IFA Seminar 2012
Foreign Affiliate Proposals Panel

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Scott Wilkie: Welcome to the first full panel this morning dealing with several aspects concerning the continuing review and refinement of the foreign affiliates system. This has become a recurring feature of the Branch Seminar as we consider the evolution of important changes to the system The panel this morning is going to consider a number of new developments, particularly including some important changes arising from the August 2012 announcement by the Department of Finance. Some of the changes reach back to earlier proposals that have continued to undergo development since. into four. A number of the proposals, notably those announced in August of 2011, deal with whether foreign accrual property income – "FAPI" – arises in the context of certain reorganziations. Generally, the approach reconciles readily with familiar analogous aspects of domestic reorganizations under Part 1 of the Income Tax Act in Sections 85 to 88. The second notable change is the introduction of a more simple anti-abuse mechanism in place of a more elaborate regime government surplus computation which has been under discussion for some time and would have introduced the "FPUC" and "suspended surplus" concepts as basic elements. The present changes also long standing issues that have involved both tax administration and tax policy concerning how undistributed earnings of foreign affiliates can be mobilized that need to be mobilized somehow or other within and out of a foreign affiliate group.

This morning we have an accomplished panel to talk about these issues. Pat Marley is a very accomplished partner of Osler Hoskin & Harcourt, LLP who has contributed in many respects to understanding the application of but the foreign affiliate regime and has the additional perspective that comes from having worked at the Department of Finance in this area at an earlier stage of his career. Dave Beaulne is uniquely positioned to talk about the foreign affiliate system. He is presently the Legislative Chief in charge of International Outbound Investment at the Department of Finance. However the texture of his career includes advising businesses as a consultant and being a member of the tax group of a global business. This allows him to speak with particular insight about current tax policy and tax legislation. Ken Buttenham is an experienced international tax partner of PricewaterhouseCoopers LLP in Toronto. He has thought and written widely about the international system and the foreign affiliate rules in particular.

History and Background

Patrick Marley: In discussing the foreign affiliate proposals, it makes sense to first provide some background as to how we got to where we are now. Rather than beginning with the introduction of the Income Tax Act (the "Act") around the time of World War I, we'll skip to the 1970s, which was really when the birth of our foreign affiliate system as we know it today occurred. With tax reform in the early 1970s both the FAPI system was introduced as well as our combined exemption/credit system (the exempt surplus and taxable surplus regime). The next major development occurred in the 1990s where an Auditor General's report discussed concern with certain double-dip transactions. In response, the Department of Finance acknowledged that those double-dip transactions were within the policy of the Act at the time. In the mid 1990s significant changes were made to the anti-deferral regime, the FAPI rules. Following those changes there was a study done in the late 1990s to consider further changes to the international tax system as part of the Mintz Committee Report. Although there were no significant legislative changes in response to that Report, several technical changes to the foreign affiliate rules were introduced around the turn of the century (2002). Those technical changes then were reintroduced in 2004, along with significant proposals to deal with suspended gains (attempting to address both foreign affiliate reorganizations as well as transactions between foreign affiliates - prevent what is colloquially referred to as 'phantom surplus', or creating surplus without an arm's-length transaction underlying it. From there Canada had a series of successive minority governments - so many of these proposals remained outstanding without being enacted - although significant refinements and revisions were made to try to make the proposals work more efficiently. The March 2007 Budget introduced a rule that would prevent certain double-dip transactions which was followed by the enactment of section 18.2. That rule was subsequently repealed – which appears to have acknowledged, from a policy prospective, that those transactions were acceptable. The next significant change to the exempt surplus system was to expand its application beyond treaty countries to include countries that we have a tax information exchange agreement with Canada.

Around 2007-2009 some of the proposals began getting enacted into law, particularly the ones dealing with foreign currency calculations and refining the application of paragraph 95(2)(a) (e.g., addressing the circumstances in which payments between two foreign affiliates may retain their exempt surplus treatment). In 2008 an advisory panel gave a report recommending various changes to the foreign affiliate system. On slide six we have summarized the main outstanding proposals that are expected to now move forward and likely become part of the next large technical bill.

The first is the proposals that were most recently released in August 2010 (originally introduced in December 2009) which address items such as surplus calculations for transactions between foreign affiliates (including "fill the hole" rules to address deficits),acquisition of control and "bump" rules, rules for foreign accrual property losses (largely tracking or matching the carry forward periods with the domestic rules), various rules applicable to partnerships holding foreign affiliates, and anti-foreign tax credit generator rules that we will discuss in more detail.

The most recent package of foreign affiliate changes were from August 2011 which deal with a number of other changes, some of which we will discuss in more detail (such as the upstream loan rules). The 2011 proposals also include significant changes to the foreign affiliate reorganization rules, a proposed hybrid surplus regime, rules for distributions and returns of capital, foreign exchange, loss rules, anti-avoidance rules for measuring surplus accounts, and rules for determining foreign accrual taxes within a consolidated group.

The last amendments we wanted to note were two changes contained in the March 2012 Federal Budget. One is the foreign affiliate dumping rules which we will discuss in detail (although not technically outbound investment rules, they are quite important for foreign affiliates). Second, there is a budget proposal to essentially relax or amend the base erosion rules in the FAPI rules applicable to Canadian banks (to make the rules work more efficiently from a banking prospective). Anyone who is interested in more detail the background and history of the foreign affiliate rules could review the materials from a 2007 seminar that Scott Wilkie and Nick Pantaleo did on this topic (discussing in about four hours what we have attempted to cover today in four minutes).

