IFA May 2013

Questions and Answers

Question 1: Offshore Investment Funds

A taxpayer resident in Canada invests in an offshore mutual fund because it wishes to take advantage of the investment expertise of the fund managers. The fund is resident in a country that does not levy an income or profits tax on the income earned by the fund; nor is there a withholding tax on payments made by the fund to the Canadian resident. The mutual fund is widely held, and is not a foreign affiliate of the Canadian taxpayer. Will section 94.1 of the *Income Tax Act* (the “Act”) apply to the Canadian taxpayer with respect to the interest in the fund?

Response:

One of the conditions for the application of section 94.1 is that one of the main reasons for the taxpayer acquiring, holding or having the interest in the offshore investment fund property was to derive a benefit from portfolio investments in certain assets in such a manner that the taxes on the income, profits and gains from the assets for any particular year are significantly less than the tax that would have been applicable under Part I of the Act if the income, profits and gains had been earned directly by the taxpayer.

Based on case law on the “one of the mains reasons” test in other provisions of the Act, it is our view that tax reduction or deferral does not have to be the only reason, or even the main reason for the investment; it merely has to be <u>one</u> of the main reasons. A particular fund manager’s expertise may be another of the main reasons for the investment. The onus is on the taxpayer to prove that <u>none</u> of the main reasons for the investment is tax reduction or deferral. In *John S. Walton v The Queen,* 98 DTC 1780, the court, quoting the Supreme Court of Canada, said that it will “look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances”. We generally would expect that a Canadian taxpayer investing in a mutual

fund resident in a tax haven country would be subject to section 94.1 of the Act.

Bill C-48, currently before Parliament, contains enhancements to section 94.1 of the Act that were announced in the Federal Budget on March 4, 2010. The “one of the main reasons” test remains the same under Bill C-48.

Question 2: Shareholder Benefit Rules and Foreign Divisive Reorganization Transaction

Assume the following facts:

(a) FA1, FA2 and FA3 are each foreign affiliates of Canco (within the meaning of subsection 95(1) of the Act) and are not resident in Canada.
(b) Canco owns 100% of the shares of FA1 and FA1 owns 100% of the shares of FA2.
(c) FA3 is either formed with nominal assets by FA1 or comes into existence as part of the legal division of FA2 into two legal entities pursuant to the corporate laws of the foreign country where FA2 and FA3 are resident ("Division").
(d) As a result of the Division, FA2 transfers some of its assets (for no consideration) to FA3 and under foreign country corporate law, FA3 must issue shares to the shareholders of FA2 pro rata based on the number of shares they hold in FA2. In this case, only FA1 holds shares in FA2 with the result that FA1 will become the sole shareholder of FA3.
(e) Under the foreign country corporate law, the legal paid up capital of the shares of FA2 will be reduced by an amount equal to the book value of the assets transferred by FA2 to FA3.
(f) Similarly, under the foreign country corporate law, the legal paid up capital of the shares of FA3 will be equal to the book value of the assets FA3 received from FA2.

Would the CRA agree that in the hypothetical example above, the Division results in a pro rata distribution by FA2 (equal to the fair market value of the assets it transferred to FA3) and therefore the payment of a deemed dividend pursuant to proposed subsection 90(2), by FA2, such that there is no shareholder benefit pursuant to proposed paragraph 15(1.4)(e) ?

Would the answer be different if the shares of FA2 were held directly by Canco and as a result of the Division, shares of FA3 were issued to Canco?

Response:

We are of the view that in the hypothetical situation above, the Division results in a pro rata distribution on the shares of FA2. Therefore, the

amount of the distribution will be deemed to be a dividend pursuant to proposed subsection 90(2). As a result, there is no shareholder benefit under proposed paragraph 15(1.4)(e) by virtue of the exception in that provision for dividends.

Our response would be the same if the shares of FA2 were held directly by Canco and as a result of the Division, shares of FA3 were issued to Canco.

Question 3: GAAR and Subsection 93(2)

Subsection 93(2) generally applies to deny a loss on the disposition of a share of a foreign affiliate (an “FA”) to the extent that exempt dividends had been received on that share, or on a share for which that share had been substituted, prior to the disposition.

What is the CRA’s position on the application of the GAAR to a series of transactions undertaken for the purpose of avoiding the application of subsection 93(2) so as to preserve the portion of a loss on the disposition of FA shares that is attributable to foreign exchange, such that it remains available to effectively offset a foreign exchange gain related to the investment in the FA shares?

Response:

It is our view that the GAAR would apply to a series of transactions undertaken by a taxpayer primarily for the purpose of avoiding the application of subsection 93(2), including in those circumstances where the otherwise denied foreign exchange loss on the disposition of FA shares would effectively offset what the taxpayer views as a foreign exchange gain on a related debt or hedging instrument, unless that foreign exchange gain is a gain described in proposed subparagraph 93(2.01)(b)(ii).

Parliament has, in proposed subparagraph 93(2.01)(b)(ii), specified precisely which related foreign exchange gains realized by a taxpayer are intended to affect the computation of the amount of the loss to be denied on the disposition of an FA share. Therefore, it is our view that except in circumstances described in proposed subparagraph 93(2.01)(b)(ii), subsection 93(2) and proposed subsection 93(2.01) are intended to deny a loss on the disposition of an FA share to the extent that exempt dividends had been received on that share, or on a share for which that share had been substituted, prior to the disposition, even in circumstances where the loss is arguably due to foreign exchange fluctuations rather than the extraction of earnings from the FA.

