

Foreign Affiliate Proposals

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Agenda

1. History/Background of FA Rules
2. FA Dumping Proposals
3. Upstream Loan Proposals
4. FTC generators
5. Foreign Accrual Capital Losses
6. Coming soon?

1. History/Background of FA Rules

- 1917 – income tax introduced
- 1938 – exemption introduced for certain dividends from foreign subsidiaries
- 1966 Carter Report
- 1969 Finance White Paper
- 1972 Tax Reform (effective 1976)
 - Introduced FAPI regime (anti-deferral rules)
 - Introduced ES/TS regime (combined exemption credit system)
- 1992 – Auditor General Report/Public Accounts Committee

1. History/Background (cont.)

- 1994/1995 - Significant changes to the FAPI rules
 - 95(2)(a.1) to (b), (l) introduced, in part in response to certain court cases (*Irving Oil, Canada Trustco, Victoria Insurance*)
- 1998 – Mintz Committee Report
- 2002 – Draft technical amendments
- 2004 – Update to 2002 proposals, and significant new proposals (suspended gains rules, changes to FA reorganization rules)

1. History/Background (cont.)

- 2007 – Proposed restriction on interest deductibility/double-dip financing
 - subsequently enacted as 18.2, then repealed
 - TIEA and “qualifying interest” rules
- 2007/2009 – Parts of 2004 proposals enacted
 - foreign currency rules/95(2)(f)
 - 95(2)(a) losses, corresponding regulations still proposed
- 2008 – Advisory Panel Report

1. History/Background (cont.)

- December 2009/August 2010 Proposals
 - “Fill the hole”/surplus account computation rules, AOC and “bump” rules, FAPL carryover, partnership rules, and **anti-FTC generator rules (Budget 2010)**
- August 2011 Proposals
 - Hybrid Surplus, Distributions/Returns of Capital, **Upstream Loans**, Foreign Affiliate Reorganizations, Foreign Exchange, Anti-Avoidance Measures relating to surplus accounts, Loss Rules, **FACL rules**, FAT for Consolidated Groups
- 2012 Budget
 - **FA Dumping**
 - FAPI base erosion rules applicable to Canadian Banks

2. Foreign Affiliate Dumping Proposals

Conditions [212.3(1)]

- Applies to an “investment” by a corporation resident in Canada (“CRIC”) in a non-resident corporation if:
 - The non-resident corporation is a FA of the CRIC
 - The CRIC is controlled by another non-resident corporation, AND
 - The investment may not reasonably be considered to have been made for *bona fide* purposes other than to obtain a tax benefit

Tax Implications [212.3(2)]

- Deemed dividend to the extent of any non-share consideration given by the CRIC for the “investment.” The deemed dividend will be subject to withholding tax at the treaty-reduced rate, if applicable
- The paid-up capital of any shares of the CRIC that are given as consideration is disregarded for all purposes
- No relief is provided from additional withholding tax when the funds invested in the FA are ultimately repatriated to the foreign parent by the CRIC

Effective Date

- Applicable to transactions that occur on or after March 29, 2012

2. Foreign Affiliate Dumping (cont.)

What is an “Investment”? [212.3(3)]

- The proposals are very broadly worded. Transactions that may give rise to a deemed dividend include:
 - The acquisition by a CRIC of shares of the capital stock of an entity that is or becomes a FA, irrespective of whether the acquisition is from a third party or related party and whether the acquisition is funded via debt, capital or cash resources;
 - A contribution of capital to a FA by a CRIC;
 - A loan of funds to a FA by a CRIC (whether at arm’s length interest or not);
 - An acquisition of debt of a FA by a CRIC;
- Transfers of shares of FAs between CRICs when the transferee CRIC pays non-share consideration;
- Transfers of FA shares directly held by a CRIC to another FA of another CRIC
- The above list is not exhaustive. The impact of the proposals needs to be considered in reviewing any financial transactions involving a foreign-controlled CRIC and a FA

2. Foreign Affiliate Dumping (cont.)

“Business Purpose” Test [212.3(5)]

