

Non-Resident Investment in Canada

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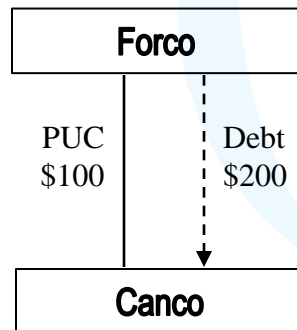
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Contents

- **Thin Capitalization Issues: Budget Proposals**
 - Ratio Change
 - Partnership as Borrower
 - Denied Interest Treated as a Dividend
 - Foreign Affiliate Loans
 - Timing Issues
- **Thin Capitalization Issues: Foreign LP as Lender**
- **Taxable Canadian Property Issues**
- **Sale of Partnership Interests: Budget Proposals**
- **Other Issues**
 - PIK Interest
 - Foreign Guarantees
 - Beneficial Ownership
 - Hybrid Arrangements

Thin Capitalization Issues: Budget Proposals

- **Ratio Change to 1.5:1**
 - Assuming historic use of 2:1 ratio, 10% of debt should be capitalized
 - If no action taken, would lose 25% of interest deductions



- If \$20 of debt is capitalized, results in \$120 equity and \$180 debt (1.5:1 ratio)
- If no capitalization, \$100 of equity would support only \$150 of deductible debt at a 1.5:1 ratio

Thin Capitalization Issues: Budget Proposals

- **Debt Capitalization Considerations:**

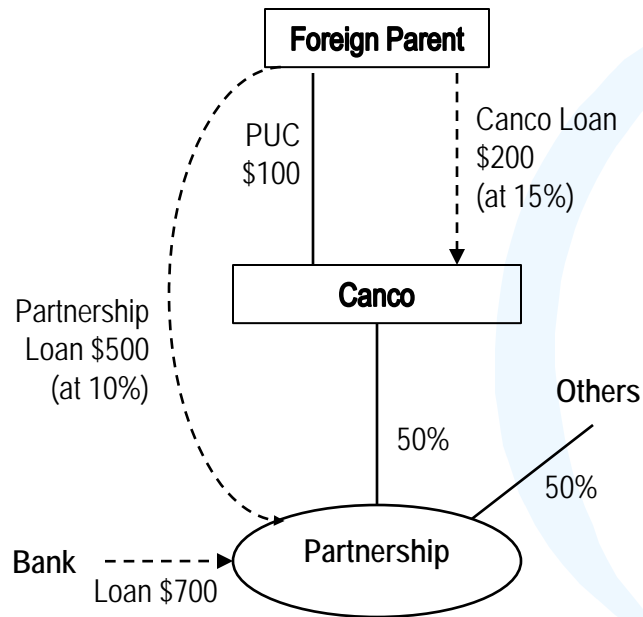
- Does Canco have retained earnings which support excess debt?
- Foreign exchange realization on capitalization
- Debt forgiveness if debt is “underwater”
- Is original interest rate still supportable?
 - Is a lower rate required in light of decreased leverage?
 - Is a new transfer pricing study required?
- Contractual limitations on repayment
 - Make whole payments required (consider subsection 18(9.1))?
 - Consent fee paid to foreign lender?
- PUC/contributed surplus may be reduced by virtue of proposed “Foreign Affiliate Dumping” rules

Thin Capitalization Issues: Budget Proposals

- **Partnership as Borrower**

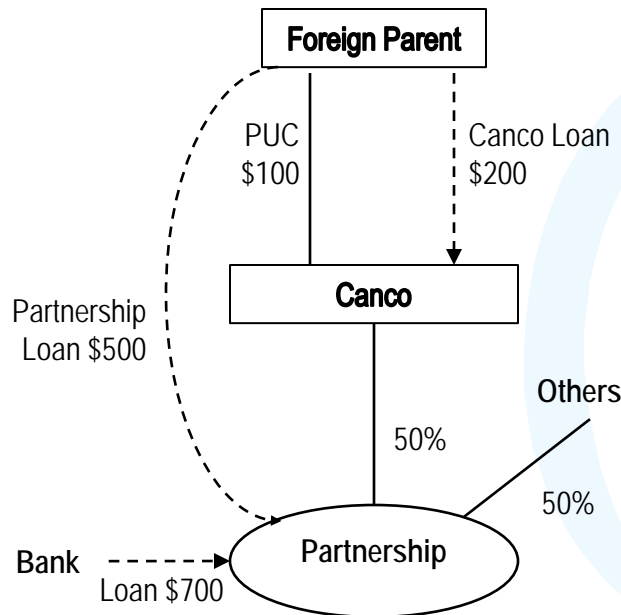
- Each member deemed to owe its “specified proportion” of partnership debts
 - Based on current year income – difficult to plan?
 - Timing issues with staggered year ends
 - Hard to estimate/anomalous results where partnership may pay a “promote” or “carried interest”
- Determination made at corporate level as to whether debt is “outstanding debt to specified non-resident”
- Proposal does not extend to trusts or branches of non-residents as suggested by Advisory Panel – may be addressed in future

