



Upstream Loans: History, Current Proposals and Planning Ideas

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Outline

1. History
2. Current Proposals
3. Planning Ideas

History

- Capital Export Neutrality:
 - Requires equal tax burden on residents whether their capital is invested within or outside their country of residence
 - Reflected by tax-and-credit system of elimination of international double taxation
 - Examples: US and, formerly, UK and Japan.
 - In theory: discourages or does not encourage capital export.
 - In practice: capital is exported but not repatriated. See effect of IRC 965 temporary 5.25% tax on dividends: 843 U.S. multinationals repatriated funds totalling \$312 billion previously kept abroad. Since 2005, approx. \$1.3 trillion kept abroad.

History

- **Capital Import Neutrality:**
 - Requires equal tax burden on capital invested within a country, whether by residents or non-residents
 - Reflected by exemption system of elimination of international double taxation
 - Examples: Most continental European countries.
 - In theory: may encourage capital export to a lower tax rate country.
 - In practice: capital exported but also ease of repatriation of capital

History

- Canadian Foreign Affiliate System is a hybrid system:
 - Exempt surplus: exemption system
 - Income from active and deemed active business from designated treaty country (DTC)
 - Non-taxable half of capital gains
 - Taxable capital gains on disposition of certain excluded property (DTC business property)
 - Taxable surplus: tax-and-credit system
 - Income from active and deemed active business from a non-DTC
 - Income from property, business other than active business, investment business from non-CFA FA
 - Taxable capital gains on disposition of certain excluded property (FA shares, etc.)
 - FAPI: attribution
 - Income from property, business other than active business, investment business from CFA
 - Taxable capital gains from non-excluded property

History

- August 19, 2011 proposals: some surprises
 - Hybrid Surplus
 - Advisory Panel recommendations?
 - Effect on tax revenue?
 - Upstream Loans
 - Economics: upstream loan vs. dividend?
 - Subsection 15(2)
 - CRA/Finance blessings: see e.g. Ruling 9807063
 - New characterization rule for distributions and elective cost recovery rule

Current Proposals

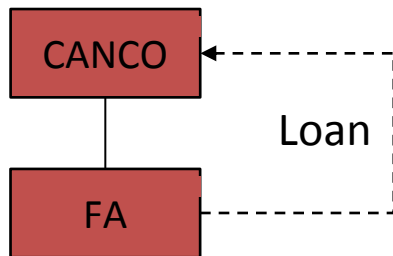
Background

- Treatment of Foreign Affiliate distributions
 - “exempt surplus”: fully deductible / no basis erosion
 - “taxable surplus”: taxable with FTC / no basis erosion
 - “pre-acquisition surplus”: fully deductible / with basis erosion
 - “hybrid surplus” (NEW): ½ exempt & ½ taxable / no basis erosion
- Deemed dividends for distributions: all pro rata distributions except on redemption and liquidation
- Surplus Ordering
 - New Surplus Ordering: ES, HS, TS, PAS
 - Elective TS before HS (with disproportionate UFT on TS)
 - Elective PAS before all others (deemed dividend if negative basis)

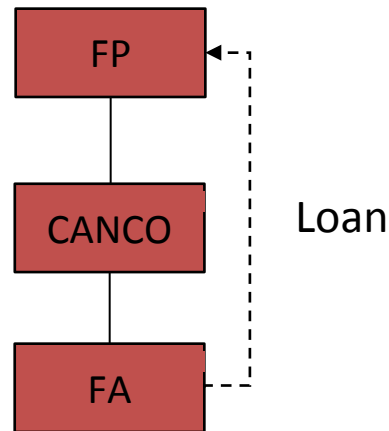
Current Proposals

- New “upstream loan” rules – proposed 90(4) to 90(10).
- Under pre-August 19, 2011 rules and rulings practices, FA could make loan to relevant Canadian taxpayer or related non-resident without adverse consequence.