- More accurately referred to as a “closer connection” test than a business purpose test?
- Subjective determination as to whether it is reasonable to conclude that the FA “investment” belongs in the Canadian company more than in any other entity in the foreign parent’s group
- Considerations include:
 - whether the business of the acquired FA is more closely connected to the Canadian business than that of other group non-resident corporations except for companies held under the FA;
 - whether the investment is made at the direction or request of a related non-resident corporation;
 - whether the CRIC’s senior officers who are resident in and work principally in Canada are involved in initiating and negotiating the investment and have the principal decision making authority in respect of the investment;
 - whether FA’s performance is more closely connected to the performance evaluation of the CRIC’s senior officers than those of other group non-resident companies except for companies held under the FA;
 - whether FA’s management reports to and are functionally accountable to the CRIC’s senior officers to a greater extent than any other senior officers of group companies; and
 - for share investments, whether the shares fully participate in the profits and growth of the FA (i.e., common shares vs. preferred shares)

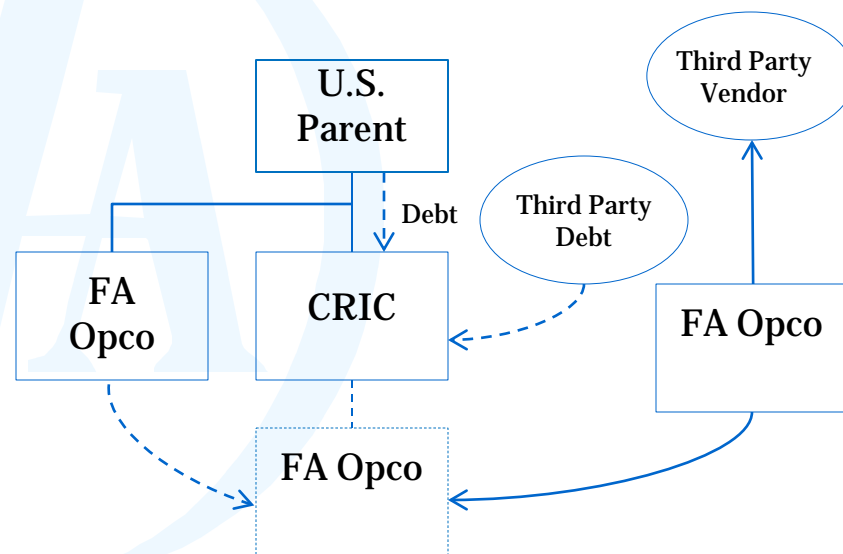
2. Foreign Affiliate Dumping (cont.)

Example 1: Acquisition of new FA - “Debt Dumping” Transaction

- CRIC is leveraged to acquire shares of a foreign affiliate (“FA Opco”) from a non-resident group company or a third party

Result:

- Interest deduction in Canada
- Tax-free dividends from FA Opco
- Non-share consideration paid by CRIC (in form of the debt or cash) is a deemed dividend under the FA dumping proposals, unless “business purpose” exception met
- Deemed dividend subject to 5% withholding tax
- FA Opco remains subject to FAPI regime, FA reporting, etc.
- Ultimately may be a capital gain in CRIC on a disposition of FA Opco and distribution of sales proceeds subject to dividend withholding tax



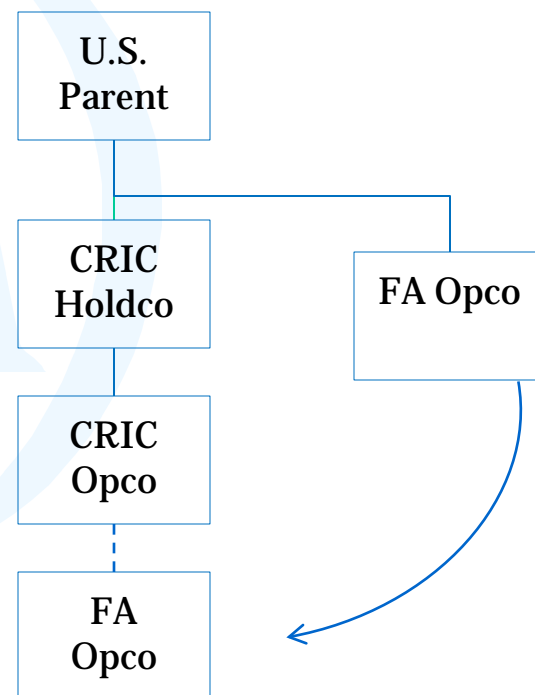
2. Foreign Affiliate Dumping (cont.)