Thin Capitalization Issues: Budget Proposals



- Canco deemed to owe \$450 to Foreign Parent (\$200 + 50% of \$500)
- Equity of \$100 supports \$150 of debt, therefore 66.67% (300/450) of interest deductions denied on Canco Loan
 - $.6667 \times \$200 \times .15 = \20 denied interest on Canco Loan
- Income inclusion to Canco of 66.67% of interest on \$250 Partnership Loan
 - $.6667 \times \$250 \times .10 = \16.67 income inclusion
- If all \$450 of debt was at Canco level, would lose \$36.67 of interest deductions ($\$55 \times .6667$)
- Rules are intended to apply proportionately so that varying interest rates at Canco and Partnership do not matter

Thin Capitalization Issues: Budget Proposals



- Canco also deemed to owe \$350 of Bank Loan – no consequence to Canco if Bank not a specified non-resident shareholder of Canco
- No adjustment to ACB of partnership interest for income inclusion
 - Income inclusion is not allocated under section 96
 - Source of income is linked to source of interest expense in partnership
- Mismatch if partnership loss attributable to interest expense is limited by the at-risk rules
 - Adjust at-risk rules to treat income inclusion as an addition to at-risk amount for this purpose?
 - Finance is aware of this issue
- Partnership's income will be reduced in respect of denied interest expense for purpose of "aspa" calculation – deemed income should not increase "aspa"

Thin Capitalization Issues: Budget Proposals

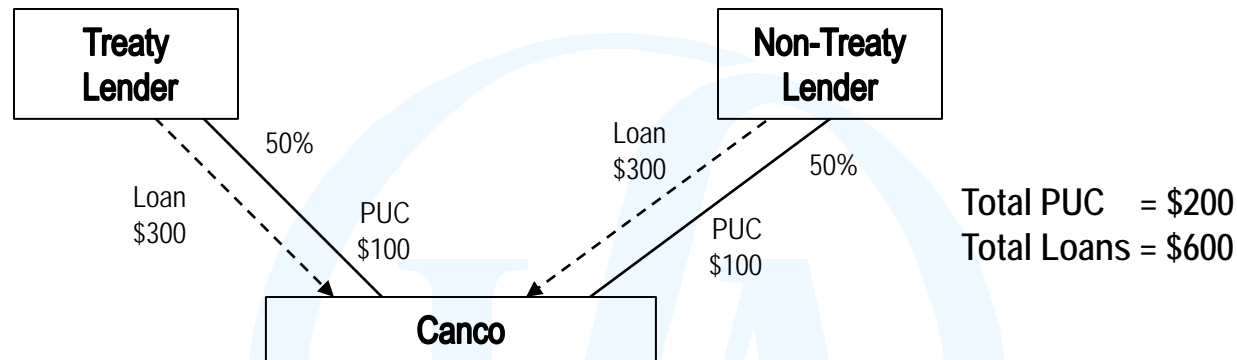
- **Denied Interest Treated as a Dividend**
 - Applies to interest which is paid or credited in a year, and also to interest “payable” in the year – Finance intends this to apply to accrued interest (“payable in respect of” the year)
 - Deemed payment at year end – earlier than section 78 or subsection 15(2)
 - Where lender is not U.S. resident, withholding rate may actually decrease from 10% to 5% (only on non-deductible interest)
 - Current year adjustments
 - Denied interest paid prior to March 29, 2012 may be subject to withholding tax (retroactive?)
 - Denied interest paid in current taxation year but after March 29, 2012 may only be partially subject to withholding tax
 - Deemed dividend considered to be paid by Canco even in respect of Partnership interest – consider practical withholding issues and effects on commercial relationships

Thin Capitalization Issues: Budget Proposals

- **Denied Interest Treated as a Dividend**
 - Foreign exchange movements – need to build in larger cushion to avoid inadvertent denied interest?
 - Penalty for late withholding
 - Excessive interest rate under paragraph 20(1)(c):
 - Previously treated as a dividend under subsection 15(1) and paragraph 214(3)(a)?
 - Subject to proposed subsection 247(12)?
 - Opinion issues – more difficult to provide clean “no withholding” opinion. Carve out “specified non-resident shareholders” from opinions?
 - ULC as borrower:
 - U.S. still recognizes interest payments
 - CRA accepts that different Canadian characterization is OK
 - Article IV(7)(b) should not become applicable by virtue of denied interest payments

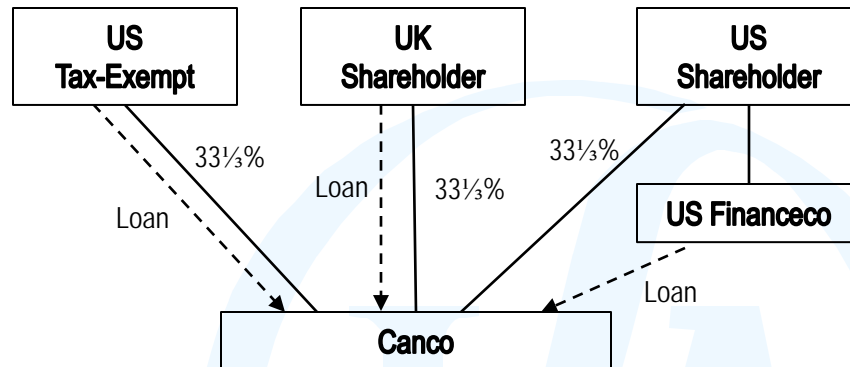
Thin Capitalization Issues: Budget Proposals

- Which withholding rate applies?