Foreign Affiliate Dumping

Ken Buttenham: Our first topic today in terms of new developments relates to the foreign affiliate dumping proposals announced as part of the 2012 federal budget released March 29, 2012.

Many would argue that these proposals represent new domestic tax rules and not really new foreign affiliate proposals per se – and I would have to technically agree since the proposals apply to transactions undertaken by Canadian taxpayers (and their foreign shareholders) and not by foreign affiliates. However, given that the rules only apply to taxpayers that have and invest in foreign affiliates, we thought it made sense to address these proposals as part of this panel.

I think it is safe to say that, from an international tax perspective, the foreign affiliate dumping proposals were the biggest surprise contained in the federal budget. And I would say the surprise was not so much that there were rules introduced but more that the rules were “foreign affiliate dumping” rules as opposed to “debt dumping” rules.

As many of you know, the ability to claim an interest deduction against domestic income to earn exempt income from shares has been a concern of the Department of Finance and the Canada Revenue Agency for many years now and they have, in fact, made various attempts, and Pat referred to at least one, to stop taxpayers from what they refer to as “debt dumping” and obtaining what they believe is an inappropriate erosion of the Canadian domestic tax base. So from this perspective so called “debt dumping” proposals would not have been a surprise. However, as we’ll see when we walk through these proposals, the conditions for application are much broader than “debt dumping” transactions.

These proposals will apply if a corporation resident in Canada (defined as a CRIC for purposes of these rules) makes an “investment” in a non-resident corporation that is or becomes a foreign affiliate of the CRIC and the CRIC is controlled by another non-resident corporation, unless you can meet what has been generally referred to as a “business purpose” exception. The approach to drafting these rules seems to have been based on an “everybody’s caught (everybody being foreign controlled CRICs) unless you’re out” approach.

The two important questions with respect to the conditions for application are: 1) what qualifies as an “investment”, and 2) how does one know if the “business purpose” exception is met? The proposals do provide additional information on these points and I’ll go into more detail on these in a moment.

The Canadian tax implications to companies caught by these rules are dependent on the type of consideration provided by the CRIC for the “investment” made. To the extent the CRIC provides non-share consideration for the investment (i.e., cash or debt), there is a dividend deemed payable to the lowest tier foreign company that controls the CRIC. This deemed dividend is subject to withholding tax just like any other dividend paid by a Canadian company.

To the extent the CRIC issues its own shares as consideration for the investment, the paid up capital in respect of the shares is disregarded for all purposes.

An indirect implication of these rules results from the fact that even if withholding tax is paid in respect of a deemed dividend there is no adjustment to the paid up capital of the shares of the CRIC. This means there will be withholding tax due again when the funds the CRIC has invested in the foreign affiliate are ultimately distributed from the CRIC.

Lastly, it is important to note that these proposals will have retroactive effect when enacted so that any “investment” transactions occurring on or after March 29, 2012 will be caught. This is why it is important to identify transactions which may be caught by these proposals now to ensure companies are not continuing to undertake transactions that will be caught by these rules.

As I mentioned on the last slide, for these rules to apply a CRIC needs to have made an “investment” in a foreign affiliate. So what is an “investment” for this purpose? You will see from this slide that the proposals are very broad in defining what an investment is. Essentially, any acquisition of foreign affiliate shares (whether from a related party or third party) or contribution to the capital of an existing foreign affiliate as well as any loans to a foreign affiliate can be caught by these rules. The proposals also include a “catch-all” category for “any transaction or event that is similar in effect to any of the transactions” otherwise included in the list in the proposals.

As I mentioned, the other important aspect of these rules is the application of the so-called “business purpose” exception because you are in these rules unless you meet this exception.

I believe this aspect of the proposals has created a lot of uncertainty within the Canadian tax community. The current wording of the exception in the proposals is not very straightforward and has confused a lot of people. The current wording seems to invite a comparison between whether it is more reasonable for the CRIC to have made the investment versus the investment being made or retained by any other related non-resident person. This has led some to believe that if you can argue that only the CRIC could have made the investment (i.e., because the cash was there and no one else had the funds to make the investment) then you were okay. I don’t believe this is the interpretation Finance intended and I believe Dave will talk to this in a few minutes but under this interpretation, some would say the role of tax motivation is unclear in the current proposals.

Of course, another interpretation of these provisions is based on the premise that if you are a foreign controlled CRIC that has made an investment in a foreign affiliate, there is a presumed tax motivation and you can only get out of the rules if you can show, ignoring tax factors, that the investment belongs in the CRIC more than in any other related company. If this is the correct interpretation, I think it is more correct to refer to this as a “closer connection” exception rather than a “business purpose” exception.

The primary factors to consider in making this determination are set out in the proposals and on this slide. As you can see, few foreign multinationals are likely to be able to meet these tests. From a practical perspective, even on good facts, whether these tests will be met is a very subjective determination which makes it hard for taxpayers to plan. Since the “closer connection” determination will be so factually based, I believe it will be very difficult to get the Canada Revenue Agency to issue rulings on this topic so taxpayers may be on their own.

I think it is useful to walk through a couple of examples to demonstrate how the proposals will work. This example depicts a CRIC controlled by a non-resident borrowing to acquire 100% of the common shares of a foreign operating company. Assuming the “business purpose” exception cannot be met, the foreign affiliate dumping proposals would apply to this transaction since a foreign controlled CRIC is making an investment into what becomes a foreign affiliate. The result is that although the CRIC will have an interest deduction in Canada and presumably receive exempt dividends from FA opco, the cash consideration paid by CRIC to acquire the foreign affiliate shares will give rise to a deemed dividend paid to U.S. Parent subject to a treaty reduced 5% withholding tax rate. CRIC may also realize a gain or loss on the ultimate disposition of the shares of FA Opco and the distribution of the sales proceeds (in excess of any debt repayment) would be subject to withholding tax. The important point to note in this example is that these proposals, as drafted, will apply in this situation no matter whether the acquisition of the FA Opco shares are from a third party or a related party, whether the borrowing to finance the acquisition is from a third party or a related party and whether the “investment” is preferred shares or 100% of the issued common shares.