Consider a case where a corporation resident in Canada (“Canco”) borrows U.S. dollars from a related party and uses them to acquire common shares of an FA carrying on an active business in the United States. Over a number of years, FA’s business activities result in a large exempt surplus balance. During the same period, a large foreign exchange gain accrues on Canco’s U.S. dollar denominated debt. In contemplation of the sale of the FA common shares and repayment of the debt, Canco acquires preferred shares of FA for nominal consideration. The exempt earnings of FA are distributed to Canco on the preferred shares. Canco then disposes of the FA common shares realizing a loss. A foreign exchange gain is realized on the repayment of the debt and the two are offset.

In this example, the issuance of the FA preferred shares and the payment of dividends thereon are avoidance transactions carried out for the purpose of avoiding subsection 93(2). Moreover, since a foreign exchange gain realized on the repayment of a non-arm’s-length debt is not a gain described in proposed subparagraph 93(2.01)(b)(ii), it was not intended that it should affect the computation of the loss denied under subsection 93(2). Therefore the issuance of the FA preferred shares and the payment of the dividends thereon result in an abuse having regard to subsection 93(2) such that the GAAR would apply. Our opinion would be the same if, for the purpose of avoiding the application of subsection 93(2), the preferred shares were issued on the initial incorporation of the FA.

We would note that the denial of a loss on the disposition of FA shares while taxing a related foreign exchange gain is, in our view, not inconsistent with the provisions of the Act read as a whole. To conclude otherwise would require the CRA to search for an overriding policy in the Act which provides for the offsetting of gains and losses which are in some way linked. A unified, textual, contextual and purposive interpretation of specific provisions of the Act does not, in our view, reveal such an overarching policy.

Question 4: PUC Planning Prior to Section 212.3

Can the CRA clarify its position on PUC planning prior to the coming into force of section 212.3 in the context of the following hypothetical facts?

NRCo owns Forco. Forco owns 100% of a Canadian operating subsidiary (CanOpco). The paid-up capital (PUC) of the shares of CanOpco is nominal.

NRCo sets up a new Canadian company (CanHoldco), and CanHoldco acquires the shares of Forco for shares of CanHoldco. The PUC of the CanHoldco shares is equal to the FMV of the shares of Forco.

Forco is wound up into CanHoldco, and the shares of CanOpco are transferred to CanHoldco. Subsection 212.1(1) does not apply on the transfer.

CanOpco pays a taxable dividend to CanHoldco in an amount equal to its retained earnings. CanHoldco deducts the dividend from its taxable income under subsection 112(1). CanHoldco pays the same amount to NRCo as a reduction of PUC.

In the context of the above facts, what is the CRA's position on the application of the GAAR if the above planning is carried out:

A. Pre-acquisition – i.e. NRCo injects equity into CanHoldco, and CanHoldco acquires Forco from an arm's length vendor (assume CanHoldco can't acquire CanOpco directly because NRCo also wishes to acquire Forco's other assets);
B. Post-acquisition – i.e. NRCo acquires Forco from an arm's length vendor, then after a number of months transfers Forco to CanHoldco in exchange for shares of CanHoldco; and
C. Non-acquisition – i.e. the NRCo, Forco, CanOpco structure has been in place since the inception of CanOpco's business activities, and NRCo transfers the shares of Forco to CanHoldco in exchange for shares of CanHoldco.

Response:

In all three cases, a new Canadian corporation (i.e. CanHoldco) is inserted between NRCo and Forco to establish cross-border PUC reflective of the FMV of the shares of CanOpco to enable surplus of CanOpco to be extracted from Canada without payment of Part XIII withholding tax. As section 212.1 does not apply, for transactions prior to section 212.3, the CRA would consider the application of the GAAR.

The GAAR Committee has determined that the GAAR applies to cases involving "Post-acquisition" and "Non-acquisition" planning as described above. The GAAR will apply to treat the return of PUC paid by CanHoldco to NRCo as a distribution of a taxable dividend subject to Part XIII withholding tax. The GAAR Committee has not recently addressed the "Pre-acquisition" tax planning case described above.

Section 212.3 of the Act (i.e. the "foreign affiliate dumping rules") was enacted by Bill C-45, generally applicable in respect of transactions and events that occur after March 28, 2012. If the acquisition of Forco by CanHoldco in all three scenarios occurred after March 28, 2012, section 212.3 would generally apply.

Question 5: Upstream Loan Rules

Question 5(a)

Proposed subsection 90(6) generally applies to include an amount in the income of a corporation resident in Canada (“Canco”) where a specified debtor receives a loan or becomes indebted to a foreign affiliate (“FA”) of Canco and none of the exceptions in proposed subsection 90(8) apply. Proposed subsection 90(9) entitles Canco to a reserve to the extent that an actual dividend from the lending FA would have given rise to a deduction under section 113 (based on the surplus balances of the lending FA at the time the loan was made or the indebtedness incurred), and subsection 91(5) (in limited circumstances).

Assume that Canco owns all the shares of FA. FA has $100 of taxable surplus (“TS”), no exempt surplus and no underlying foreign tax (“UFT”) balances. The TS is attributable to foreign accrual property income (“FAPI”) of FA and has been fully included in the income of Canco and the ACB of FA’s shares. Assume that FA makes a $100 loan to Canco and the “specified amount” in respect of the loan is included in Canco’s income pursuant to proposed subsection 90(6). Will a reserve be available to Canco pursuant to the provisions of proposed subsection 90(9)?

Response 5(a)

Under the general ordering of surplus distributions, the notional dividend contemplated in proposed subsection 90(9) would, in the above case, be out of FA’s TS.

Pursuant to proposed subparagraph 90(9)(a)(ii), the deduction that would be available under subsection 91(5) if a dividend were paid by the FA will be an element in computing the reserve in proposed subsection 90(9), only if the specified debtor is a person described in proposed sub-clause 90(9)(a)(i)(D)(I) or (II) (i.e. a non-resident person with which Canco does not deal at arm's length, or a partnership any member of which is a non-

resident person with which Canco does not deal at arm's length). In the scenario described above, there is no amount included in the reserve under proposed subparagraph 90(9)(a)(ii) in respect of the previously taxed FAPI, because the specified debtor is Canco (which is not a person described in proposed sub-clause 90(9)(a)(i)(D)(I) or (II)).