- Applying a 1.5:1 ratio, Canco may deduct interest on only one-half of the interest owing to its two lenders
- 50% of interest deemed to be paid as a dividend
 - Is Canco able to choose which interest is deemed paid as a dividend, in order to minimize withholding taxes?
- Finance intends interest denial to be proportionate across all debt and all specified non-residents (in the example, 50% of each dollar of interest paid to each lender is denied)
 - Canco is able to designate which payments to each lender are recharacterized

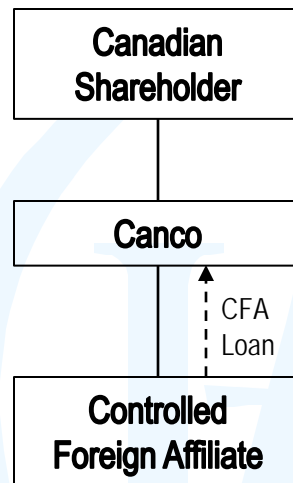
Thin Capitalization Issues: Budget Proposals



- Assume denied interest under subsection 18(4)
- Applicable withholding rates (assume NAL lenders):
 - US tax-exempt – 0% (interest was 0%)
 - UK Shareholder – 5% (interest was 10%)
 - US Financeco – 15% (interest was 0%)
- What if US Financeco transfers loan to US Shareholder before applicable interest payment? (Neither subsection 214(6) nor 214(7) applies to a transfer between non-residents). What if Loan was transferred to a Canadian corporation before interest payment?

Thin Capitalization Issues: Budget Proposals

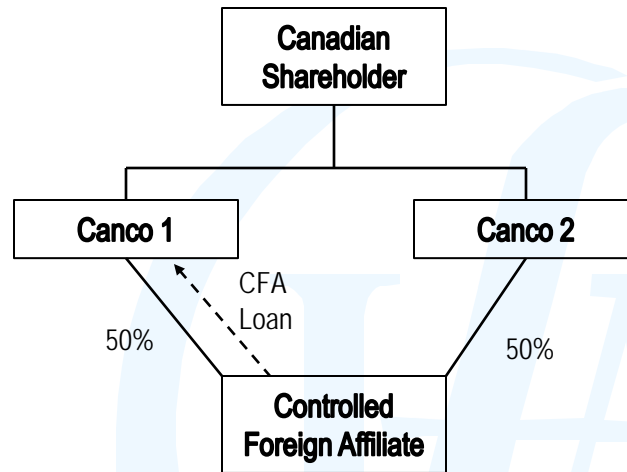
- **Foreign Affiliate Loans**



- Controlled Foreign Affiliate is a non-resident person that does not deal at arm's length with a “specified shareholder” of Canco
- No foreign equity into Canco, so all interest deductions are denied, even though interest is FAPI
- Draft subsection 90(4) may also result in an income inclusion to Canco for the principal amount of the CFA Loan
- New thin capitalization proposal restricts application of subsection 18(4) to extent of interest included in Canco's income as FAPI

Thin Capitalization Issues: Budget Proposals

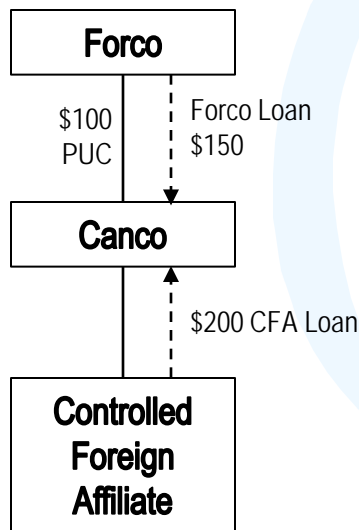
- **Foreign Affiliate Loans**



- Partial denial where Controlled Foreign Affiliate not wholly-owned
 - Canco 1 is taxable on only 50% of FAPI – is only half of denied interest relieved?
 - Finance is aware of this issue
- Relief also only applies to FAPI net of a subsection 91(4) FAT deduction – consider Canadian withholding tax on interest. Consider circularity issue for FAT where deemed dividend is subject to a different rate of withholding tax than interest
- Characterization of denied interest as a deemed dividend applies only for Part XIII purposes – should not alter characterization of interest as FAPI
- Consider different year ends – interest may be FAPI in a later year – Finance is aware of the timing issue
- Wording may need to be broadened to include controlled foreign affiliates under partnerships