Example 2: Investment of Canadian generated funds

- CRIC Opco, indirectly held by U.S. Parent, uses its internally generated funds to purchase all of the common shares of FA Opco

Result:

- Tax-free dividends from FA Opco
- Non-share consideration paid by CRIC (in form of cash) is a deemed dividend under the FA dumping proposals, unless “business purpose” exception met
- Deemed dividend subject to 15% withholding tax (U.S. Parent does not own directly shares with at least 10% of the votes/value of CRIC Opco)
- FA Opco remains subject to FAPI regime, FA reporting, etc.
- Ultimately may be a capital gain in CRIC Opco on a disposition of FA Opco and distribution of sales proceeds to U.S. Parent subject to dividend withholding tax



2. FA Dumping – Finance Comments

- FA dumping vs debt dumping
- Informal submissions - general:
 - tax benefit
 - corporate reorganizations
 - public companies
 - cash vs debt
 - common vs preferred shares
 - overlap with ss.17(2)

2. FA Dumping – Finance Comments

- Informal submissions - general (cont'd):
 - loans bearing arm's length interest
 - repayment period for loans
 - double tax on unwind
 - acquisitions not sourced from CRIC funds
- Informal submissions – primary factors
 - location of management
 - preferred shares

3. Upstream Loan Proposals

- Upstream loan rules – draft 90(4) to (10)
- Rules intended to discourage FAs with taxable surplus (TS) or hybrid surplus (HS) from loaning their earnings to Canada rather than paying dividends.
- No requirement for lender FA to have TS/HS
- Similar to rules in 15(2) dealing with loans to shareholders
- 90(4) does not apply where 15(2) applies

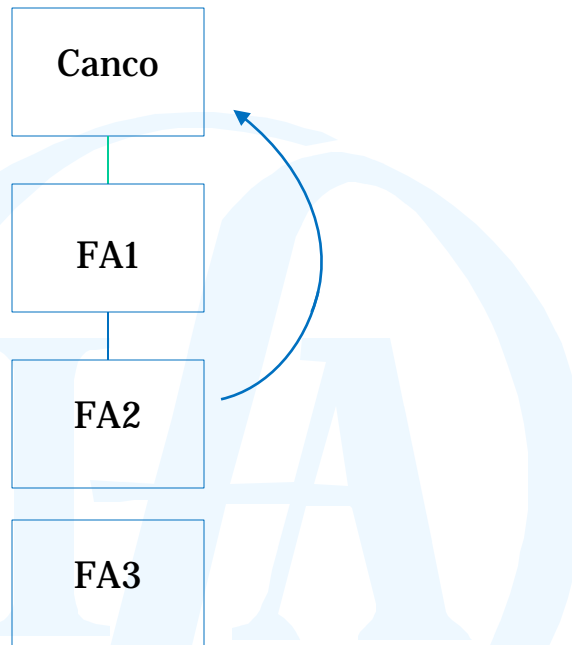
3. Upstream Loan Proposals (cont.)

