTER

International Tax News

MESSAGE FROM PRESIDENT OF IFA CANADA

Several significant Canadian international tax developments occurred in 2012: the foreign affiliate dumping rules, changes to the thin capitalization rules, numerous foreign affiliate amendments and tax cases such as *Velcro*, *Glaxo* and *Fundy Settlement*, which dealt with tax issues of global importance, not just Canadian. No doubt we will see more in 2013.

IFA Canada will continue to provide members with informed discussion and commentary on international tax developments through webinars, lectureships, seminars and updates to our website. To these we add this inaugural issue of the IFA Canada Newsletter.

This newsletter will give members an update of recent and upcoming IFA activities and touch upon significant international tax developments, within Canada and beyond.

Many thanks to our Communications Committee for producing this newsletter. I know that they will welcome your feedback on this issue and your suggestions for future issues.

Looking ahead, watch for details of our upcoming YIN webinar in April ("experienced" tax practitioners are welcome as well!) and our international tax seminar, May 23 and 24, 2013, in Montreal.

All the best for 2013,

Nick Pantaleo, FCA
President – IFA Canada

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IFA ACTIVITIES

The 2012 IFA International Tax Seminar was held in Ottawa on May 17 and 18. This presented a great opportunity for more government involvement. Many sessions included representatives from the Department of Finance and the Canada Revenue Agency as well as the Tax Court of Canada. Topics included the foreign affiliate proposals, transfer pricing and competent authority updates. We were also fortunate to have speakers from abroad, such as Edward Troup from the Tax and Welfare, HM Treasury in London, Manfred Naumann from the Federal Ministry of Finance in Germany and Michael Danilack from the IRS in Washington, D.C. They provided significant insight into administrative and legislative trends in their respective countries.

The annual IFA Congress was held in Boston from September 30 to October 4. Subject 1 was "Enterprise Services," for which the Canadian reporters were Claire Kennedy (Bennett Jones LLP) and Yi-Wen Hsu (Couzin Taylor LLP). Subject 2 was "The Debt-Equity Conundrum". The Canadian reporters were Dean Kraus (Stikeman Elliott LLP) and Jodi Kelleher (KPMG LLP).

Canadian participants at the Congress included Brian Arnold as a panel member for Subject 1, Jinyan Li as the Chair for the session on "International Telecommunications Income", John Oatway as a panel member for "Mutual Agreement Procedure and the Resolution of Cross-Border Disputes" and Danny Cisterna as a panel member for "VAT and Non-resident Sellers".

In November, the IFA YIN network hosted a webinar on the foreign affiliate dumping rules, featuring presenters Jeff Oldewening of KPMG LLP in Toronto and Derek Chiasson with Norton Rose LLP in Montreal. Michael Kandev, Canada's IFA YIN global network representative, was moderator. The popular webinar had more than 200 attendees calling in or attending in Montreal, Toronto and Vancouver.Another webinar is planned for April 2013.

Planning is well underway for the annual international tax

seminar, to be held in Montreal on Thursday, May 23 and Friday, May 24. The seminar will be chaired by Brian Bloom of Davies Ward Phillips & Vineberg LLP in Montreal and Ken Buttenham of PwC LLP in Toronto. Topics will include the Bill C-48 foreign affiliate technical amendments, planning after the foreign affiliate dumping rules, U.S. tax developments and transfer pricing developments, as well as recent tax case and rulings updates. The usual CRA and Finance roundtables will also be offered.

In previous years, the Travelling Lectureship generally has been held between January and April. This year, the Lectureship will be in the autumn. Stephen Richardson, former Associate Deputy Minister at the Department of Finance, will speak on Tax Policy in Canada.

The 2013 Annual Congress – in Copenhagen, Denmark from August 25 to 30 – marks IFA's 75th Anniversary. The two major topics will be the "Taxation of foreign passive income for groups of companies" and the "Exchange of information and the cross-border cooperation between tax authorities." The link to the Annual Congress website is on the IFA Canada website under "Events."