If the notional dividend was out of FA's TS, no amount would be computed under clause 90(9)(a)(i)(C) because FA has no UFT and no deduction would be available under paragraph 113(1)(b) in respect of that notional dividend. Moreover, there would be no amount computed under clause 90(9)(a)(i)(D) because no portion of the notional dividend was out of FA's pre-acquisition surplus.

However, we note that firstly, the ACB of the shares of FA held by Canco is increased under paragraph 92(1)(a) as a result of the subsection 91(1) inclusion in respect of the FAPI of FA and secondly, proposed paragraph 5901(2)(b) of the Regulations allows a taxpayer to make an election to "side step" the normal ordering rules of subsection 5901(1) of the Regulations and instead, have the whole dividend deemed to be paid out of pre-acquisition surplus. Since Canco would have been in a position to make an election under proposed paragraph 5901(2)(b) of the Regulations to deem the dividend to be paid out of pre-acquisition surplus, it is our view that for the purposes of proposed subsection 90(9) an amount may "reasonably be considered to have been deductible" in respect of the dividend under paragraph 113(1)(d). Therefore an amount would be included in the subsection 90(9) reserve under proposed clause 90(9)(a)(i)(D).

Question 5(b)

Proposed subsections 90(6) to 90(15) generally apply in respect of loans received and indebtedness incurred after August 19, 2011. However, they also apply in respect of a particular loan received or indebtedness incurred on or before August 19, 2011 that remains outstanding on August 19, 2014

as if it was received or incurred on August 20, 2014[1]. There is an exception for loans repaid within two years of inception.

Consider a case where on September 1, 2011 a foreign affiliate (FA) of a corporation resident in Canada (Canco) made a loan to a “specified debtor” in respect of Canco. If Canco sells the shares of the FA such that FA ceases to be a foreign affiliate of Canco before September 1, 2013, and the loan is outstanding on September 1, 2013, will Canco be deemed to have an income inclusion pursuant to proposed subsection 90(6) on September 1, 2011?

Consider another case where prior to August 19, 2011 a foreign affiliate (FA) of a corporation resident in Canada (Canco) made a loan to a “specified debtor” in respect of Canco. If Canco sells the shares of the FA before August 19, 2014, will Canco be deemed to have an income inclusion pursuant to proposed subsection 90(6) on August 20, 2014, if the loan remains outstanding on August 20, 2016?

Alternatively, if Canco sells the shares of FA after August 20, 2014 but the loans remains outstanding on August 20, 2016, will subsection 90(6) apply?

Response 5(b)

In the first case, FA made a loan to a “specified debtor” in respect of Canco on September 1, 2011. Since proposed subsection 90(6) provides that the relationships between Canco, FA and the debtor are to be tested at the time the loan is received or the debt incurred (in this case, September 1, 2011), if the loan is not repaid by September 1, 2013 (even if FA is no longer a FA of Canco on September 1, 2013), the exception in proposed paragraph 90(8)(a) will not apply and proposed subsection 90(6) will apply, such that Canco will have an income inclusion on September 1, 2011. On a positive note, Canco will be entitled to a deduction pursuant to proposed subsection 90(14) when the indebtedness is repaid.

[1] In accordance with their coming into force provisions.

In the other case, the coming into force provisions instruct us to apply proposed subsections 90(6) to (15) as if the loan was received or indebtedness was incurred on August 20, 2014. If FA is not a FA of Canco at the time the loan is considered to have been made, proposed subsection 90(6) will not apply to Canco. Thus, where prior to August 19, 2011 a FA of Canco made a loan to a "specified debtor" in respect of Canco, if Canco sells the shares of the FA on or before August 19, 2014, even if the loan is outstanding on August 20, 2016, Canco will not have an income inclusion pursuant to proposed subsection 90(6) on August 20, 2014 (because on August 20, 2014, FA is no longer a foreign affiliate of Canco). However, if the sale of the shares of FA takes place on or after August 20, 2014 and the loan remains outstanding on August 20, 2016, since proposed subsection 90(6) provides that the relationships between Canco, FA and the debtor are to be tested at the time the loan is received or the debt incurred (in this case, August 20, 2014), it will apply, such that Canco will have an income inclusion on August 20, 2014, notwithstanding that those relationships are no longer in place on August 20, 2016. Note that Canco will get a deduction pursuant to proposed subsection 90(14) when the indebtedness is repaid.

While the wording of the proposed legislation is clear, we question whether a proposed subsection 90(6) income inclusion is appropriate where the lending corporation is no longer a foreign affiliate at the time the two year time limit referred to in proposed paragraph 90(8)(a) is reached. If the issue arises in the context of a ruling request or a referral from a CRA auditor, we will consult with the Department of Finance on this issue with a view to potentially taking an administrative position to alleviate the apparent anomaly.

Question 5(c)

Will the CRA use its various positions on subsection 15(2) as a guide for administering proposed subsections 90(6) to (15)? In particular, would the

position in paragraph 38 of Interpretation Bulletin IT 119R4 which provides administrative relief from interest and penalties in respect of the requirement to remit withholding tax on dividends deemed paid to non-residents (by virtue of the application of subsection 15(2) and paragraph 214(3)(a)) be applied in the context of a case where proposed subsection 90(6) applies retroactively to include a specified amount in the income of a taxpayer resident in Canada (such that no interest and penalties will be applied when a previously filed return is reassessed)?

Response 5(c)

The determination of the application of proposed subsections 90(6) to 90(15) to a given situation is a question of fact and will be determined on a case by case basis. However, the CRA will generally look to its practices on the application of subsection 15(2) to deal with practical issues involving the application of proposed subsections 90(6) to 90(15) to a given situation.