- Results in income to a taxpayer where a “specified debtor” in respect of the taxpayer receives a loan from/becomes indebted to a FA of the taxpayer
 - Income inclusion is the “specified amount” of the loan (surplus entitlement in FA)
- Deduction when any part of the loan/debt is repaid
 - Repayment must not be part of a series of loans or other transactions and repayments

3. Upstream Loan Proposals (cont.)

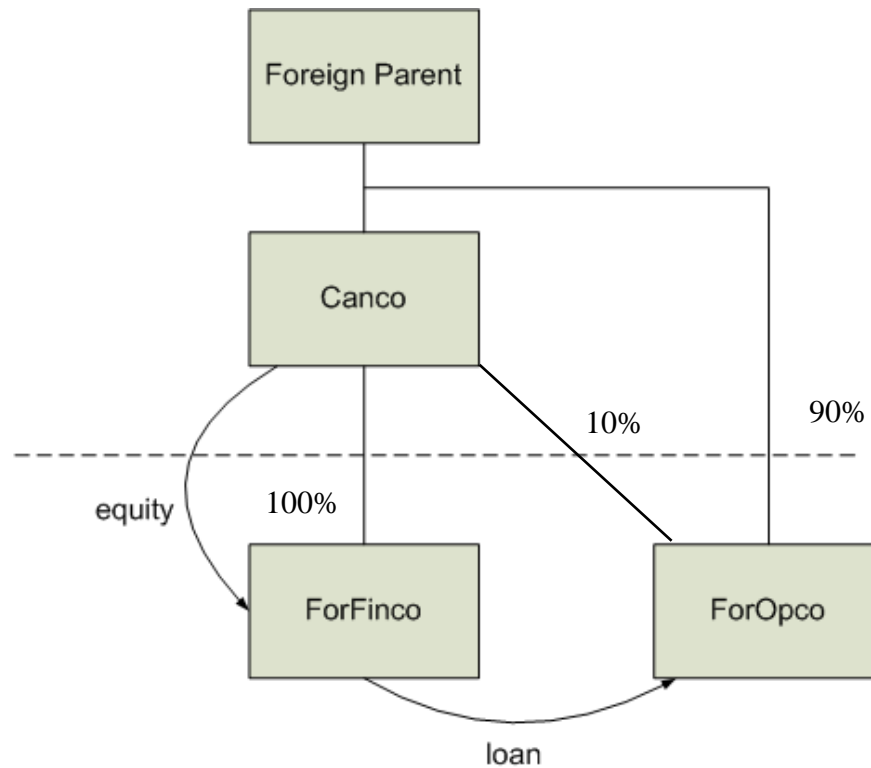
- Excluded Loans
 - Repayment within two years
 - Loan made in ordinary course of lending business
- Additional Deduction
 - 90(6)/(7) “reserve” mechanism
 - Amounts that could have been distributed tax-free to the Canadian taxpayer
 - Significant limitations on (90(6)) rule (such as no dividend rule)

3. Upstream Loan Proposals (cont.)



- FA2 loans \$100 to Canco
- FA1 has \$50 of ES; FA2 has \$0 ES; FA3 has \$50 of ES
- Does 90(6) apply (i.e., reasonable to consider that FA3 would have distributed ES to FA2, or that 93(1) deemed dividend could have applied?)
- Impact of FA1 paying \$10 dividend?

3. Upstream Loan Proposals (cont.)



- Potential application of 95(2)(a)
- Potential application of 17(2)
- Potential application of upstream loan rules
- Potential application of FA dumping rules
- Impact of subsequent repayment of loan and distribution of proceeds to Canco?

3. Upstream Loans – Finance Comments

Summary of past submissions:

- additional transitional relief
 - length of time
 - FX gains and losses
- ACB / 113(1)(d)
- downstream surplus
- dividend prohibition
- SEP in lender vs SEP in borrower

3. Upstream Loans – Finance Comments

New issues:

- 90(6) deduction and hypothetical foreign WHT
- interaction with foreign affiliate dumping
 - double tax
 - repayment of upstream loan

4. FTC Generator Proposals

- The FTC Generator Proposals¹
 - March 2010 Budget
 - Comments by Finance at 2010 IFA Seminar
 - August 27, 2010 proposals
 - Submissions received by Finance until September 27, 2010
 - March 2011 Budget – nothing
 - March 2012 Budget – nothing

¹FTCG Proposals – 91(4.1) to (4.5), 126(4.11) to (4.13) and Regulations 5907 (1.03) to (1.06)