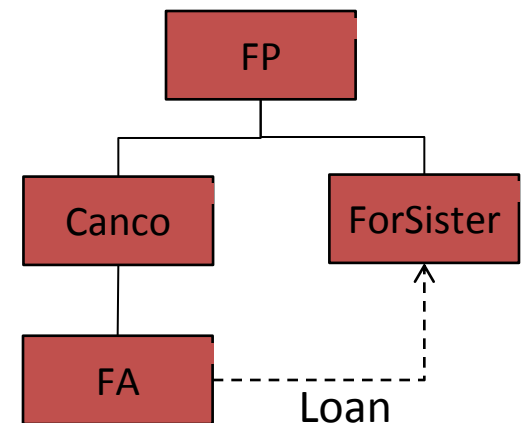
Loan to Canco



Loan to Foreign Parent



Loan to Foreign Sister



Current Proposals

- Coverage (subject to exceptions)
 - a loan or other debt owing to a FA
 - owing by a “specified debtor”
 - Relevant Canadian taxpayer
 - Person Non-arm’s length with relevant Canadian taxpayer
 - Not a section 17 CFA (controlled by Canadians)
- Treatment
 - income inclusion in year when debt issued (at amount of debt X SEP)
 - income deduction on future repayment

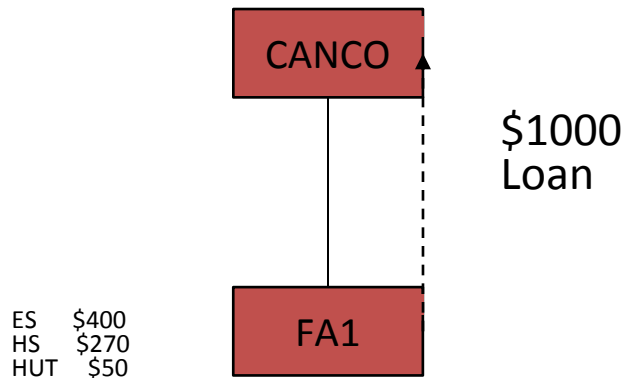
Current Proposals

Exceptions

- 2-Year Debt – repaid within two years of arising
 - if no replicating series
 - outstanding loans deemed made 19 August 2011
- Ordinary Course Lending
 - all debts arising in ordinary course of creditor's business, and loans made in ordinary course of creditor's money lending business
 - only if bona fide arrangements made for payment within reasonable time
- Deductible Surplus on Hand
 - Debt may be subdivided into deductible portions
 - No dividends may be paid while debt outstanding
 - No protection for having outside basis
- Section 17 CFA Debtors – Canadian control required

Current Proposals

EXAMPLE 1



Assumptions

- Prior to 19 August 2011, FA1 made a loan to Canco of \$1000.
- FA 1 has ES of \$400, HS of \$270 and HUT of \$50.

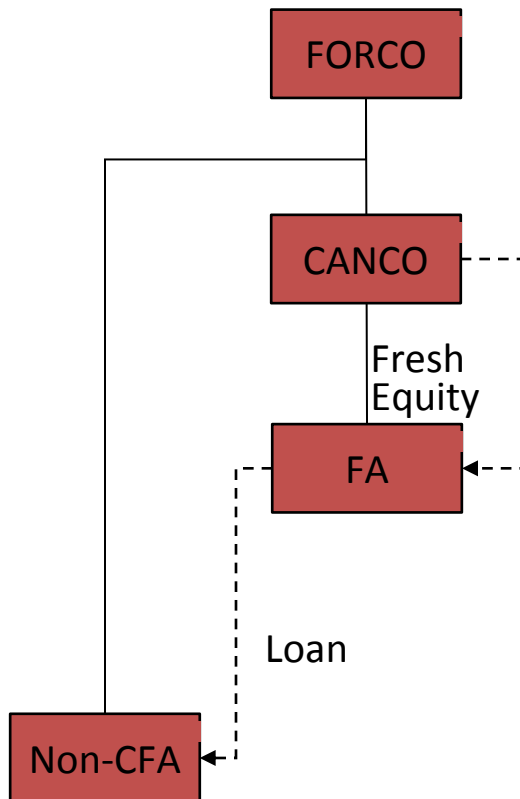
Analysis

- Canco is a specified debtor of FA1
- Loan would be caught under 90(4) with 2 year period beginning on 19 August 2011. Assume no repayment.