Example 2 illustrates the aspect of the proposals that has probably been the biggest surprise to people – the fact that the proposals can apply in situations where a CRIC uses its own after-tax generated funds to invest in or acquire a foreign affiliate. That is, situations where there is no “debt dumping.” In this example, CRIC Opco uses its own funds to purchase 100% of the common shares of FA Opco. The foreign affiliate dumping rules will result in a deemed dividend here equal to the cash consideration paid by CRIC Opco for the shares. Of course, this assumes the “closer connection” exception cannot be met. The dividend is deemed paid by CRIC Opco to U.S. Parent. The interesting point to note in this example, however, is that the treaty reduced withholding tax rate applicable to the deemed dividend would be 15% since U.S. Parent does not directly own shares with the requisite votes and value to gain access to the 5% rate in the treaty. There is planning that may be available to gain access to the 5% treaty reduced withholding tax rate; however, this is definitely a trap to be aware of. Lastly, as I mentioned earlier, the withholding tax on the deemed dividend is not considered a prepayment of the withholding tax due when CRIC Holdco ultimately distributes these funds to U.S. Parent. That is, there is no PUC increase or some other mechanism available to ensure there is no double tax ultimately paid in respect of these earnings. Now I think Dave has a few comments.

Dave Beaulne: I would like to start by commenting on something that you just said Ken. You mention that this provision will have retroactive effect. When people hear that I am sure that they get a little jolted, I certainly did. Could you please clarify what you meant by that.

Ken Buttenham: It goes to the point that all transactions happening after March 29th may be caught. There is no transitional rule or time period for taxpayers to adjust to these new rules.

Dave Beaulne: So he means that when the legislation is enacted, say 6 months from now, it will have effect going back to March 2012. He doesn’t mean that transactions that occur before Budget 2012 would be caught.

As pointed out by Ken and Pat, foreign affiliate dumping is arguably not a foreign affiliate measure. For those of you who have read the draft legislation from the Notice of Ways and Means Motion in the Budget you will have noted that there are only two very minor amendments to rules contained in subdivision i of division B of Part I of the Income Tax Act, the area where most of the foreign affiliate rules are. Those amendments deal with the partnership look-through rules in section 93.1 and are more definitional than substantive. The bulk of the proposed foreign affiliate dumping rules is contained in Part XIII of the Act in a new section 212.3. That section was the main focus, if not the entire focus, of Ken’s presentation, but there are related rules contained in the thin capitalization rules contained in subsection 18(4), the deemed dividend rules in subsection 84(1) and the taxpayer migration rules in sections 128.1 and 219.1. So why are we covering foreign affiliate dumping in this session when arguably it belongs in the afternoon session on inbound developments? Mainly because there have not been many developments in the foreign affiliate area since this topic was covered a few months ago at the Canadian Tax Foundation conference. Having said that, there was one announcement in Budget 2012, as mentioned by Pat, on the base erosion rules and Canadian banks, but there is not much to talk about on that topic because no details have yet been released. Also, the thin cap upstream loan rule that was announced in the Budget has a foreign affiliate connection, but that issue will be covered in the inbound session along with the other thin cap rules announced in the Budget - since we are covering foreign affiliate dumping, we thought we would leave them something interesting to talk about.

For the next fifteen to twenty minutes, I will describe some of the main comments that we have been hearing on the foreign affiliate dumping proposal. I would caution you not to read too much into my representation of these comments, or anything else I say on FA dumping: no definitive conclusions have been arrived at yet. We are still in listening mode and we will take stock after everyone has had a chance to give us their input.

FA Dumping vs Debt Dumping

A recurring general observation on these rules is in respect of its scope. Many have complained, including Ken just a few minutes ago, that it is broader than the “debt dumping” measure proposed by the Advisory Panel on Canada’s System of International Taxation. In some respects it is, but the Advisory Panel did point out that there were problems with an interest deductibility restriction model for countering debt dumping and that is one of the reasons we have included the cash transactions in the scope of the FA dumping rule. Also the variations of the classic debt dump transaction that are referred to in the Budget documents, i.e. foreign affiliate acquisitions that do not involve debt, do seem to us to be logical extensions of the debt dumping theme. Thus the “foreign affiliate dumping” label was chosen in direct recognition of the fact that not all of the transactions within its scope involve debt, as pointed out by Ken.

Before I get into some of the more specific comments we received, I would like to briefly address a more general theme to some of these comments. Many taxpayers and their advisors have suggested that we should take steps to make the rules more neutral. For example, as Ken pointed out, to allow access to a five percent withholding tax rate rather than a fifteen or twenty-five percent rate in various structures. Others have suggested that we should ensure that corporations resident in Canada (CRICs) that are subject to the deemed dividend rule on the acquisition of a foreign affiliate should be allowed some paid-up capital (PUC) recognition for a future extraction of the foreign affiliate from the Canadian group. Without foreclosing on the possibility of providing relief for those types of issues, keep in mind that I am not expressing any conclusions here, I would point out that the Budget documents very clearly state that it is the government’s intention to ‘curtail foreign affiliate dumping.’ Thus one view is that if the government achieves that stated intention, there should be no need to consider how to make the rules more neutral. In this regard I will make two other comments. First, we are quite aware that the Advisory Panel alluded to the application of a higher withholding tax rate than that available under our tax treaties, in order to better deter dumping transactions. Thus the Advisory Panel members likely think that the government has been generous in allowing for withholding tax rates as low as five percent. Second, the Budget documents warn that the government will monitor developments with respect to foreign affiliate dumping in order to determine whether additional action is warranted. In other words, if the current proposals are not effective at stopping the dumping, we may need to supplement them with additional rules, or perhaps increase the withholding tax rate.