4. FTC Generator Proposals (cont.)

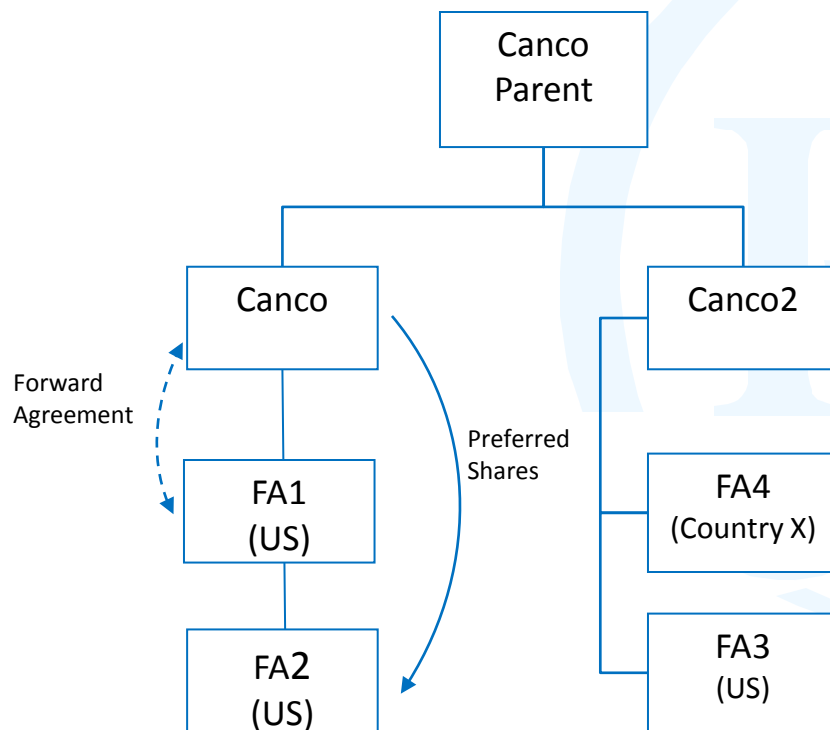
- Application of August FTC Generator proposals:
 - Proposals will apply if the “hybrid condition” is met:
 - A partner’s direct or indirect share of partnership income is less for foreign tax purposes than it is for Canadian tax purposes
 - A pertinent person or partnership (“PPOP”) is considered to own fewer shares in a corporation or have a lesser direct or indirect share of partnership income (the corporation or partnership also being a PPOP) for foreign tax purposes than for Canadian tax purposes.
 - Result is denial of FTC, FAT and UFT for foreign taxes paid
 - Generally effective for taxation years ending after March 4, 2010 with transitional rules for taxation years ending after March 4, 2010 and on or before the August 27, 2010 announcement date

4. FTC Generator Proposals (cont.)

- Definition of PPOP
 - The August 27th proposals can be interpreted to extend the application of the rules far beyond the chain with the “offending” hybrid instrument due to the definition of “pertinent person or partnership”
 - A “pertinent person or partnership” in respect of a taxpayer is:
 - The taxpayer
 - A Canadian resident person dealing NAL with the taxpayer
 - A partnership if a member is a PPOP in respect of the taxpayer
 - A foreign affiliate of: i) the taxpayer, ii) a person that is a PPOP in respect of the taxpayer, or (iii) a partnership that is a PPOP in respect of the taxpayer

4. FTC Generator Proposals (cont.)

Example – Related Canadian Groups



Analysis

- Hybrid condition is met in relation to Canco's hybrid financing of US group
- Proposed ss. 91(4.1) and 5907(1.03) deny FAT and UFT in respect of any FAPI or taxable earnings of FA1 and FA2
- Due to PPOP definition rules also apply to FA3 and perhaps FA4 (if hybrid condition is met pursuant to Country X tax law)

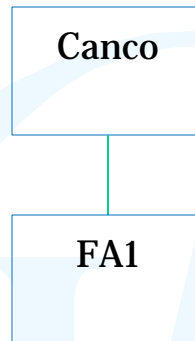
Results

- Result is application of FTC generator rules to FA3 and FA4 (potentially) even though not party to hybrid financing
- Result is no relief for actual foreign taxes borne indirectly by Canco and Canco2
- Is review of the application of all foreign tax laws to all financing instruments in related party structure necessary?