Proposed subsection 90(6) only applies to include a "specified amount" in the income of a taxpayer resident in Canada. Therefore, consistent with its practice in the context of the application of subsection 15(2) to Canadian resident debtors, the CRA will not provide administrative relief from interest and penalties in the context of the application of proposed subsection 90(6). Instead, the CRA will exercise its right to enforce the payment of interest and penalties (if applicable), for any tax not paid by the Canadian resident taxpayer, by the balance due date for the year in which proposed subsection 90(6) applies to include a "specified amount" in its income.

Question 6: Foreign Affiliate Dumping and PLOI Rules

Question 6(a)

For transactions or events before August 14, 2012, a taxpayer can elect to apply a transitional version of the foreign affiliate dumping rules. Does the CRA consider that the original version of paragraph 212.3(10)(f) that would apply during the transition period captures the indirect acquisition of foreign affiliates (i.e. the acquisition of Canadian companies owning foreign affiliates)?

Response:

Transitional paragraph 212.3(10)(a) reads like current paragraph 212.3(10)(a) and describes a direct acquisition of the capital stock of a subject corporation by a CRIC. Transitional paragraph 212.3(10)(f) provides that an investment in a subject corporation by a CRIC includes any transaction or event that is similar in effect to any of the transactions described in transitional paragraphs 212.3(10)(a) to (e).

The determination of whether a CRIC's particular acquisition of the shares of a Canadian company owning foreign affiliates would be similar in effect to its acquisition of shares of the capital stock of subject corporations as described in transitional paragraph 212.3(10)(a), such that the transitional paragraph 212.3(10)(f) would apply to the CRIC's acquisition of the shares of the Canadian company, is a question of fact that could only be determined after reviewing all of the facts and relevant information regarding the particular acquisition.

However, in general, we would view a CRIC's acquisition of the shares of a Canadian company owning foreign affiliates to be similar in effect to the CRIC's acquisition of shares of the capital stock of a subject corporation if the total fair market value of all the foreign affiliate shares that are held directly or indirectly by the Canadian company comprises all or substantially all of the total fair market value of all of the properties owned by the Canadian company.

Question 6(b)

Does the PUC reinstatement rule in subsection 212.3(9) apply where the PUC of the CRIC that was previously suppressed is subsequently reduced as part of the redemption of shares owned by the non-resident corporate parent as well as on a return of PUC on the shares?

Response:

New subsection 212.3(9) allows for a reinstatement of PUC in respect of a class of shares of a CRIC or a qualifying substitute corporation immediately before a distribution/reduction of capital in certain circumstances where the PUC was initially reduced by the operation of paragraph 212.3(2)(b) or (7)(b).

In our view the words "reduces…the paid-up capital in respect of the class…" as they appear in subsection 212.3(9) are broad enough to encompass a reduction in PUC of shares of a class that arises as a consequence of a redemption of shares of that class. We find contextual support for this interpretation in the wording of subsection 84(4).

Question 6(c)

Can a PLOI election under either of subsection 15(2.11) or 212.3(11) be considered to be made in respect of a particular debt if the election specifies that it is being made in respect of each indebtedness owing by the particular debtor to the particular CRIC? In other words, can it be expressed and made in a way that covers all indebtedness owing by the particular debtor to the particular CRIC, or will a separate election be required for each indebtedness?

Response:

In order for a particular amount owing to be a PLOI, pursuant to either subsection 15(2.11) or 212.3(11), an election in respect of the amount owing must be filed with the Minister of Revenue on or before the filing-due date of the CRIC for the year in which the amount became owing (or, for the purposes of subparagraph15(2.11)(d)(ii), on or before the filing-due date of the CRIC for its taxation year in which ends the fiscal period of the qualifying Canadian partnership in which the amount became owing).

If the filing due date is the same for electing PLOI treatment for more than one amount owing (i.e., more than one amount owing became owing in a given taxation year of the CRIC or, for the purposes of subparagraph 15(2.1)(d)(ii), of the qualifying Canadian partnership), a single written communication may be prepared and filed with the Minister which contains an election for each particular amount owing. However, in order for a PLOI election to be valid, in our view, it must refer to a specific amount owing.

Question 6(d)

In the context of paragraph 212.3(16)(a) [exception – more closely connected business activities], if a subject corporation carries on an active business related to the CRIC's Canadian business (e.g. local distributor of goods manufactured by the CRIC) and also carries on similar activities in respect of operations of non-resident members of the non-resident corporate parent's group, is there a threshold that would be relevant in determining whether the subject corporation's business is more closely connected to the CRIC's (e.g., subject corporation's revenues are derived 51% from distributing CRIC's products, and 49% from distributing products of other group members)?

Will the CRA require data concerning <u>all</u> other group members in order to compare the relative degree of connectedness?

Response:

The determination of whether a particular CRIC's investment in a particular subject corporation meets the more closely connected test in subsection 212.3(16) can only be made following a review of all of the circumstances of a particular situation. We have, as yet, no firm guidelines. However, in making a determination of whether the business activities test contained in paragraph 212.3(16)(a) is met, we would consider the Department of Finance's comments in their Explanatory Notes that:

> "…This requirement reflects the intention that the exception from subsection 212.3(2) apply only where the relationship between the CRIC's and the subject corporation's businesses clearly justify the investment in the subject corporation being made by the CRIC rather than by another member of the multinational group."

In order to determine whether a particular CRIC's investment in a particular subject corporation meets the business activities test contained in paragraph 212.3(16)(a) we would need to consider the business activities of:

- the CRIC;
- all corporations resident in Canada with which the CRIC does not, at the investment time, deal at arm's length;
- the subject corporation;
- all subject subsidiary corporations, as that term is described in paragraph 212.3(16)(a); and
- all non-resident corporations with which the CRIC, at the investment time, does not deal at arm's length, other than any corporation that is, immediately before the investment time, a controlled foreign affiliate of the CRIC for the purposes of section 17 of the Act.