Thin Capitalization Issues: Budget Proposals

- **Foreign Affiliate Loans**



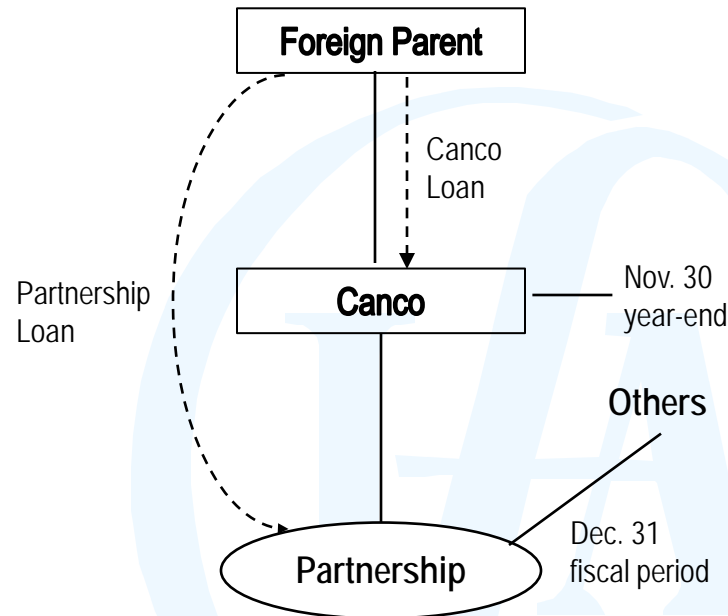
- CFA Loan to Canco is an “outstanding debt to a specified non-resident” – proposals don’t suggest a carve out
- Based on proportionality, 200/350 of all interest denied, including interest on Forco Loan; only 200/350 of interest on CFA Loan to Canco is denied – relief appears limited to this smaller amount even though all interest on CFA Loan is FAPI
- Should CFA Loan to Canco be carved out of definition of “outstanding debts to specified non-residents”?
- Finance is aware of this issue

Thin Capitalization Issues: Budget Proposals

- **Timing Issues**

- Proposals have different application dates:
 - Ratio change – for taxation years that begin after 2012
 - Partnership Debts – for taxation years that begin on or after March 29, 2012
 - Denied interest treated as Dividend – for taxation years that end on or after March 29, 2012
 - Foreign Affiliate Loans – for taxation years that end on or after March 29, 2012

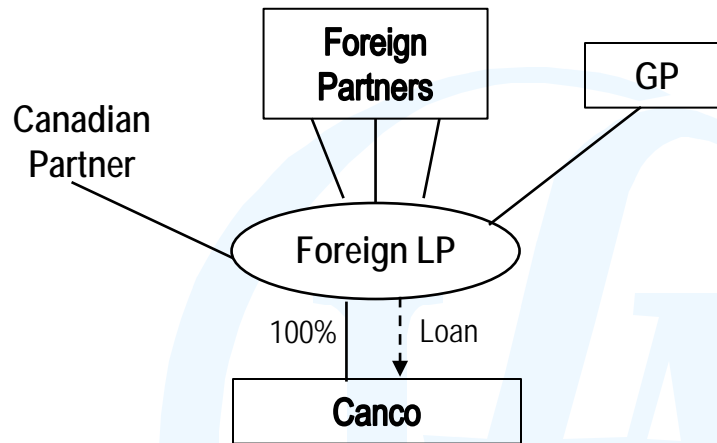
Thin Capitalization Issues: Budget Proposals



- Canco deemed to owe portion of Partnership Loan for its taxation year commencing December 1, 2012
- Ratio does not reduce to 1.5:1 until Canco's taxation year commencing December 1, 2013
- Any denied interest is treated as a dividend in (or after) Canco's taxation year commencing December 1, 2011
- Fiscal period of Partnership does not seem directly relevant to this analysis

Thin Capitalization Issues: Foreign LP as Lender

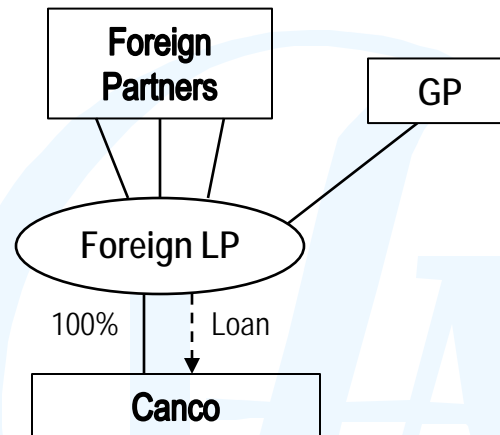
- **Interest Paid to Foreign LP**



- For thin capitalization rules, a partnership was not a person under section 96 (proposals should not affect this conclusion?)
- See 2005-0155331E5 – if all partners deal at AL with each other, and no partner owns 25% or more of Foreign LP, subsection 18(4) will not apply
- Swiss Bank issue re NAL? Issue there was NAL with corporation, not between investors
- Assume one Foreign Partner owns 30% of Foreign LP:
 - Appears that (at least) 30% of PUC of shares of Canco should be counted?
 - What is withholding tax rate under Budget Proposals if interest denied – rate applicable to 30% partner, or average of all rates of all partners?
- Appears to “remain” interest for the purpose of subsection 96(1) allocation to Canadian resident partners