Canco net income inclusion 12/31/11

Income inclusion 90(4)	\$1000
Deduction re: ES 90(6)	(400)
Deduction re: HS	<u>(nil)</u>
Net	\$600

Current Proposals



EXAMPLE 2 (Cash Redeployment Planning)

Assumptions

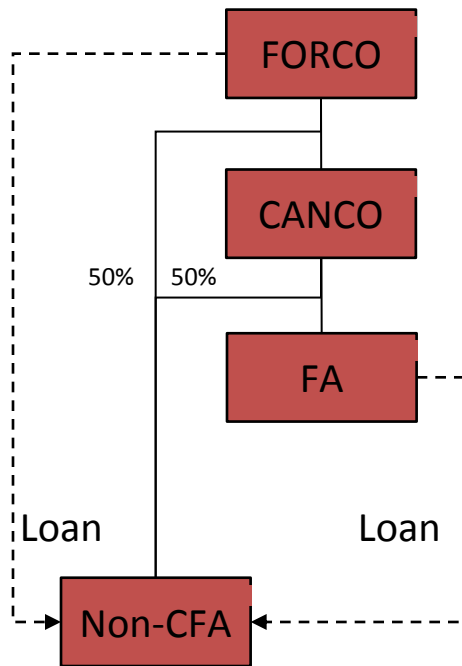
- Forco owns Canco and Non-CFA
- Canco has excess cash
- Canco forms & capitalizes FA with fresh equity
- FA makes loan to Non-CFA

Analysis

- No protection for Canco's outside basis in FA
- No consideration for fact that FA has no TS or HS
- Canco has no "qualifying interest" ("QI") in Non-CFA (10% of votes and value), so FAPI on interest
- Distribution by Canco would have triggered WHT
- 2-year clock ticking on existing structures

- Modifications under consideration by Finance but likelihood of accommodation is uncertain

Current Proposals



EXAMPLE 3 (Non-CFAs)

Assumptions

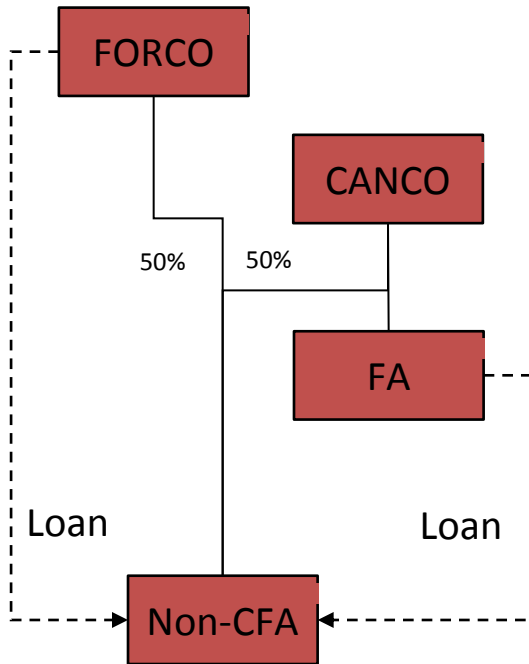
- Forco owns Canco
- Canco owns FA
- Each of Forco and Canco owns 50% of Non-CFA
- Each of Forco and FA makes loan to Non-CFA

Analysis

- CFA exemption based on section 17, so Non-CFA because not controlled by Canco
- No consideration of fact that loans may be proportionate by all shareholders
- Canco has QI in Non-CFA, so no FAPI on interest income, and may be ES

Current Proposals

EXAMPLE 4 (Non-CFAs, Arm's Length)



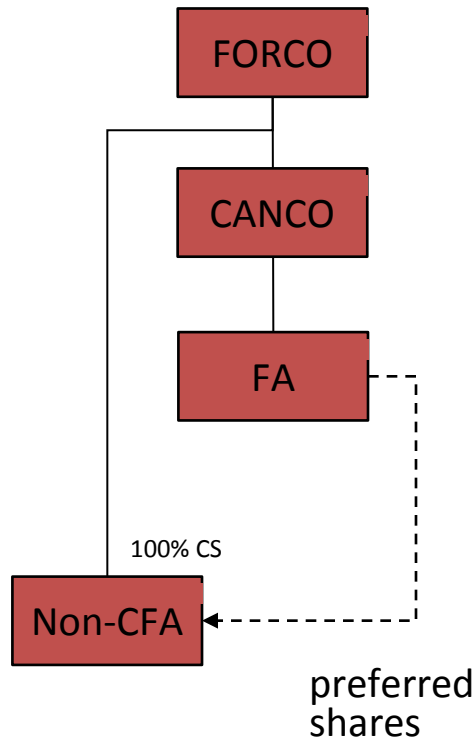
Assumptions

- Forco deals at arm's length with Canco
- Canco owns FA
- Each of Forco and Canco owns 50% of Non-CFA
- Each of Forco and FA makes loan to Non-CFA