Tax Benefit

Many have wondered whether the exception in paragraph 212.3(1)(c), the so-called “business purpose test”, does or should require that there be a tax benefit from making the foreign affiliate investment or that the tax benefit be the predominant purpose for making the foreign affiliate investment, in order to be caught by the foreign affiliate dumping rules. That is not our intention. The reference to tax benefit in paragraph 212.3(1)(c) is meant only to ensure that the avoidance of Canadian tax is not to be considered a valid business purpose under that test. Thus the test is meant to put all Canadian tax considerations aside in deciding whether the foreign affiliate can reasonably be considered to belong under Canada more than anywhere else in the worldwide group. The factors set out in subsection 212.3(5) are meant to be the primary focus of that analysis and none of those are tax factors. Similarly, we expect to clarify in the explanatory notes that Canadian tax motivation is not to be taken into account as a secondary factor.

Some have wondered whether Canadian tax avoidance should be a factor, presumably a negative factor, in determining whether the exception should apply. However, adding Canadian tax as a factor would arguably lead this rule away from its intended application. The business purpose test seeks to compare the situation of the CRIC to that of a Canadian-based multinational; one that is not controlled by anybody. Thus if the CRIC is acting in a similar manner to a Canadian multinational, it should generally qualify for the exception. Since tax benefits are often key considerations in the purchase of a foreign affiliate by a Canadian multinational, leaving those considerations out of the business purpose exception should ensure better comparability.

Corporate Reorganizations

Another focus of the comments on the foreign affiliate dumping rules is the application of the rules to common types of corporate reorganization transactions. For example, amalgamations and wind-ups of Canadian corporations that own foreign affiliates, transfers of foreign affiliate shares between Canadian corporations, subsection 85.1(3) transfers of foreign affiliate shares and section 86 reorganizations of the shares of the foreign affiliate itself. Without concluding, I question whether some of these transactions would be caught by the foreign affiliate dumping rules, but it seems that many practitioners think that there is at least a concern that the rules could apply and that this would be an inappropriate result.

The argument would be that if there is no new investment in a foreign affiliate as a result of these types of transactions, the policy objectives of the foreign affiliate dumping rules would not be contravened and these transactions should therefore be carved out. Although the “lack of new investment” argument does seem somewhat valid to me, I think that this issue is primarily about grandfathering. Let’s not forget that the government has grandfathered all pre-budget foreign affiliate dumps. Some may say that we had to as the transactions-based deemed dividend approach proposed in section 212.3 does not lend itself to retrospective application. That may be true, but we could have had a companion rule with a different focus, such as income imputation or limitations on related interest deductions, with such a companion rule applying only to pre-budget transactions. Thus, a question that arises is how generous the grandfathering should be. Most seem to accept that it would not be appropriate to grandfather new investment in an existing foreign affiliate. That is at one end of the spectrum. At the other end are pre-budget foreign affiliate investments. The reorganization transactions seem to fall somewhere in between. Whether or not reorganization transactions are accommodated, I would think that certain forms of them are likely not to be carved out, such as a conversion of common shares of a foreign affiliate into preferred shares where the new common shares are not owned by the CRIC.

Public Companies

Another interesting topic that has come up is that of CRICs that are public companies. In other words, Canadian companies that have a controlling non-resident but that also have minority shareholdings that trade on a public exchange. The premise is that public CRICs have fiduciary obligations to their minority shareholders that wholly owned CRICs would not normally have and that they deserve an outright carve out from the rules. Without ruling out the possibility of an outright carve out, maybe these additional fiduciary obligations should just be incorporated into subsection 212.3(5) as additional factors. It would, after all, still seem important to test the active involvement of the Canadian officers, whether the controlling non-resident directs the CRIC to make the investment, what types of shares are involved and the connectedness of the businesses of the CRIC and the foreign affiliate. Also it begs the question as to why the listing of the minority shares on a public exchange is relevant. Why wouldn’t similar considerations arise with private companies that have minority shareholders? And why stop there? What if a foreign-controlled wholly owned CRIC has outside directors on its board? As I mentioned earlier, what’s important is whether the CRIC is acting in a manner similar to a non-controlled Canadian company. If it is, it should arguably qualify for the exception under 212.3(1)(c). The fact that a public CRIC has additional fiduciary obligations, whatever those might be, may just mean that it is more likely to satisfy the factors in subsection 212.3(5).

Cash vs Debt

The application of the foreign affiliate dumping rules to cash transactions seems to be one of the major sources of outrage about the broad scope of the rules. As I mentioned earlier, the Budget proposal does arguably reflect a broader scope than what the Advisory Panel recommended. Some of the main reasons we believe cash transactions should be covered are as follows:

- First, just as base eroding interest deductions are created with borrowings made to acquire foreign affiliate investments in a classic debt dump, transferring cash out of Canada on a foreign affiliate acquisition eliminates the taxable income earned in Canada from the investment of the cash.

- Second, cash-sourced foreign affiliate acquisitions avoid the need for the CRIC to dividend the cash to the foreign parent thereby avoiding Canadian dividend withholding tax.