Thin Capitalization Issues: Foreign LP as Lender

- **Withholding Tax Issues re: Interest Paid to Foreign LP**

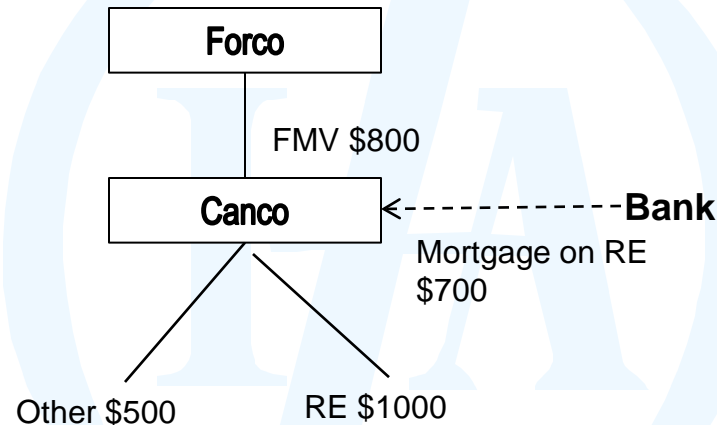


- See 2009-0340031E5 – paragraph 212(13.1)(b) treats Foreign LP as a non-resident person for withholding tax, also for purposes of NAL test in paragraph 212(1)(b) Therefore no look-through to partners for purposes of paragraph 212(1)(b)?
- Will look through to partners for treaty relief
- If one or more Foreign Partners is an Article XXI tax-exempt, status of “related” for purposes of Article XXI(4) is determined on a look-through basis

Taxable Canadian Property Issues

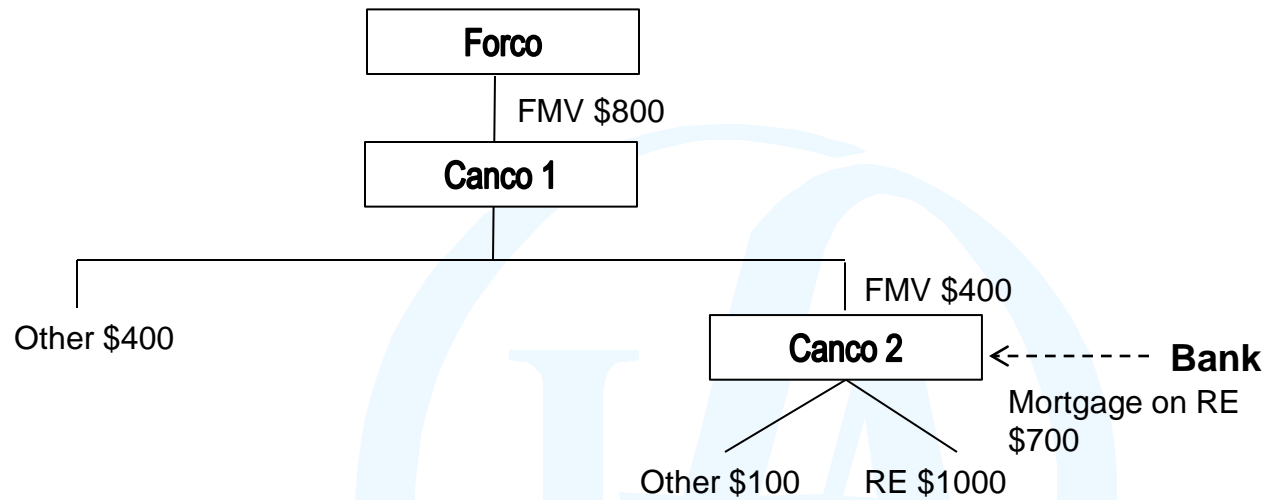
- **Gross vs net**

- CRA position announced at 2011 Annual Conference is to exclude debt - look only at gross value of assets