The IFA Canada website is continually being updated, so be sure to log in to review transcripts, audio and video from previous Seminars, Lectureships and Webinars. Updates regarding future events will also be on the website, with links to program outlines and registration.

CANADIAN INTERNATIONAL TAX DEVELOPMENTS – YEAR IN REVIEW

Legislative Developments

Foreign Affiliate "Dumping"

The new foreign affiliate dumping rules deem a dividend to have been paid by a corporation resident in Canada ("CRIC") that is controlled by a non-resident company ("Parent"), if the CRIC makes an investment in the shares or debt of a foreign affiliate ("Subject Corporation"). Generally, the deemed dividend applies to two situations: where debt is issued by the CRIC to acquire the investment and where the CRIC's own cash is used to fund the investment in the foreign affiliate. The deemed dividend is subject to withholding tax that would not be refundable upon the unwinding of the investment. If shares are issued by the CRIC to acquire the investment, the paid-up capital of those shares is deemed to be nil. While the rules contain a business purpose exception, it is very narrow and therefore likely will have little application. The deemed dividend will apply to certain indirect acquisitions of a foreign affiliate (e.g., when a Canadian corporation is acquired and a significant portion of its assets include foreign affiliates). Important exceptions are made for reorganizations and for loans that bear a prescribed rate of interest. Generally, these rules create a significant challenge for foreign-controlled Canadian companies owning foreign affiliates.

Thin Capitalization

Four changes to the thin capitalization rules were proposed:

- reduce the debt-to-equity ratio from 2:1 to 1.5:1;
- extend the scope of the rules to debts owing by partnerships with a Canadian-resident corporation as a member;
- treat the disallowed interest expense under the thin capitalization rules as a dividend; and
- exclude from the scope of the rules interest on a debt owing by a Canadian corporation to its controlled foreign affiliate.

Transfer Pricing Secondary Adjustments

The Canadian statute now provides a legislative framework for secondary adjustments that arise as a result of transfer pricing adjustments. Under these rules, the net transfer pricing adjustment with a non-resident is deemed to be a dividend (unless the non-resident is a controlled foreign affiliate of the Canadian taxpayer). Assessing these amounts as dividends has been common practice and has some support based on the existing legislative framework and case law. The rules accommodate the prior administrative position regarding the repatriation of funds to Canada to avoid the secondary adjustment assessment.

Upstream Loans and Other Foreign Affiliate Measures

Foreign affiliate measures have been evolving – for as long as a decade in some cases. Many outstanding issues were included in the 900+ page technical amendments package that was released on October 24, 2012. Topics include: "upstream loan" rules, foreign tax credit ("FTC") generator rules, rules including absorptive mergers as foreign mergers for certain rollover provisions and a narrowing of the proposed surplus reclassification

rule in regulation 5907(2.02) to apply only to exempt earnings arising from a disposition of property (other than money) to certain designated persons.

The upstream loan rules are anti-avoidance rules designed to prevent taxpayers from making upstream loans from foreign affiliates in order to avoid what would otherwise be taxable dividends that are not fully offset by deductions under section 113. The most recent proposals include extensive revisions to the upstream loan rules, which were originally released on August 19, 2011. The changes include greater transitional relief and a temporary measure to eliminate historical foreign exchange gains that will be welcomed by those taxpayers who had upstream loans outstanding as of August 19, 2011.

Case Law Summary

Copthorne Holdings Ltd. v. The Queen, 2011 SCC 63

The Supreme Court of Canada ruled in *Copthorne* that the general anti-avoidance rule (GAAR) deprived the taxpayer of the benefit arising from a paid-up capital (PUC) preservation transaction.

Two sister corporations that had previously been parent and subsidiary horizontally amalgamated, whereby their PUC amounts were aggregated to form the PUC of the new company. Had they vertically amalgamated as parent and subsidiary, the PUC of the former subsidiary would have been cancelled upon amalgamation. The new company redeemed some of its shares. The Crown alleged that GAAR applied to cancel the PUC of the former subsidiary, and to the extent that the amount of share redemption by the new company exceeded the PUC as determined on this basis, it should be taxed as a deemed dividend.