- Third, including cash transactions avoids the need to have complex rules to thwart the cash damming practices that would surely develop if we were to only attack foreign affiliate acquisitions that were made with borrowed funds.

Common vs Preferred Shares

Another area of significant criticism is the application of the foreign affiliate dumping rules to common shares. Virtually everybody accepts that the rules should apply to preferred shares (and I'll come back to this), but many seem to think that common shares are very different and do not pose the same risk to the tax base. I find this surprising given that the Advisory Panel came to the conclusion that all equity interests, whether preferred or common, should be targeted. However, I would recognize that theoretically common shares have a greater potential to add to the Canadian tax base on an eventual disposition than do preferred shares. But common share valuations are still susceptible to manipulation, especially when they are ultimately sold by the CRIC to another member of the multinational group. Transfer pricing rules can only go so far in protecting the tax base from this kind of manipulation. That is one of the main reasons we have FAPI base erosion rules. From this perspective, one might even argue that preferred shares are less offensive than common shares because it is not as easy to manipulate the value of preferred shares. Even if valuation were not a concern, common share acquisitions can effect a long term deferral of that possible Canadian tax down the road and thus the near term impact on the Canadian tax base is no different than it is for preferred shares.

Overlap with Subsection 17(2)

The relationship between subsection 17(2) and the FA dumping rules has also been a topic of discussion. Some have suggested that the income imputation model inherent in the subsection 17(2) rule would be a more appropriate model to follow for FA dumping than the current deemed dividend and PUC grind proposal. I won't dwell on this point. I think that this suggestion is another example of stakeholders striving to make the FA dumping rule more neutral. Again, this is arguably inconsistent with the government's stated desire to "curtail" FA dumping.

Another observation that has been made is that we may need to revisit the scope of section 17 on the premise that the mischief targeted by subsection 17(2) is being fully addressed by the FA dumping rules and there is no need for these two overlapping regimes. The argument would be that both of these regimes are aimed at foreign-controlled Canadian companies using foreign affiliates in a way that erodes the Canadian tax base and the FA dumping rules seems more comprehensive and more restrictive, so maybe we don't need subsection 17(2) anymore.

Loans Bearing Arm's Length Interest

Another common request is to exclude from the definition of "investment" in subsection 212.3(3) loans made by a CRIC to a foreign affiliate that bear an arm's-length rate of interest. Presumably the theory would be that there can be no tax base erosion where Canada receives taxable interest income.

Although this seems like a logical premise, we are struggling a bit with the suggestion, for the following reasons:

- First, transfer pricing, as we all know, is not a science. There are no clear guidelines for determining suitable arm's-length interest rates. Taxpayers will always choose the extreme points in a range in order to achieve their tax planning objectives.

- Second, one can easily see the scope for a CRIC to borrow from one party at a long term high rate and lend to a foreign affiliate at a short term low rate, in order to create tax arbitrage.

- Third, if the government were prepared to live with this transfer pricing risk, that may be an argument for scrapping the current proposals and replacing them with an income imputation model.

To summarize on this point, I think most would agree that non-interest bearing loans are the equivalent of equity and should be caught by the FA dumping rules. Most might also agree that if there were a rock solid precise mechanism for testing arm's-length interest rates and controlling cash damming, a carve out for loans bearing interest at a market rate would be appropriate. Unfortunately, nobody has found that magic formula.

Repayment Period for Loans

It has also been suggested that we should introduce a safe harbour repayment period for loans made by a CRIC to a dumped affiliate; this would bring the

FA dumping rules in line with subsections 15(2), 17(2) and 90(4), which have repayment periods ranging from one to two years. Presumably such a rule would apply to all loans, whether or not they are interest bearing.

Acquisitions not Sourced from CRIC Funds

Another suggestion that we have heard is that there should be a carve-out from the rules for foreign affiliate acquisitions that are funded by equity injections from the foreign parent into the CRIC. At first blush that may seem logical. Where is the Canadian tax base erosion if there is no Canadian surplus cash being used and no interest deductions? However, ignoring the obvious concerns about tracing, the equity injection would undoubtedly give rise to either PUC or contributed surplus, either of which could be used to boost thin cap room and either of which can be used to subsequently make a tax-free distribution of surplus out of the CRIC. That's why we are grinding PUC and making amendments to the thin cap and deemed dividend rules in respect of contributed surplus. However, if the suggestion is more about the prospect of a double hit, once on the PUC/contributed surplus and again on the cash acquisition of the foreign affiliate, then I would think that this is more of an interpretive matter. If this is the case, I would like to hear that reasoning fully fleshed out so that we can think about whether we need to work on some of our language.

Primary Factors

Now onto the very brief section of my presentation dealing with the primary factors for the business purpose exception from the FA dumping rules. I will start by noting that the overwhelming majority of the comments that we have received on the FA dumping rules concern matters other than the factors proposed in subsection 212.3(5), even though that's the only area for which we specifically invited comments.

We have received many comments expressing criticism as to the overall lack of certainty in the analysis of the factors. In particular we have been asked to provide some weighting as to the importance of the factors and/or some guidelines as to how many factors need to be met. We expect to say more about these points in the explanatory notes, so for now I will just say that it is not our intention to turn this into a mathematical determination. The objective of the business purpose test is to exempt from the FA dumping rules Canadian companies that act like Canadian multinationals would. The factors in subsection 212.3(5) are aimed at describing the business circumstances surrounding acquisitions of foreign affiliate shares by Canadian multinationals. Different factors will be more important in different circumstances, and some may not apply at all in some valid business cases. We recognize that it will be difficult to meet these factors in many cases. If that were not the case, it would not be a very effective rule. We especially do not expect many related party foreign affiliate acquisitions to qualify for the business purpose exception. However, we do expect that CRICs that truly are running the show in respect of their foreign affiliate investments will have no trouble concluding that they meet the exception.