Question 6(e)

In the computation of the amount to be included in income under paragraph 17.1(1)(b) in respect of a PLOI, element A of the formula is the greater of two amounts. One of those amounts is the amount of interest payable in respect of a debt obligation – entered into as part of a series of transactions or events that includes the transaction by which the PLOI arose – to the extent that the proceeds of the debt can reasonably be considered to have directly or indirectly funded, in whole or in part, the PLOI.

Could the indirectly funded rule in paragraph 17.1(1)(b) be avoided through the use of cash damming techniques? For example, what if a CRIC sets up two bank accounts and uses account A to receive borrowings and fund business expenses and account B to receive business revenues and fund a PLOI, or alternatively, CRIC 1 uses its business revenues to fund a PLOI while CRIC 2 (a sister corporation where there are no cross-shareholdings, or inter-company debts, with CRIC 1), uses borrowings to fund its business expenses?

Response:

For the purposes of interest deductibility, it is noted in paragraph 16 of IT-533, *Interest Deductibility and Related Issues,* that cash damming readily allows taxpayers to trace borrowed money to specific uses for purposes of paragraph 20(1)(c). However, we infer from the language

> "a debt obligation - entered into as part of a series of transactions or events that includes the transaction by which the amount owing arose"

and

> “the proceeds of the debt obligation can reasonably be considered to have directly or indirectly funded, in whole or in part the amount owing”

which appear in subparagraph (ii) of the description of A in paragraph 17.1(1)(b) and not in paragraph 20(1)(c), that it was intended that the application of paragraph 17.1(1)(b) would not be limited by the principle of “tracing” as it has related to paragraph 20(1)(c). Accordingly, we are not prepared to concede that the proceeds of a debt obligation cannot reasonably be considered to fund a PLOI simply because those proceeds were deposited into one account while the funds used to directly make the PLOI were withdrawn from another.

The determination of whether it can reasonably be considered that the proceeds from any particular debt obligation of the CRIC (or a qualifying Canadian partnership, a person resident in Canada with which the CRIC did not, at the time the PLOI arose, deal at arm's length or a partnership of which the CRIC or the person is a member) had directly or indirectly funded, in whole or in part, a particular PLOI can only be determined after reviewing all of the facts and relevant information regarding the entering into of the debt obligation and the making of the PLOI. However, it is our general view that it would be reasonable to expect that the proceeds from a borrowing had directly or indirectly funded, in whole or in part, a PLOI when a CRIC borrows money and, while the borrowing is outstanding, it makes a PLOI. Whereas, it is difficult to imagine circumstances in which it would be reasonable to consider that the borrowings of a sister Canco, where there are no cross shareholdings or inter-corporate debts, had directly or indirectly funded the PLOI of a CRIC.

Question 6(f)

Subsection 212.3(10) defines “investment” in a subject corporation made by a CRIC and subparagraph 212.3(10)(c)(i) excludes an amount that becomes owing by the subject corporation to the CRIC that arises in the ordinary course of business of the CRIC and that is repaid, other than as

part of a series of loans or other transactions and repayments, within 180 days after the day on which the amount becomes owing.

(i) Would CRA accept FIFO as the method to track the origination and settlement of multiple debts that may arise from inter-company dealings or cash pooling?

(ii) Would CRA consider a “series of loans” to arise where there are inter-company dealings or cash-pooling but each item arises for its own reasons and not in contemplation of recycling an existing item?

(iii) Would CRA accept that each loan in a “series” will be repaid once all loans in the series have been repaid?

Response:

It is our understanding that the reference to “inter-company dealings” in the question is a reference to the transaction of a CRIC selling property or services to a subject corporation on credit in the ordinary course of the CRIC's business. An amount owing to the CRIC as the result of such an inter-company dealing would, in our view, meet the ordinary course of business exception in subparagraph 212.3(10)(c)(i) if the resulting debt is repaid within the time limit required by that exception.

“Cash pooling” arrangements take many forms and the determination of whether a particular “cash pooling” arrangement results in an amount that becomes owing to a CRIC that arises in the ordinary course of the business of the CRIC is a question of fact that could only be determined after reviewing all of the facts and relevant information regarding the particular cash pooling arrangement and the business of the particular CRIC. However, we would note that the ordinary course of business exception in subparagraph 212.3(10)(c)(i) could, in our view, apply when a CRIC temporarily advances funds at risk in its business (i.e., the permanent removal of such funds would have a destabilizing effect on the business of

the CRIC) to a subject corporation if the resulting debt is repaid in the manner required by that exemption.

In our view, the repayment rule in subparagraph 212.3(10)(c)(i) is similar to the rule in subsection 15(2.6) that applies in the shareholder debt context.

(i) If a particular amount owing is made up of several amounts owing of the same nature (for example as the result of numerous individual acquisitions of product or services on credit), we would accept FIFO as the method to track the origination and settlement of multiple amounts owing. Whereas, if a particular amount owing is made up of several amounts owing of different natures (for example one amount owing may be secured and payable at maturity whereas another amount owing may be unsecured and payable in installments and/or the amounts owing may have different interest rates), we would expect the debtor to specify which amount owing is intended to be repaid by a particular payment.

(ii) Our views on whether the repayment of a particular amount owing is part of a series of loans or other transactions and repayments are set out in Interpretation Bulletin IT-119R4, *Debts of Shareholders and Certain Persons Connected With Shareholders*. In general terms, it is a question of fact whether or not a repayment of an amount owing is part of a series of loans or other transactions and repayments. Specifically, however, repayments of a temporary nature (for example, certain cash pooling arrangements) may be evidence of a series of loans and repayments.