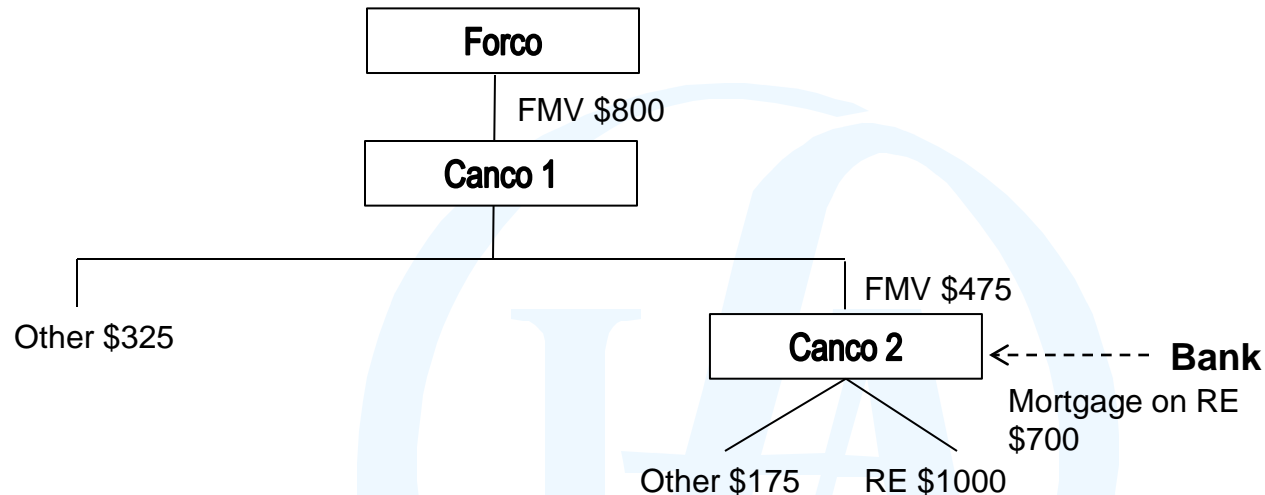
- RE is 66.67% of gross asset value ($\$1000/\1500), therefore Canco shares are TCP
- Irrelevant that net value of RE is only \$300

Taxable Canadian Property Issues



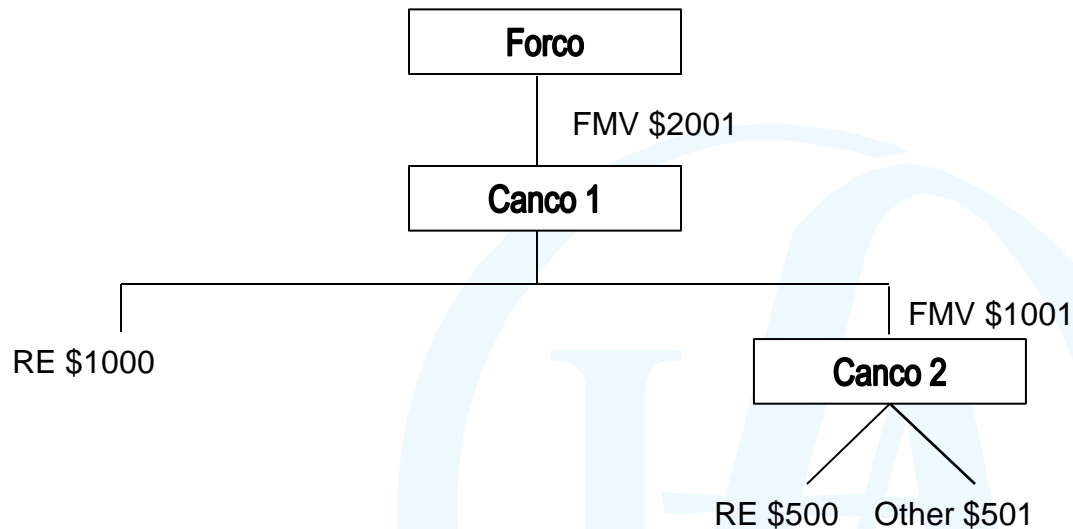
- Are shares of Canco 1 TCP? Same example, but tiered structure
- On a consolidated basis, RE is 66.67% of gross asset value ($\$1000/\1500)
- Shares of Canco 2 are TCP (not excluded under bracketed words)
- How is Canco 2's RE attributed to Canco 1? CRA's position is that $\$1000/\1100 of $\$400$ share value ($\$364$) is considered gross asset RE to Canco 1. Shares of Canco 1 are not TCP ($\$364/\800)
- Difficulty in obtaining information where Canco 1 has only a minority interest in Canco 2 (no need to obtain information if Canco 2 shares are not TCP because of 25% listed exception)

Taxable Canadian Property Issues



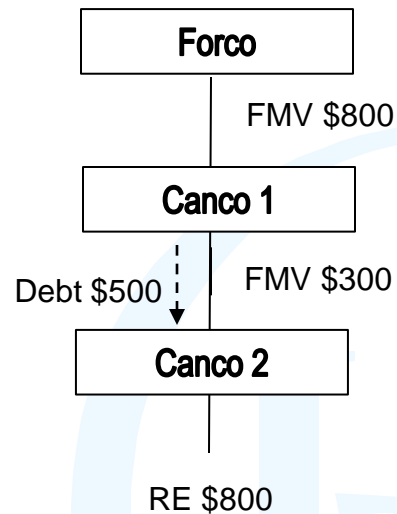
- Are shares of Canco 1 TCP if we shift \$75 of other assets to Canco 2? Same tiered example, with small relative movement of other assets
- Shares of Canco 2 are TCP (not excluded under bracketed words)
- \$1000/\$1175 of \$475 share value (\$404) is considered gross asset RE to Canco 1. Shares of Canco 1 are now TCP (\$404/\$800)

Taxable Canadian Property Issues



- Are shares of Canco 1 TCP?
- On a consolidated basis, RE is 75% of gross asset value ($\$1500/\2001)
- However, shares of Canco 2 are not TCP (excluded under bracketed words)
- How is Canco 2's value treated for TCP test at Canco 1 level? CRA's position appears to be that no part of the \$1001 value in the Canco 2 shares is gross asset RE. Shares of Canco 1 are not TCP ($\$1000/\2001)
- How "low" can you go?