I will now turn to more specific comments on the primary factors.

Location of Management

It has been suggested that the requirement that officers of the CRIC be located in Canada is inappropriate in many circumstances and that even in Canadian multinationals the corporate leaders may not all be located in Canada. However, it should be kept in mind that the lack of economic benefits to Canada is a key reason for the introduction of these rules. If officers of the CRIC are not located in Canada, the potential economic benefits to Canada are lessened. So one view is that the fact that Canadian multinationals may also have these issues does not justify giving foreign multinationals a break. If anything it suggests that perhaps those Canadian multinationals should have similar restrictions apply to them.

Preferred Shares

Coming back to the common versus preferred share distinction, in advocating for a carve-out for common shares, most commentators have agreed that preferred shares should be caught by the FA dumping rules. The factor in paragraph 212.3(5)(b) is meant to indicate that a preferred share investment is a negative factor in the analysis of the business purpose test and that a common share investment is not meant to be a positive or negative factor. Given the wide ranging support to have the FA dumping rules catch all preferred share investments and the fact that, under the current formulation of the rules, it is conceivable that certain preferred share investments could qualify for the exception, a question arises in my mind as to whether this factor should be dropped and turned into an outright carve-<u>in</u> to the rules.

Scott Wilkie: The “foreign affiliate dumping rules” have a very strong orientation toward constructive distributions or an appropriations element of Canadian value, in the nature almost of shareholder benefit rules. We are now going to switch to what may be seen as a similarly directed proposed “upstream loan” regime, concerned with the use of foreign surplus within or by a foreign affiliate group which may be seen as benefiting the group’s Canadian owner.

Upstream Loans

Pat Marley: We wanted to first give a very brief overview of the upstream loan proposals, and then get into an example to illustrate how they can apply on their own, and how they interact with some of the other rules in the ITA (including the foreign affiliate dumping rules we just discussed). At a very high level, the upstream loan rules were intended to discourage foreign affiliates of Canadian companies from making loans back to Canada, particularly when the loans were sourced with taxable surplus, or now hybrid surplus, of the affilaite (effectively extending the tax deferral that they enjoy from earning income offshore while allowing their Canadian parent access to the funds through loans). However, there are no conditions in the rules requiring an affiliate to have taxable surplus or hybrid surplus for the rules to apply. Also, although the rules are referred to as the "upstream" loan rules, the loans do not actually have to be upstream (they could also be downstream or side stream). Very broadly, the rules apply when a specified debtor in respect of a taxpayer receives a loan from, or becomes indebted to, a foreign affiliate. A specified debtor includes the Canadian taxpayer, as well as certain non-arm's length persons (and may also include another foreign affiliate, other than a "controlled foreign affiliate" using the Section 17 definition of that term). Foreign affiliates that are controlled by a foreign parent or a related foreign company are not excepted from the rule (i.e., exception only where the foreign affiliate is Canadian controlled). If the rules apply there is an income inclusion into the Canadian company, with an offsetting deduction when the loan gets repaid. So the impact of the rules prevents deferral (i.e., it's more of a timing issue than an actual income inclusion such as may apply under the foreign affiliate dumping rules).

The main exception is if the loan gets repaid within two years (although it may not be know at the time a loan is made when it may be repaid). If the loan is anticipated to be repaid within two years, the taxpayer may not include a net income inclusion. However, if that turns out not to be true then the income inclusion is retroactive back to the time the loan was made. So when filing returns taxpayers should file on the basis of what they think is going to happen in terms of whether the loan will be repaid or not within that period.

Other exceptions are provided, such as an exception for loans made in the ordinary course of a lending business. An offsetting deduction is also provided where there is sufficient exempt surplus or other tax-free surplus balances in the foreign affiliate chain (based on the theory that such amounts could otherwise have paid as an exempt dividend back to Canada). In that case the loan does not really extend any deferral period (i.e., potentially avoiding foreign withholding tax on a dividend rather than extending the Canadian deferral on foreign earnings). That mechanism applies to essentially have an income inclusion but then an offsetting deduction up to the tax-free surplus balance – which rolls over each year so that if the tax-free surplus balance is not available in a later year while the loan remains outstanding then there may be an income inclusion in that later year. The rule for tax-free surplus balances is only available if there are no dividends paid back to the Canadian company (and is illustrated in the example). There is no matching up of the amount of the surplus and the amount of the dividend. In this first example, we have a Canadian company with a series of three foreign affiliates. Foreign affiliate two makes a $100 loan back to Canco. Let's assume the loan remains outstanding for more than the two-year period; and is not made in the ordinary course of business so none of the other exceptions apply. The upstream loan rules would apply to include $100 in the Canadian company's income. Yhe purpose for this slide is to illustrate how the exempt surplus exception applies, and to show whether it applies if foreign affiliate one has $50 of exempt surplus, and foreign affiliate three also has $50 of exempt surplus. Specifically, the exception should apply if it is reasonable to consider that one or a series of dividends that the amount, in this case $100, could have been paid back to Canada free of Canadian tax. Here, in a hypothetical dividend situation, foreign affiliate three could have distributed up its $50 of surplus up to foreign affiliate two and up the chain such that there is a sufficient amount of exempt surplus available.

Another question posed at the bottom of this slide is what would occur if foreign affiliate one paid a $10 dividend. As drafted, it would appear that the entire exception would then cease to apply, rather than just $10 of the $100 amount.