Analysis

- CFA exemption based on section 17, so Non-CFA because not controlled by Canco
- But, not “specified debtor” because arm's length
- No consideration of fact that loans may be proportionate by all shareholders, but disproportionate arrangements could affect arm's length determinations
- Canco has QI in Non-CFA, so no FAPI on interest income, and may be ES

Current Proposals



EXAMPLE 5 (Equity Investments)

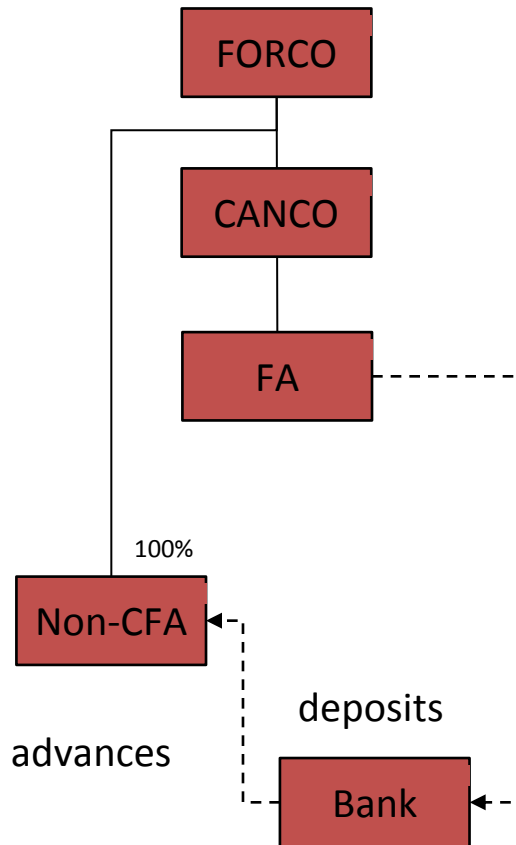
Assumptions

- Forco owns Canco and Non-CFA
- Canco owns FA
- FA acquires preferred shares of Non-CFA

Analysis

- Rule applies only to loans and other indebtedness
- Not applicable to equity investments
- Equity investment makes Non-CFA a FA of Canco (and a CFA for FAPI purposes), so dividends may be ES, TS, HS, PAS
- 95(6) anti-avoidance rules?
- GAAR?

Current Proposals



EXAMPLE 6 (Back-to-Back Through Banks)

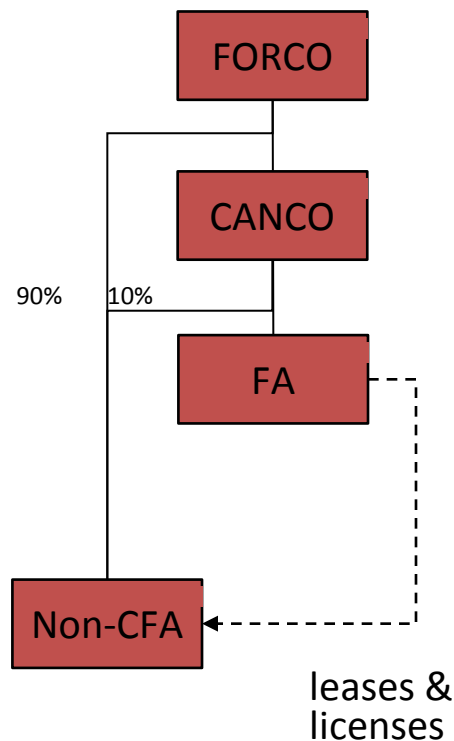
Assumptions

- Forco owns Canco and Non-CFA
- Canco owns FA
- Bank is arm's length group banker
- FA makes deposits with Bank
- Non-CFA has advances from Bank

Analysis

- Not affected if deposits arise in the ordinary course of FA's business, or if repaid within 2 years (unless part of replicating series)
- If not ordinary course and longer than 2 years, query whether might be affected
 - no "directly or indirectly" language
 - subject to GAAR

Current Proposals



EXAMPLE 7 (Leases and Licenses)