Taxable Canadian Property Issues



- Are shares of Canco 1 TCP?
- On a consolidated basis, RE is 100% of gross asset value
- Shares of Canco 2 are TCP (not excluded under bracketed words)
- Is the debt considered gross asset RE to Canco 1?

Sale of Partnership Interests: Budget Proposals

- **Subsection 100(1)**

- Now applies to dispositions of partnership interests to non-residents as well as tax-exempts
- Rule is extended to dispositions as part of a series of transactions or events
 - Supplemental information refers to “indirect sales” and dispositions made “directly or indirectly”
 - Consider need to restrict application of proposals in commercial tiered structures (e.g. private equity funds, REITs)
 - Vendor may have no knowledge of or control over what purchaser does
 - Need representations that purchaser will not resell to a tax-exempt or non-resident?
- Paragraph 26 of NWMM?

Sale of Partnership Interests: Budget Proposals

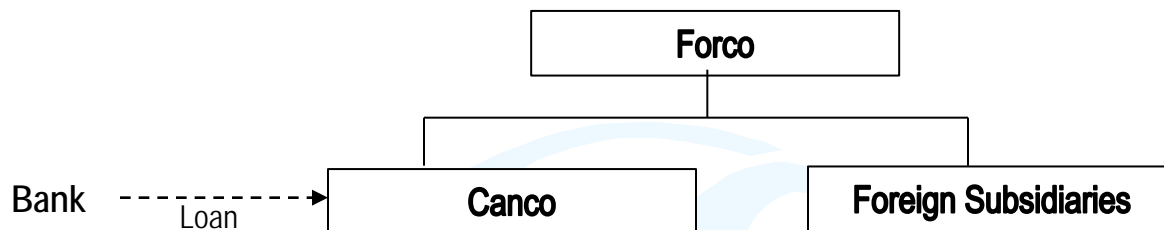
- **Draft Subsection 100(1.1)**

- Safe harbour on sale to non-resident (not tax-exempt) where the partnership uses all of its property in carrying on business through a Canadian PE
- Refers to all the property – not all or substantially all of the property
 - Does the safe harbour contemplate holding partnerships?
 - Should safe harbour also contemplate non-depreciable capital property and other TCP (not treaty protected property)?
- Should subsection 100(1) only apply to the “income aspect” of a gain attributable to depreciable property or eligible capital property?
- Should carve out apply to all transfers between non-residents?

PIK Interest

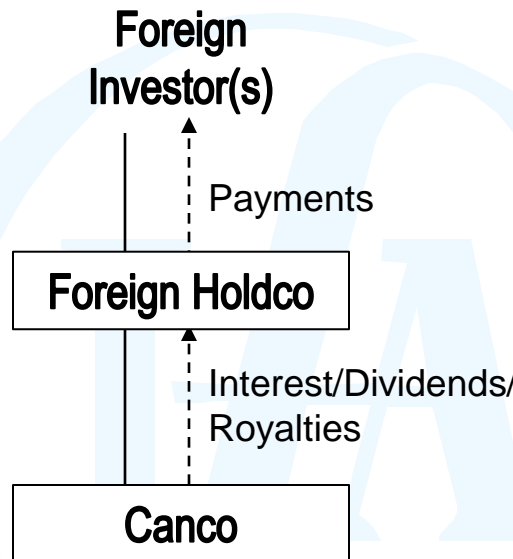
- Defer and add to principal
 - Paragraph 20(1)(d) applies (mismatch in back-to-back loan structures)
 - No payment for withholding tax purposes – consider section 78
- Satisfy interest through the issuance of additional notes
 - Paragraph 20(1)(d) doesn't apply
 - Interest is considered paid for withholding tax purposes
 - Interest on PIK notes may not be deductible – not borrowed money or purchase price of property under paragraph 20(1)(c)?
- Pay interest in cash which is immediately loaned back to corporation for additional notes
 - Paragraph 20(1)(d) doesn't apply
 - Interest is considered paid for withholding tax purposes
 - Interest on PIK notes should be deductible
 - Does cash need to move?