Finding that the transaction violated the object, spirit and purpose of subsection 87(3), the Supreme Court of Canada agreed with the Crown that GAAR applied.

The Supreme Court of Canada also reiterated its previous jurisprudence on the test for determining whether a transaction is part of a “series of transactions” and confirmed that the words “in contemplation of” may be applied retrospectively as well as prospectively.

FLSmidth Ltd. v. The Queen, 2012 TCC 3

In *FLSmidth*, the Tax Court of Canada denied a subsection 20(12) deduction for U.S. income tax paid by a taxpayer in a situation involving a cross-border “tower” financing structure.

Subsection 20(12) allows a deduction for foreign income tax paid if:

- it is paid in respect of the taxpayer’s income from a business or property; and
- for a corporate taxpayer, the tax cannot reasonably be regarded as having been paid in respect of income from shares of a foreign affiliate.

Under the Tower structure before the Court, income on which the U.S. tax was paid (interest received from U.S. corporation) was not the same income against which the taxpayer sought to take a subsection 20(12) deduction (dividend received by partnership of which the taxpayer was a member). The Crown argued that the deduction was unavailable since there was no “direct link” between the U.S. tax paid and the income against which the deduction was claimed.

Paris J. disagreed, noting that the wide scope of the phrase “in respect of” requires only that the foreign tax be connected with or related to the taxpayer’s income. However, Paris J. went on to say that the phrase should be read similarly for the purposes of the second condition, and held that the taxpayer’s income was received in respect of income from shares of a foreign affiliate, even though the taxpayer received dividends from the foreign affiliate only indirectly. The taxpayer’s subsection 20(12) deduction was denied.

This case is currently under appeal to the Federal Court of Appeal.

Velcro Canada Inc. v. The Queen, 2012 TCC 57

The Tax Court of Canada in *Velcro* decided who the beneficial owner of a royalty payment made by a Canadian resident company was in a situation where the recipient of the royalty payment had a further obligation to pay royalties to another company.

The taxpayer, a Canadian resident corporation, made royalty payments to a corporation resident in Netherlands, which had an obligation to pay approximately 90% of those payments to a company resident in the Netherlands Antilles, a country with which Canada did not have an income tax treaty. The Canadian company availed itself of the *Canada-Netherlands Tax Treaty* and withheld tax at reduced treaty rates. The Crown challenged the arrangement, arguing that the Dutch Antilles company was the beneficial owner of the

royalty payments and therefore withholding tax of 25% applied.

Rossiter A.C.J. concluded that the taxpayer demonstrated that the Dutch company was the beneficial owner based on the indications of 1) possession, 2) use, 3) risk and 4) control of the royalty payments. Especially important to his conclusion was the fact that the royalty payments were co-mingled in the Dutch company's accounts with other moneys. This showed the Dutch company's discretion in the use of the funds. On these bases, Rossiter A.C.J. allowed the taxpayer's appeal.

Fundy Settlement v. The Queen, 2012 SCC 14

Fundy Settlement (also known as the *Garron Family Trust* case) represents the Supreme Court of Canada's pronouncement that the "central management and control" test, long established as the test for determining the residency of corporations, applies to the determination of residency status of a trust.

This case involved family trusts whose beneficiaries were two individuals resident in Canada. The trustee of both trusts was a licensed Barbados resident trust company. However, the trustee had a minimal role in the management of the trust, acting only upon the beneficiaries' instructions. As part of an arm's length sale transaction, the trusts realized substantial capital gains. Because of the exemption provided in the *Canada-Barbados Tax Treaty*, the treatment of the capital gains depended on whether the trusts were resident in Barbados or not.

The Supreme Court of Canada, noting the similarities between corporations and trusts and citing the principle of fairness, determined that the proper test to be applied to the determination of a trust's residence was the central management and control test. Finding that the trusts were resident in Canada after applying the test, the Supreme Court dismissed the taxpayers' appeal.

The Queen v. Peter Sommerer, 2012 FCA 207

In *Sommerer*, the Federal Court of Appeal considered whether subsection 75(2) applied to attribute to a taxpayer gains realized by an Austrian private foundation from the sale of property that was purchased from the taxpayer.