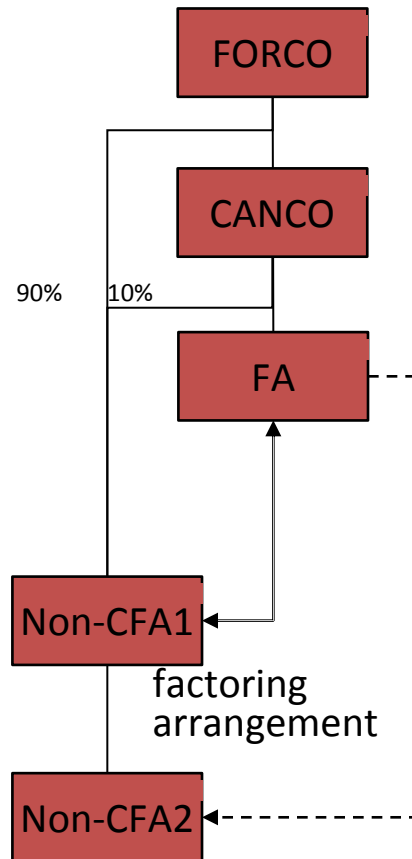
Assumptions

- Forco owns Canco (and 90% of Non-CFA)
- Canco owns FA (and 10% of Non-CFA)
- FA leases or licenses property to Non-CFA

Analysis

- Rule applies only to loans and other indebtedness
- Not applicable to leases and licenses kept current
- Canco has a QI in Non-CFA, so no FAPI on rent or royalty income, and may be ES
- GAAR?

Current Proposals



EXAMPLE 8 (Factoring Arrangements)

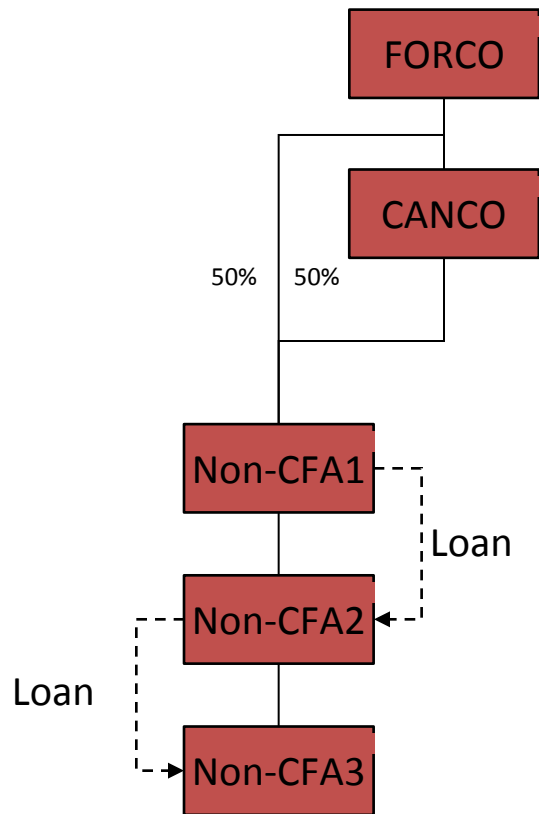
Assumptions

- Forco owns Canco (and 90% of Non-CFAs)
- Canco owns FA (and 10% of Non-CFAs)
- FA engages in factoring of trade receivables of Non-CFAs
 - Non-CFA1 sells goods to Non-CFA2 on terms
 - Non-CFA1 sells trade receivables to FA

Analysis

- If debt does not arise in ordinary course of FA's business, but always repaid within 2 years, query whether each receivable is a separate matter or part of a replicating series
- Meeuse v The Queen, 94 DTC 1397 (TCC, Bowman)
 - more than mere succession of loans is required
 - unrelated subsequent borrowing ok

Current Proposals



EXAMPLE 9 (Trap: Chain of Debts)

Assumptions

- Forco owns Canco
- Canco owns FA
- Each of Forco and Canco owns 50% of Non-CFA1
- Non-CFA1 makes loan to Non-CFA2, and Non-CFA2 makes loan to Non-CFA3