Foreign Guarantees



- Assume Forco and Foreign Subsidiaries guarantee Canco's Loan, with no guarantee fee
- Does subsection 247(2) apply to deem a guarantee fee:
 - Subsection 214(15) – deemed interest payment
 - Part XIII tax (but 0% under U.S. Treaty)
- See 2011-0416261E5
- But words of subsection 247(2) may not support a deemed guarantee fee payment and Part XIII tax. Consider subsection 247(10)
- Draft subsection 247(12) does not appear to apply

Beneficial Ownership



- Canco pays interest, dividends or royalties to Foreign Holdco

Beneficial Ownership

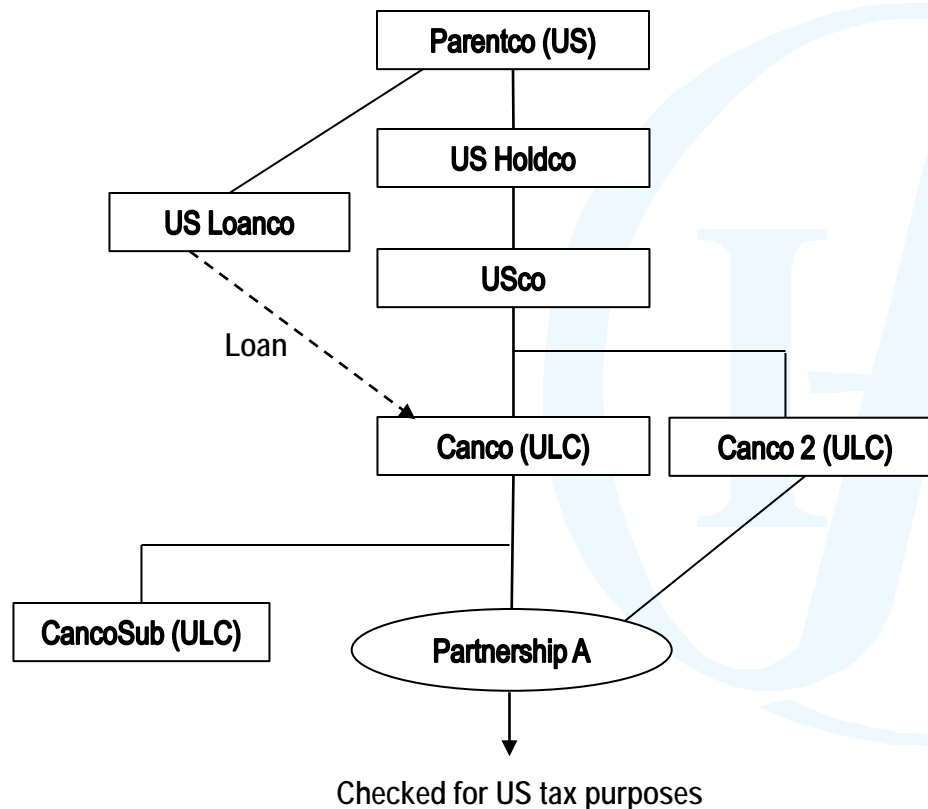
- *Velcro* decision – ensure Foreign Holdco has possession, use, risk and control of interest/dividends/royalties:
 - Commingle interest/dividends/royalties with other funds in Foreign Holdco – no requirement to distribute specific funds and no automatic flow of funds
 - Leave a “spread” in Foreign Holdco
 - If possible, change currency of payments out of Foreign Holdco, and leave funds in Foreign Holdco for a period of time (earning interest)
- Ensure Foreign Holdco is not an agent (ability to bind principal), nominee or conduit
- Fairly narrow test to meet beneficial ownership. *Velcro* not appealed
- OECD commentary? April 29, 2011 Discussion Draft

Hybrid Arrangements

- OECD Report
 - “Hybrid mismatch arrangements” include hybrid entities, hybrid instruments, dual residence, hybrid transfers
 - Results could include double deductions, single deduction/no inclusion, foreign tax credit generators
 - Report concludes that hybrid mismatch arrangements generate significant policy issues in terms of tax revenue, competition, economic efficiency, fairness and transparency
 - Report recommends that countries consider targeted rules to counter certain hybrid mismatch arrangements
- ALESCO New Zealand Ltd.
 - New Zealand anti-avoidance rule is applied to a convertible note issued by New Zealand subsidiary to its Australian parent
 - Convertible note was a hybrid instrument
 - New Zealand court notes the absence of taxation in Australia

Hybrid Arrangements

- 2011 Tax Ruling – 2010-0361591R3



- Loan effectively moved from USco to US Loanco to avoid Article IV(7)(b)
- CRA confirms Article IV(7)(b) will not apply, and GAAR will not apply
- Does it matter if Partnership A distributes all of its earnings to Canco and Canco 2 so they are recognized as income for U.S. tax purposes?
- Ruling discusses U.S. DCL rules – facts state that DCL rules would apply if there was a loss in Canco, Canco 2 and CancoSub
- Should U.S. DCL rules influence Article IV(7)(b) and GAAR? Should Article IV(7)(b) look only to the taxation of the interest income itself?
- CRA commentary at 2010 ABA Conference
- CRA's position is that Article IV(7)(b) may apply where there is a double dip, or a deduction with no corresponding income inclusion