5. Foreign Accrual Capital Losses

- FAPI computation currently a single computation
 - additions for income amounts and one half of capital gains
 - deductions for income losses and one half of capital losses
- Under domestic rules, capital losses may not be used to shelter ordinary income
- Proposals will “stream” foreign accrual capital losses (FACLs) so that they may only be deducted against FAPI capital gains
- Unused FACLs may be carried back three years and forward 20 years to offset FAPI capital gains

5. FACLs (cont.)

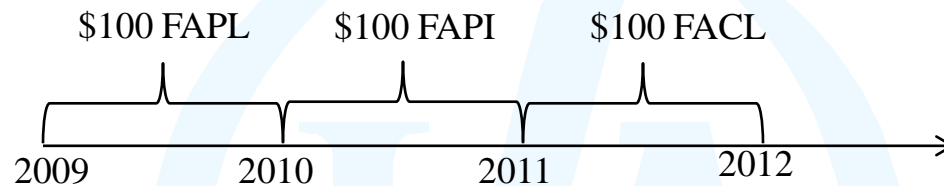


- FA1 has: \$100 of FAPI
\$50 active business loss
\$50 FACL

5. FACLS (cont.)

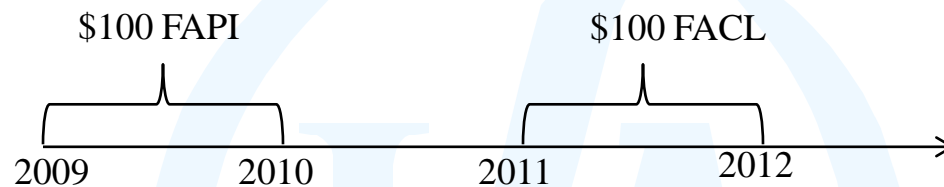
- New FACL rules apply to taxation years *ending* after August 19, 2011
- Rules apply for current taxation year and affect transactions undertaken in contemplation of former rules

5. FACLs (cont.)



- FA has a calendar tax year
- 2010 - FA realizes \$100 FAPL from a capital loss
- 2011 - FA realizes \$100 FAPI
- 2012 - FA realizes \$100 FACL

5. FACLs (cont.)



- FA has a calendar tax year
- 2010 - FA realizes \$100 FAPI
 - (\$50 income and \$50 taxable capital gain)
- 2012 - FA realizes \$100 FACL

5. FACLS (cont.)

- Proposals also prevent the generally-applicable loss-suspension rules from applying to dispositions of “excluded property,” ensuring that such losses are taken into account in computing surplus
- Proposals also prevent certain rollovers on share-for-share exchanges from applying to shares with an accrued loss, and modify certain loss denial rules to generally allow losses on FA shares that relate to foreign currency fluctuations where certain offsetting foreign exchange hedging gains are realized

6. Coming Soon?

- December 2009/August 2010 Proposals
- August 2011 Proposals
- Budget 2012 Proposals
- Outstanding Comfort Letters

6. Coming Soon?

<u>ITA reference</u>	<u>Date of Comfort Letter</u>
17(1)(b)(iii), 17(2)	September 3, 2002
93.1(2), 95(2)(a), 95(2)(o), 95(2.2)	April 19, 2006
95(1), 95(2)(n)	May 26, 2011
95(1)	October 15, 2010
95(2)(a)(i)	June 4, 2009
95(2)(a.3)	December 18, 2000; July 17, 2006
95(2)(b)	March 23, 2010
95(2.5)	July 17, 2006
R. 5907(1) "earnings"	May 16, 2005; August 17, 2005
R. 5907(1.1)	June 9, 2006