In Next, in example two we wanted to show the interaction between the upstream loan rules and some of the other regimes in the Act. It's a somewhat simple fact pattern where a Canadian company puts equity funding into a foreign affiliate (FINCO) which makes a loan to a foreign affiliate (OPCO). If we started with the premise that the Canadian company had excess funds on hand; the one thing it could have done would be to simply pay a dividend to the foreign parent. It would pay Canadian withholding tax on the dividend or, if it's a return of capital, no Canadian tax and the money would leave Canada altogether. But instead of doing that, let's assume that Canco puts equity into FINCO which makes a loan to OPCO. The first thing to look at is whether the FAPI rules apply to the interest income earned by the foreign FINCO. The FAPI rules may or may not apply depending on whether paragraph 95(2)(a) applies. Let's assume for the moment that the foreign OPCO had an active business so that we don't have the FAPI rules applying. The second thing that we would look at is subsection 17(2). As Dave was mentioning earlier, subsection 17(2) can apply to impute a prescribed interest income into the Canadian company. In this simple fact pattern, subsection 17(2) would apply and so the Canadian company would have an income inclusion based on a prescribed return on $100. We then look to the upstream loan rules, which would apply here even though we have a loan between two foreign affiliates since foreign OPCO is not Canadian controlled (despite the fact that it would be ordinarily be a controlled foreign affiliate because it is controlled by the Canadian company together with the foreign parent). So the upstream loan rules apply to include $100 in the Canadian company's income. So now the Canadian company has income of $100 plus the prescribed return on $100. And then we go to the foreign affiliate dumping rules, and those rules arguably apply as well. There is an indirect investment rule - so if the foreign FINCO otherwise meets the business purpose test then the foreign affiliate dumping rules may also apply. And so the consequence would then be that CANCO is deemed to pay a dividend up to the foreign parent. We then would have Part XIII withholding tax layered on top of the other income inclusions. On a subsequent repayment of the loan, in bringing the funds back up to Canada and distributing up to the foreign parent, we've got another layer of Part XIII withholding tax that could apply. In total, there are four different Canadian taxes that can apply here. Perhaps the short answer is that it is not a good idea to do this restructure, but I will pass it over to Dave to comment.

Dave Beaulne: The upstream loan rules are among the most significant features of the August 19th package and, although the pace has slowed in recent months, we do continue to receive comments. I'll address some of the more recent comments in a couple of minutes.

I will first summarize the key submissions we received in the consultation period that ended October 19th, 2011.

Transitional Relief

The most common submissions were requests for additional transitional relief for loans outstanding on August 19th, 2012. Stakeholders have argued that the currently-proposed two-year repayment window is not enough. There have also been requests for special offset rules in respect of the foreign exchange gains and losses that can arise on the repayment of certain upstream loans. That issue arises where the foreign affiliate has loaned to its Canadian parent in a currency other than Canadian dollars, or other than its elected functional currency for those who have elected under section 261. We are sympathetic to some of these requests.

Reserve Mechanism

There were also a number of comments with respect to the so-called "reserve" mechanism in proposed subsection 90(6). As a general comment, I would note that this rule is being significantly reworked in order to clarify its intended application, and to provide some relief for issues that have been raised. In fact, section 90 as a whole is being reworked and renumbered. Last I checked the reserve mechanism was not in 90(6) anymore.

I have listed on the slides three items relating to the reserve mechanism. I will deal with the two easiest first.

- As mentioned by Pat, the proposed rules do not allow foreign affiliates to pay dividends while there are outstanding upstream loans that rely on subsection 90(6). We are recommending that this restriction be removed.

- As indicated on slide 17, there is interpretive uncertainty as to whether downstream surplus is allowed to be taken into account in computing the reserve. It was always our intention to allow this. Thus we are recommending that the next version of the legislation clarify that downstream surplus is to be taken into account.

- The more difficult issue is whether the ACB that is available for pre-acquisition surplus dividends should be taken into account in the reserve computation. However, we are sympathetic to allowing recognition of ACB in at least some circumstances.

Surplus Entitlement Percentage

There is also an issue with surplus entitlement percentage (SEP). Loans between foreign affiliates are exempted from the upstream loan rules to the extent that they are both controlled foreign affiliates within the meaning of section 17. We have received submissions asking us to provide additional relief in respect to inter-affiliate lending. Some have requested that an additional concept be introduced to allow for loans between non-CFAs where the Canadian shareholder’s SEP in the lender is less than or equal to its SEP in the borrower. Others have suggested that even if the SEP in the borrower is lower, the income inclusion should only be to the extent of the excess. We have some sympathy for these points.

Hypothetical Foreign Withholding Tax

A new issue has come up in recent weeks with respect to the subsection 90(6) reserve. The question is, in determining the amount that would be deductible by the relevant Canadian corporation if the upstream loan amount had instead been distributed as dividends up the chain, whether one should take into account any foreign taxes that might be incurred. If for example, foreign dividend withholding tax would be incurred somewhere in the chain, the cash available for distribution would be less than the full amount of the loan. Thus the section 113 deductions would be less than the full amount.

I would think that this issue also comes up in the context of subsection 93(1) where hypothetical dividends are paid to move the surplus up to the foreign affiliate whose shares are being sold. Thus I would think that the answer should be the same for both subsections 93(1) and 90(6). I understand that the CRA is of the view that no hypothetical foreign taxes would be deducted in the subsection 93(1) analysis. Thus I would expect that they would take the same position with respect to 90(6).