(iii) In our view, a final, *bona fide*, repayment would not be considered part of a series for the purpose of subparagraph 212.3(10)(c)(i). Therefore, we would consider that a particular amount owing by a subject corporation to a CRIC which arose in the ordinary course of the business of the CRIC would meet the exception in subparagraph 212.3(10)(c)(i) if its final, *bona fide*, repayment was made within 180 days after the day on which the particular amount became owing, even if, arguably, that *bona fide* repayment is the last transaction in a series of loans or other transactions and repayments.

Question 6(g)

Do internal dispositions give rise to "proceeds" for the purposes of clause 212.3(9)(c)(ii)(A), and does it matter whether the CRIC retains a complete or partial indirect interest in the subject shares? For example, what if the CRIC sells shares of one foreign affiliate ("FA1") to another foreign affiliate ("FA2") for cash?

Response:

As noted in the closing words of clause 212.3(9)(c)(ii)(A), a PUC reinstatement is not available to a CRIC when its disposition of shares of a subject corporation results in an acquisition of those shares to which subsection 212.3(18) applies. In our view, this exclusion will result in many internal dispositions not resulting in the availability of a PUC reinstatement. However, if the PUC in respect of a class of shares of the capital stock of a CRIC (the "Class") had previously been suppressed as a result of its investment in FA1 and then the CRIC sells FA1 to FA2 for cash such that the CRIC's cross border investment is reduced and then, within 180 days, reduces the PUC in respect of the Class, in our view, the PUC reinstatement provided for in subsection 212.3(9) will apply.

Question 6(h)

Can a subsection 212.3(3) dividend substitution election be made even if there is no qualified substitute corporation in the group?

Response:

Pursuant to the subsection 212.3(3) dividend substitution election, all or a portion of a dividend that would otherwise be deemed to be paid by the CRIC to the parent and received by the parent from the CRIC, pursuant to paragraph 212.3(2)(a), may instead be deemed firstly, to be paid by one or more qualified substitute corporations and/or secondly, to be paid to and

received by another non-resident corporation that is controlled by the parent.

The phrase "…in respect of classes of shares of the capital stock of any of the CRIC and one or more of the qualifying substitute corporations…" as it appears in the preamble to subsection 212.3(3) allows, in our view, an election to be made, pursuant to subsection 212.3(3), in respect of shares of the CRIC when there are either no qualified substitute corporations in the group or if there is simply no desire to have any other corporation be viewed as the payer of the dividend. Furthermore, the phrase "is, as reduced by the application of subparagraph (i), deemed…" as it appears in subparagraph 212.3(3)(a)(ii) does not, in our view, require that an amount be agreed on in respect of a class of shares of the capital stock of a qualifying substitute corporation, only that any such amounts be considered in the application of subparagraph 212.3(3)(a)(ii). As a result, the entirety of a dividend that would otherwise be deemed to be paid by the CRIC to the non-resident corporate parent and received by the parent from the CRIC, pursuant to paragraph 212.3(2)(a), may instead, pursuant to subparagraph 212.3(3)(a)(ii), be deemed to be paid by the CRIC to another non-resident corporation in the group and received by that other non-resident corporation from the CRIC.

Finally, the CRIC and the parent may choose to elect under subsection 212.3(3) simply to trigger paragraph 212.3(6)(a) and thereby subsection 212.3(7). In such case, there need not be a qualified substitute corporation or a non-resident corporation other than the parent taking part in the election but to achieve its goal, the election must satisfy subparagraph 212.3(6)(a)(ii).

Question 7: Thin Capitalization

Assume that a Canadian subsidiary has two loans outstanding to specified non-residents: its US Parent and a UK related company. A portion of the interest payable on the two loans is denied under the thin capitalization rules and is deemed to be a dividend under the changes to the rules. Can the taxpayer allocate the deemed dividend first to the US Parent such that the 5% dividend rate applies rather than the 15% rate applicable on a deemed dividend to the UK sister company?

Response:

Subsection 18(4) prevents a corporation resident in Canada from deducting interest on certain debts owing to specified non-residents to the extent that the debts exceed a permissible debt-to-equity ratio, currently 1.5:1. Subsection 18(4) denies a deduction for a portion of a corporation's total interest paid or payable to specified non-residents through consideration of the appropriate portion of non-resident debt-to-equity.

Where a corporation is denied a deduction of interest by subsection 18(4), paragraph 214(16)(a) deems the appropriate portion of each amount of interest otherwise paid or credited by the corporation to the specified non-residents to be a dividend, and not to be interest for the purposes of Part XIII of the Act.

However, paragraph 214(16)(b) allows the corporation to designate all or a portion of each specific interest payment to a particular non-resident as a dividend, to the extent of the total amount of the interest payments to that non-resident that were otherwise deemed to be a dividend under paragraph (a). Paragraph 214(16)(b) effectively allows the corporation to determine the timing of the deemed dividends for Part XIII purposes, allowing some flexibility and certainty as to Canco's Part XIII withholding and remittance obligations in regards to the deemed dividend amounts. However, the paragraph does not allow the corporation to transfer a deemed dividend from one payee to another, to alter amounts paid to a specified non-resident, or to affect the timing of amounts paid.

Following from the example described in the question, assume that the Canadian resident corporation (Canco) has $1,000 in paid-up capital, and no other equity for the purposes of the thin capitalization rules throughout the entire year. Canco has two $1,000 loans outstanding, one from the US corporation (US-Co) bearing annual interest at 7%, and the other from the UK corporation (UK-Co) bearing annual interest at 5%. Both loans require semi-annual, interest-only payments at the end of Canco's second and fourth fiscal quarters. Canco and UK-Co are both wholly-owned subsidiaries of US-Co.