Analysis

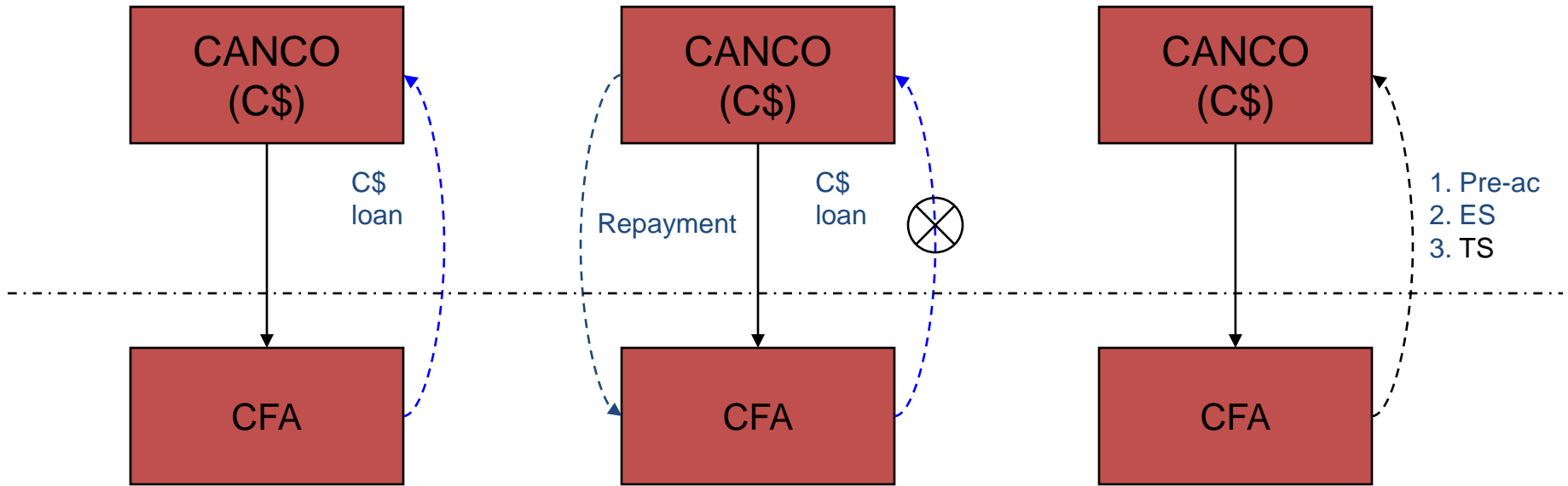
- CFA exemption based on section 17, so Non-CFAs because not controlled by Canco
- No consideration of fact that loans are to wholly-owned subsidiaries (or otherwise proportionate)
- Duplication of effect because no carve-out for loans funded with already affected loans
- Canco has QI in Non-CFAs, so no FAPI on interest income

* Finance addressed similar fact pattern at CTF Conference in November 2011, and expressed “sympathy” with application where the SEP within the chain is the same and no Canadian base erosion