Interaction with FA Dumping

As pointed out by Pat, there may be situations where the new FA dumping rule and the upstream loan rule both apply to the same loan. In that event, a double tax exposure arises. However, to the extent that these situations are inadvertent, there is a two-year period in which to repair this situation under the upstream loan rules. Also an interpretive issue has arisen with respect to the repayment of upstream loans and whether such payments might be investments in a foreign affiliate under proposed paragraph 212(3)(f) on the basis that they are similar in effect to a loan or other transfer of property to a foreign affiliate. This is a very interesting question and we are giving it due consideration.

Thin Cap Relief

For completeness, because we are talking about upstream loans, I thought I should flag again the thin cap upstream loan measure announced in Budget 2012. That topic will be covered in the afternoon session on inbound taxation.

Scott Wilkie: We will now turn to refinements of legislation to deal with "foreign tax credit generators" in the foreign affiliate context, and the use of foreign affiliates' capital losses in light of proposed changes to prevent their use against "ordinary" rather than capital gains income of a foreign affiliate.

Foreign Tax Credit Generator Proposals

Ken Buttenham: First, I thought it would be useful to provide people with a reminder of the current state of the proposals as released in August 2010. Under the August proposals the rules generally apply if what I call the "hybrid condition" is met. That is, the rules will apply if a partners direct or indirect share of a partnerships income is less for foreign tax purposes than it is for Canadian tax purposes; or a pertinent person or partnership is considered to own fewer shares in a corporation or have a lesser direct or indirect share of a partnerships income for foreign tax purposes than for Canadian tax purposes. The existence of a hybrid instrument that is viewed as equity for Canadian tax purposes but as debt for foreign tax purposes for example would meet the hybrid condition. The result of the application of these rules is a denial of all foreign tax credits, foreign accrual tax and underlying foreign tax (depending on the circumstances) in respect of foreign taxes paid in the jurisdiction for which the hybrid condition is met. Consistent with the original March 2010 proposals, the effective date for the August proposals is for taxation years ending after March 4, 2010; however, there are transitional rules.

The August proposals also contained significant changes that would expand the application of the FTC generator rules considerably. This is due in part to the introduction of the defined term "pertinent person or partnership". Essentially, the FTC generator rules apply to a foreign affiliate when a PPOP holds an investment in another PPOP and, under the foreign tax law of the country that taxes the foreign affiliate, the hybrid condition is met with respect to that investment.

The definition of a PPOP is set out on this slide. This is a very broad definition that essentially includes every related company in a group. Further, the fact that the hybrid condition can be met for a foreign affiliate in respect of any investment between PPOPs and is not limited to investments in that foreign affiliate chain gives these proposals very broad application.

An example should help clarify the broad application of the August proposals. In this example, we have two related Cancos each with their own foreign affiliate groups. The Cancos are each owned by Canco Parent. Canco has chosen to finance its foreign affiliates with US operations with a preferred share investment that, when taken together with the forward and other agreements, are treated as a debt instrument for US tax purposes. Given the existence of a hybrid instrument between Canco and its US group (which are all PPOP's), the hybrid condition is met with respect to FA1 and FA2. The result is a denial of any foreign accrual tax and underlying foreign tax within the FA1 /

FA2 group. I think the real surprise that came with the August amendments was that FA3 and perhaps FA4 can also be caught by the FTC generator proposals. This is because from the perspective of the taxpayer, Canco2, and the foreign affiliate, FA3, a PPOP, Canco, holds a hybrid instrument in another PPOP, the FA1/FA2 group. As a result, the hybrid condition is met with respect to FA3 even though there is no actual hybrid instrument in the Canco2 group. In addition, the hybrid condition may also be met in respect of FA4 if the tax laws of Country X also view Cancos preferred share investment (either individually or together with the forward and other agreements) as debt.

At last year's IFA seminar we looked at some of the practical issues that come with this broad application of the rules and I believe Finance indicated that it was considering whether changes were required. Dave, do you have an update for us?

Dave Beaulne: The cross chain aspect to the rules was intentional. What we were worried about was loans from one chain to the other. When you have a loan from one chain to the other you don't have an equity percentage, so it wouldn't have been caught in the "single chain" rule. But we do recognize that the current formulation of the rule goes too far. Thus, we are recommending amendments to provide a better focus to the cross chain aspect of the rule, more specifically to make it apply only where there is a fairly clear link between the two chains by way of some kind of funding arrangement.

Foreign Accrual Capital Losses

Pat Marley: The main change in the foreign affiliate area with respect to foreign accrual capital losses was intended to track the domestic rules. Specifically, the change ensures that, in computing FAPI, capital losses can only be used to shelter capital gains. The slide shows an interpretative issue when transitioning into the new system. The issue is whether you can use capital losses that are FAPLs to shelter prior FAPI or vice-versa. This particular example has FAPI earned in the 2011 year, and a FAPL in the 2012 year. The question is whether you could carry that FAPL back three years to offset a portion of your FAPI in 2010 that arose from a capital gain or capital loss. In other words, if you had FAPI in 2010 can you shelter it with the FAPL that is realized afterwards.

Dave Beaulne: We realize that the language that is out there isn't very clear so we are recommending clarifications. We are going to clarify it so that, in Pat's example here, the $100 FAPL from 2010 will not be restricted in any way in its carry forward to a future year and, similarly, that the FACL that arises in 2012 would only be allowed to be carried back to the FAPI in 2010 to the extent that the FAPI includes capital gains.

Outstanding Comfort Letters

Dave Beaulne: I just wanted to make sure that I made one comment about this list on the last slide. Some may have heard about a pending foreign affiliate package that is meant to clean up the outstanding comfort letters, among other things. This is the list of comfort letters that we are working with right now. Ken prepared it, and people from my group confirmed it. If anybody thinks we are missing anything, I welcome your input.