Under this scenario, the interest payments from Canco in respect of the two loans are:

Quarter 2:	Quarter 4:
$35 interest paid to US-Co	$35 interest paid to US-Co
$25 interest paid to UK-Co	$25 interest paid to UK-Co

With the permitted 1.5-to-1 debt-to-equity ratio, Canco has $500 of total excess debt, calculated as ($2,000 – 1.5 x $1,000)/$2,000, or 25% of $2,000. Accordingly, 25% of the annual interest paid by Canco on the loans to US-Co and UK-Co will be denied deduction under subsection 18(4).

Pursuant to subparagraph 214(16)(a)(i), the appropriate portion (i.e., 25%) of each interest payment from Canco to US-Co and UK-Co is deemed to be a dividend for the purposes of Part XIII, absent a designation under paragraph 214(16)(b).

As such, absent a paragraph 214(16)(b) designation, the non-resident interest payments from Canco will be treated as:

Quarter 2:	Quarter 4:
$26.25 interest paid to US-Co	$26.25 interest paid to US-Co
$ 8.75 dividend paid to US-Co	$ 8.75 dividend paid to US-Co

$18.75 interest paid to UK-Co	$18.75 interest paid to UK-Co
$ 6.25 dividend paid to UK-Co	$ 6.25 dividend paid to UK-Co

However, paragraph 214(16)(b) allows Canco to designate amounts of specific interest payments as dividends paid to the respective non-resident recipient, i.e., US-Co or UK-Co , up to the total amount of interest deemed to be a dividend to that respective payee.

More specifically, Canco was deemed to have paid $17.50 of total dividends to US-Co and $12.50 of total dividends to UK-Co pursuant to paragraph 214(16)(a). In this situation, Canco may prefer to designate $17.50 of its fourth quarter US-Co interest payment to be a dividend, and $12.50 of its fourth quarter UK-Co interest payment to be a dividend.

Therefore, following the designation, the non-resident interest payments from Canco will be treated as:

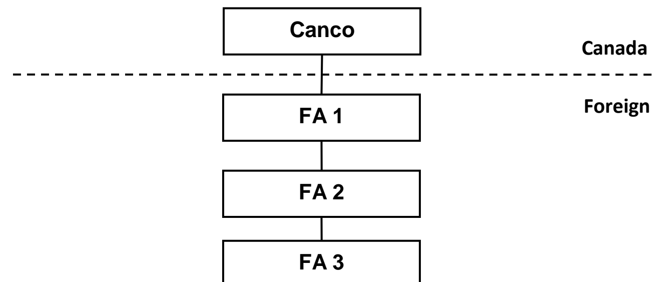
Quarter 2:	Quarter 4:
$35.00 interest paid to US-Co	$17.50 interest paid to US-Co
	$17.50 dividend paid to US-Co
$25.00 interest paid to UK-Co	$12.50 interest paid to UK-Co
	$12.50 dividend paid to UK-Co

Question 8: Form T1134

The following questions are related to the new Form T1134, *Information Return Relating to Controlled and Not-Controlled Foreign Affiliates*, released by CRA early in 2013.

Question A

Section 3B of the new T1134 Summary Form requires a disclosure of the equity percentage between two foreign affiliates of a reporting entity. In the case of a tiered corporate structure where Canco (the reporting entity) owns 100% of FA 1, FA 1 owns 100% of FA 2, and FA 2 owns 100% of FA 3, please consider the following:



Since "equity percentage" is defined in subsection 95(4) as including direct and indirect share ownership percentages, both FA 1 and FA 2 will have a 100% equity percentage in FA 3. In this case, should FA 3 be reported in Section 3B twice (i.e., FA 1's 100% equity percentage in FA 3, and FA 2's 100% equity percentage in FA 3)?

Response:

Yes, that is correct.

Question B

If the answer to Question A is yes, this could mean a great number of repetitive reporting by large multinational groups. For example, if FA 3 owns another 200 foreign affiliates, those 200 foreign affiliates will each be reported at least 3 times, resulting in a Section 3B disclosure of more than

600 entries. Would the CRA provide any administrative relief in this repetitive reporting situation?

Response:

The CRA is considering developing an administrative policy to provide relief in such situations.

Question C

There has been a change in the administrative relief on filing requirements previously provided for dormant or inactive foreign affiliates. The new Form T1134 now limits the administrative relief for dormant or inactive foreign affiliates to situations where the total cost of investment in all foreign affiliates is less than $100,000. The $100,000 threshold is very low for large multinational corporations. This basically means that large multinational companies would now have to report dormant or inactive foreign affiliates. Is this the intent of the proposed change?

Response:

Yes. Section 233.4 of the *Income Tax Act* requires reporting of information regarding all foreign affiliates. In order to reduce the burden on filers, the CRA provided relief from filing this information for dormant or inactive foreign affiliates–the relief was simply an administrative relief.

Unfortunately, the previous administrative thresholds surrounding dormant or inactive foreign affiliates created a reporting gap between Form T1135 filing requirements and Form T1134 filing requirements. Since the CRA continues to prioritize efforts to ensure compliance surrounding offshore tax matters, it was necessary to close this gap to be consistent with the legislative thresholds for Form T1135.

Question 9: Convertible and Exchangeable Debentures

What is the CRA's current position with respect to the application of the Part XIII tax to convertible and exchangeable debentures owned by foreign lenders (i.e., paragraph 212(1)(b), the definition of "participating debt interest" in subsection 212(3), subsection 214(7) and their qualification as an "excluded obligation" under paragraph 214(8)(c) of the ITA)?

Is there anything new to report?

Response:

Convertible Debentures

In response to Q.12 at the CRA Round Table at the May 2009 IFA conference, the CRA stated that where there is a conversion of a traditional convertible debenture (as described in the response) by its original holder for common shares of the capital stock of the issuer, there would generally be no excess under subsection 214(7) of the ITA.