The taxpayer was a "beneficiary" of an Austrian private foundation settled by his father. He sold a number of shares to the private foundation on which it in turn realized capital gains in sales to third-party purchasers. The Crown sought to include the gains in the taxpayer's income under subsection 75(2). That subsection provides that tax results arising from trust property contributed by a taxpayer (or another property substituted for it) shall be deemed to be those of the taxpayer if the property (or its substitute) may revert to the taxpayer.

While it was true that it was theoretically possible for the shares to revert to the taxpayer, Sharlow, J.A. disagreed that an absolute sale of property could give rise to an attribution under subsection 75(2) as the Crown contended. Such a reading of subsection 75(2) could result in the same capital gain being attributed to more than one taxpayer. On these grounds, the Court dismissed the Crown's appeal in favour of the taxpayer.

The Queen v. GlaxoSmithKline Inc., 2012 SCC 52

GlaxoSmithKline is the first transfer pricing case considered by the Supreme Court of Canada, in which the relevance of the circumstances surrounding the transaction in the determination of an appropriate arm's length price was acknowledged.

The taxpayer was a Canadian member of a multinational group that manufactured and sold branded pharmaceutical products. Pursuant to a license agreement, the taxpayer obtained a chemical ingredient required for one of its products from a non-resident member of the group. The Crown challenged the transfer price of the ingredient, comparing it against the much lower prices paid by two Canadian generic pharmaceutical companies during the same period for a chemically identical product in arm's length transactions. The taxpayer asserted that the prices paid by the generic manufacturers were not good proxies because the license agreement pursuant to which it was obligated to pay higher prices conferred benefits that were unavailable to the generic manufacturers (being the ability to sell the branded product at higher prices).

The Supreme Court rejected the "transaction-by-transaction" approach advanced by the Crown and instead held that determination of an appropriate transfer price involved "consideration of all circumstances of the Canadian taxpayer relevant to the price paid to the non-resident supplier," such as the license agreement at issue in this appeal. In the course of its reasons, the Supreme Court also clarified the proper role of the OECD guidelines, which is to serve as commentary and to provide methodology for calculation, but which must take a position subordinate to the provisions of the Canadian statute.

The Supreme Court sent the case back to the Tax Court to consider the appropriate transfer price taking into account the licence agreement.

GLOBAL INTERNATIONAL TAX DEVELOPMENTS

OECD Releases Intangibles and Safe Harbour Discussion Drafts

The OECD released a discussion draft of proposed changes to the OECD's Transfer Pricing Guidelines with respect to intangibles. The OECD also released a discussion draft on the revision of the "safe harbours" guidelines and on transfer pricing timing issues. Transfer pricing issues related to intangibles have been identified as a key area of concern by governments and taxpayers due to insufficient international guidance on intangibles, particularly in the definition, identification and valuation of intangibles. The discussion draft on intangibles provides further guidance on:

- identifying intangibles
- identifying parties entitled to intangible-related returns
- transactions involving the use or transfer of intangibles
- determining arm's-length conditions in cases involving intangibles.

The safe harbour discussion draft is equally important, because it proposes sample agreements for tax authorities to use in determining safe harbours for certain simpler cross-border transactions. Implementation of these agreements, in particular as between Canadian and U.S. tax authorities, would significantly decrease the resources currently employed on resolving transfer pricing disputes.

Proliferation of Earnings-Stripping Rules

Earnings-stripping rules generally seek to restrict the amount of related-party interest that a foreign-owned corporation can deduct by limiting it to a percentage of that corporation's earnings before interest, tax, depreciation and amortization. The United States was the first country to adopt such an approach, with rules enacted in 1989. Denmark, France, Germany and Italy recently adopted similar rules. In 2012, Japan, Spain, Finland and Portugal announced their intentions to do the same.

While it is often said that the American tax system, and more particularly their outbound tax system, may need to be updated, it would appear that elements of their inbound system are attractive enough for many countries to simply copy the approach the United States adopted almost 20 years ago.