Planning Ideas

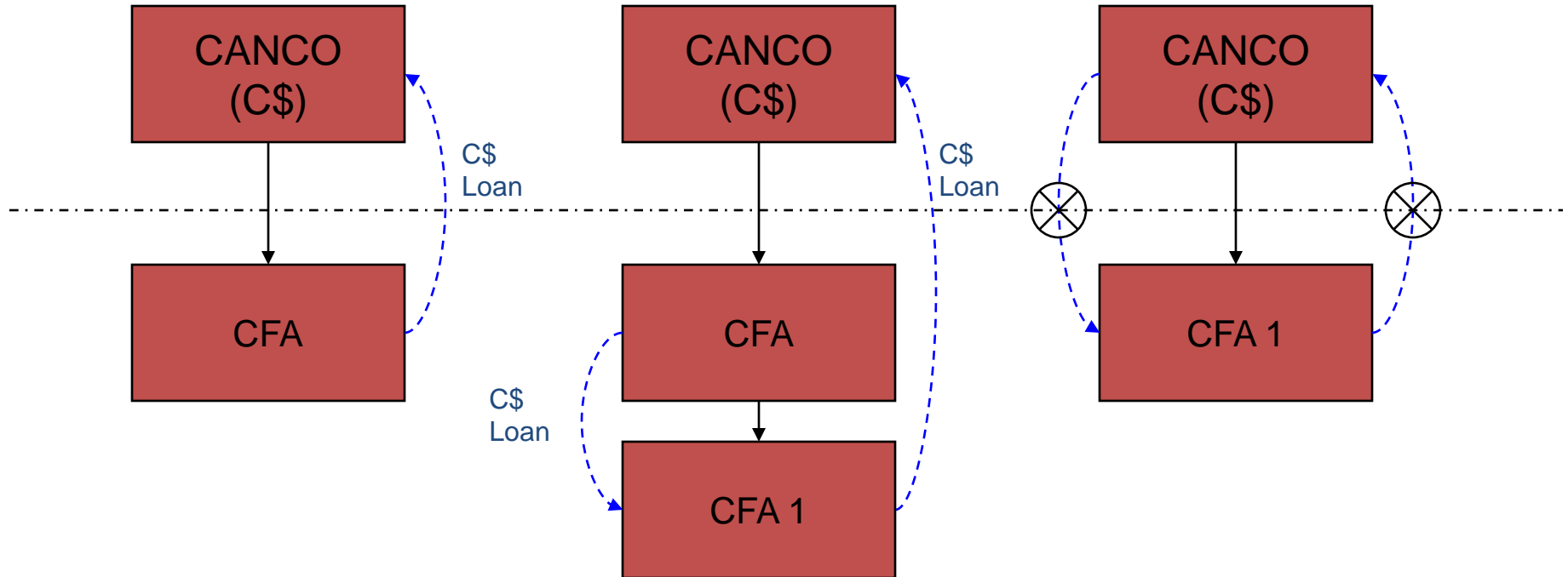
- Upstream loan hit list:
 - TS loans:
 - From active business in a non-DTC (unlikely)
 - From taxable capital gain on disposition of excluded property FA shares, etc. (before August 19, 2011)
 - HS loans (after August 19, 2011)
 - ES loans
 - CIF: re-issuance on August 19, 2011
 - Previous functional currency election?
 - Loan in a currency other than surplus calculating currency?
 - Insufficient good surplus for ss. 90(6)?
 - PAS surplus loans
 - Loans from equity-financed CFA to related non-resident

Planning Ideas



- Repayment in C\$
- Distribution of repaid C\$: (1) PAS (ACB), (2) ES, (3) TS.
- Is amount available for repayment?
- Daylight loan?
- Withholding tax?

Planning Ideas



- “Slide-down” of loan into a new CFA (CFA 1) in consideration for an equivalent note
- QLAD of CFA under proposed 88(3) ITA: capital gain realized on disposition of shares in CFA = amount of loan – ACB of shares (no suppression election under 88(3.3) LIR)
- Setoff of loan and note (80 ITA inapplicable)
- No need for daylight loan
- Possibly no withholding tax

Planning Ideas

Complications...

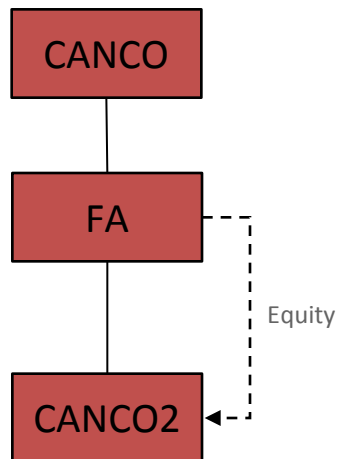
- FX gains and losses
 - Loans in a currency other than functional currency = FX gain or loss
 - See insufficient good surplus
- Meaning of « repaid » in ss. 90(5) ITA
 - See ss. 15(2) ITA
 - Limitation on options for eliminating tainted loan
- Watch out s. 80 debt forgiveness rules

Planning Ideas

Building blocks for potential solutions...

- Scope of application of 90(4)
- How to “move” debt?
- Proposed QLAD regime in ss. 88(3) ITA
- Ss. 80.01(4) ITA, and
- Previous rulings (see Ruling 9807063)

Planning Ideas



Assumptions

- ▶ Canco owns FA
- ▶ FA has excess cash that Canco wishes to use to acquire a new Canadian business
- ▶ Instead of distributing cash from FA to Canco, FA incorporates Canco2 and capitalizes share equity to acquire the new Canadian business

Analysis

- ▶ Rule applies only to loans and other indebtedness, not equity investments – even if in a related Canadian company
- ▶ Rule also does not apply to future “upstream” loan of cash from Canco2 to Canco

Thank You!

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