In June 2012, the Income Tax Rulings Directorate ("ITRD") issued a ruling (document 2011-0418721R3) stating that the regular periodic interest payments on a certain convertible debt would not be "participating debt interest" as defined in subsection 212(3) of the ITA. The convertible debt had been issued by a taxable Canadian corporation to a non-resident. The ruling letter should be released to publishers of tax information in the near future.

The ITRD of the CRA is currently examining certain questions of interpretation and submissions made by The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants ("Joint Committee") concerning the possible application of Part XIII tax with respect to convertible debentures issued by issuers in Canada.

The Joint Committee would like the CRA to establish guidelines that would apply to a broad range of convertible debentures that are issued in Canada. These debentures, referred to as “standard convertible debentures” by the Joint Committee, would include the usual provisions that are included in most convertible debenture contracts.

The ITRD has written to the Department of Finance in order to obtain its views concerning the tax policy with respect to the application of paragraph 212(1)(b), subsection 214(7), paragraph 214(8)(c) and the definition of “participating debt interest” in subsection 212(3) of the ITA, in the context of convertible debentures.

Our analysis of the relevant issues is substantially advanced. However, we believe that it is important to obtain the views of the Department of Finance concerning the tax policy in relation to these issues before the ITRD provides any guidelines to the Joint Committee concerning convertible debentures. At this time, we are unable to provide any guidance as to when we will be in a position to provide a response to the Joint Committee.

Exchangeable Debentures

Exchangeable debentures have been used in the past in the context of the “monetization” of shares of the capital stock of public corporations owned by the issuers of debentures. The interest paid on exchangeable debentures could be a proxy for the dividends paid on the shares into which the debentures are convertible. Accordingly, it may be relevant to determine whether the interest paid on exchangeable debentures constitutes “participating debt interest” within the meaning of the definition in subsection 212(3) of the ITA.

We are not prepared to provide additional comments concerning the potential application of Part XIII tax with respect to exchangeable debentures without knowing all the relevant facts in relation to particular situations (including the terms and conditions of the exchangeable debentures).

If you have concerns concerning the application of Part XIII of the ITA with respect to exchangeable debentures in the context of proposed transactions, we encourage you to request an advance income tax ruling.

Question 10: Treaty Protocol and Hybrid Entities

Are there any new issues with respect to Article IV(6) and (7) of the US treaty that have been raised with Rulings and would be of interest? It seems most rulings are becoming repetitive in this area. Similarly, are there any new issues that have arisen with respect to the services PE provision in the US treaty?

Response:

New issues with paragraphs IV(6) & IV(7)

Since the 2007 signing of the Fifth Protocol to the Canada-United States Tax Convention (the "Treaty"), the Canada Revenue Agency (the "CRA") has been asked to consider many strategies designed to ensure that either paragraph (6) of Article IV does apply to a particular amount, or that paragraph (7) of that Article does not apply to a particular amount, along with the possible application of the general anti-avoidance rule. In these instances, it has been recognized that some structures may be utilized for legitimate reasons without engaging in potentially abusive transactions.[i] As your question suggests, where we have considered it appropriate to do so in the circumstances, we have issued favourable rulings in response to these requests.

Among the strategies previously considered, the CRA is aware of some structures designed to avoid the application of paragraph (7) of Article IV through the introduction of an interposing entity located in a third jurisdiction. In this regard, the CRA has previously expressed its long-standing concerns over the practice of abusive "treaty shopping". More recently, we note that the Department of Finance bolstered these concerns in Budget 2013, announcing consultations on possible measures designed to "protect the integrity of Canada's tax treaties" from these practices. In addition, the GAAR Committee has recently approved the application of the GAAR to a treaty shopping case.

Accordingly, we will continue to consider ruling requests involving the application of paragraph (7) of Article IV on a case-by-case basis. However, in light of the significant concerns outlined above, taxpayers should not expect the Income Tax Rulings Directorate to look favourably upon a ruling request involving an interposing entity located in a third jurisdiction designed to avoid the application of paragraph (7) of Article IV of the Treaty.

New issues with paragraph V(9)

The last conference in which we spoke at length about paragraph (9) of Article V of the Treaty was the 2011 Canadian Tax Foundation Annual Conference. In addition to those views, the Income Tax Rulings Directorate has also recently provided an advance ruling on the applicability of Article V of the Treaty to a specific proposed transaction.[ii] The facts of that ruling involved a US resident corporation ("USco") carrying on a web-based business. USco's business included Canadian residents among its users, and provided for the sale of advertising space on its websites to Canadian-resident businesses, and the sale of digital content by Canadian resident software developers.

Under the proposed transactions, a Canadian resident subsidiary of USco ("Canco") was to build and operate a data centre consisting of numerous servers in Canada, and use that data centre to provide website and data hosting services to USco. USco would pay Canco an arm's length fee for these services. Canco would not have the authority to legally bind USco or create any legal obligation for USco, and would not provide any services to Canadian resident users, advertisers or software developers. Employees of USco would not have unsupervised access to the servers, although they would be able to manage the software and data resident on the server by remote access.

In our analysis, we considered the fixed base PE provision in paragraph (1), the agency PE provision in paragraph (5) of Article V, and the services

PE provision in subparagraph (9)(b). On the facts provided, we ruled that the application of Article V of the Treaty would not result in USco being considered to carry on a business through a permanent establishment in Canada.

While considering this situation, we noted that USco also had another Canadian subsidiary providing services to USco in connection with marketing and sales support activities for USco's development and expansion of its user, advertiser and software developer base in Canada. However, as it specifically states in the ruling, we were not asked to and did not address how these facts may have affected our determination of whether USco would have a permanent establishment in Canada.

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[i] Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada, JCX-57-08 (Washington, DC: Joint Committee on Taxation, July 8, 2008), paragraph VI(B).

[ii] Ruling 2012-0432141R3