Hong Kong Developments

Earlier this year, the Hong Kong Inland Revenue Department announced the procedures that companies must follow to obtain an advance pricing arrangement (APAs). The program initially focuses on bilateral and multilateral APAs between Hong Kong and a country with which it has a comprehensive tax treaty. Unilateral APAs will be considered in certain circumstances, for example if no tax treaty exists and the other country is prepared to conclude a unilateral APA on the same transaction.

Many multinationals use Hong Kong in their supply chain management planning and subsidiaries in Hong Kong therefore often have significant cross-border transactions. The ability to conclude an APA with Hong Kong will provide certainty for many transactions.

Another significant development between Hong Kong and Canada was the signing of the tax treaty with the Government of the Hong Kong Special Administrative Region on November 11, 2012. Although this treaty generally follows the OECD model treaty, in a number of respects – such as withholding tax on dividends and interest – the residency provisions are somewhat unique, because Hong Kong is not considered to be a "sovereign state." The treaty is expected to come into force in Canada after 2013 and in Hong Kong after March 31, 2014.

"Unconditional" French Limitation on Interest Expense

The French government introduced a new unconditional limitation on interest deductibility, in addition to existing limitations such as thin capitalization rules and certain anti-abuse provisions. The rule permanently denies the deduction of 15% of net interest expenses (i.e. the difference between interest expenses and interest income) incurred by certain French corporate taxpayers in 2013 increasing to 25% in 2014. This new restriction will apply to both related and unrelated financing but will not apply if net interest expenses incurred by the taxpayer do not exceed €3million. In a tax-consolidated group, the limitation and the €3 million threshold will apply at the group level.

Vodafone Tax Case

The Indian Supreme Court issued its decision in the landmark Vodafone case in early 2012. The Court concluded that the gains arising from transfer of foreign Company's shares were not liable to tax in India - even though the sale involved an indirect transfer of an

underlying Indian company – and therefore Vodafone was not subject to Indian withholding tax on the purchase sale of a foreign (i.e., non-Indian) company's shares held outside India. The Court considered, and opined on, various arguments relating to strategic tax planning as opposed to tax avoidance, substance over form, and the ability of Indian tax authorities to "look through" structures with the objective of taxing transactions in India.

The Indian government subsequently sought to enact rules that would retroactively apply to transactions involving indirect transfers, which would also make Vodafone subject to tax on the transaction. The proposed retroactivity annoyed investors and the Government created the Parthasarathi Shome Committee to undertake stakeholders' consultations and re-examine the controversial bill, in particular the retrospective effect on indirect transfers. Among other things, the Committee concluded that the provision should generally be applied prospectively and also recommended certain exemptions.

New Dutch Limitation on Interest Deduction and Abolition of Dutch Thin Cap Rules

Article 13l of the Dutch Corporate Income Tax Act (CITA) was introduced to limit the deduction of "excessive interest" (and related costs) on loans from related or third -party creditors incurred to finance the acquisition of, and the investment in, qualifying participations in Dutch and/ or foreign subsidiaries. The "excessive interest" rules apply if and to the extent the cost price of a taxpayer's participations exceeds the size of the taxpayer's equity for tax purposes. Qualifying participations include qualifying shareholdings in another entity, options over those qualifying shares and hybrid loans granted to a specific group of borrowers.

As a general rule, Article 13l does not apply to acquisitions of or investments in participations that are an expansion of a group's "operational activities," nor does it apply to interest on debt that relates to active group financing activities. Article 13l applies to tax years beginning on or after January 1, 2013. Grandfathering is possible for investments in participations that were made in tax years starting on or before January 1, 2006. The exception relating to the expansion of operational activities and the grandfathering rules are overruled in certain situations, for example in case the finance structure of the acquisition or the investment results in a double dip or double non taxation as a result of the use of hybrid entities or hybrid instruments. Article 13l is part of the Dutch government's on-going response to the European Court of Justice decision in *Bosal*.

The Dutch thin capitalization rules are abolished for tax years starting on or after January 1, 2013, with the advent of Article 13l, so as not to overburden investors with restrictions. Earnings-stripping or other more severe alternatives will not be introduced.

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