INTERNATIONAL TAX PLANNING FOR HARD AND VOLATILE TIMES

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CROSS-BORDER DEBT RESTRUCTURING: RECENT DEVELOPMENTS

The current challenges in the global economy have resulted in a credit crunch, with many corporations exploring opportunities to refinance debt. Tax practitioners are being called on to address issues that rarely arise in a healthier economy—the tax ramifications of loan modifications, debt restructuring, and foreclosures.

In the United States, the American Recovery and Reinvestment Tax Act of 2009 provides for new rules to ease debt restructurings and provide incentives to businesses. In particular, a debtor will be permitted to defer recognition of cancellation of debt (COD) income on certain debt restructurings that occur in 2009 and 2010. This deferral generally applies broadly to COD income that is triggered with respect to debt that is forgiven in whole or in part, modified to provide for a reduced principal amount, or acquired by the debtor (or a related party). Any qualifying COD income realized in 2009 or 2010 is deferred for US tax purposes and recognized rateably over a five-year period beginning in 2014. In addition, limits on the use of net operating losses (NOLs) and built-in losses following an ownership change are suspended where such losses occur pursuant to a restructuring plan taken by the US Treasury Department under the Emergency Economic Stabilization Act of 2008. Finally, new rules were introduced to permit certain taxpayers with NOLs for 2008 and/or 2009 to elect to carry the NOLs back five years, instead of two years, subject to various conditions.[1]

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[1] The new rules were signed into law on November 6, 2009 as the Worker, Homeownership and Business Association Act of 2009, which expanded the relief originally contained in the American Recovery and Reinvestment Tax Act of 2009.

In Canada, the Economic Action Plan in the February 6, 2009 federal budget to stimulate economic growth did not contain similar specific tax incentives for businesses. Some relief is provided by recent amendments such as the extension of the carryforward of NOLs from 10 to 20 years and the extension of the rules that apply to accrued capital gains and losses of a corporation on an acquisition of control to also apply to capital gains and losses on foreign currency debt.[2]

This paper addresses certain types of debt restructurings and their Canadian income tax implications under the Income Tax Act (Canada).[3] It consists of two parts. The first part focuses on debt restructuring effected primarily by a Canadian debtor, while the second part focuses on outbound considerations and the foreign affiliate context.

PART I: DEBT RESTRUCTURING

The main focus of the first part of this paper is on debt restructuring in the context of a Canadian-resident debtor (generally a "taxable Canadian corporation" for the purposes of the Act) with non-resident creditors. It is assumed that the debtor determines its Canadian tax results in Canadian currency.[4]

There are many types of debt restructurings that may be effected, depending on the particular circumstances. Each of the types of restructuring gives rise to a number of tax considerations, most of which are beyond the scope of this paper.[5] A few issues are addressed below, with others being more particularly considered.

Conversion to Equity

In general, a debtor will enter into a recapitalization transaction in cases where it is unable to pay interest and/or principal on its outstanding debt. A typical debt restructuring converts the debt to common or preferred shares of the debtor. A holder of the debt may be able to effect a tax-free rollover of the debt for shares under subsection 51(1), if the terms of the debt confer on the holder the right to make the exchange, whether originally or as a result of an amendment to the terms of the debt, or under subsection 85(1), if an election is filed.

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[2] Subsection 111(12) of the Income Tax Act (as cited infra note 3).

[3] RSC 1985, c. 1 (5th Supp.), as amended ("the Act"). All statutory references are to the Act unless otherwise indicated.

[4] That is, a functional currency tax reporting election has not been made under section 261.

[5] For recent articles on these topics, see Thomas A. Bauer, "Restructuring Debt Obligations," *2008 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2008), 37:1-30; Gerald D. Courage, "Utilization of Tax Losses and Debt Restructuring," *2006 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2006), 9:1-86; and Peter H. Baek, "Tax Planning for Recessionary Times," *Report of Proceedings of Fifty-Fifth Tax Conference*, 2003 Tax Conference (Toronto: Canadian Tax Foundation, 2004), 53:1-34.

Amendment to the Terms of the Debt

In some cases, the debtor obtains relief through modifying or amending the terms of its debt such as by extending the maturity date, changing the interest rate, adding a conversion right, adding or removing security, and postponing payment of interest. This issue is discussed further below.

Exchange for New Debt

In other cases, rather than amending the terms of the debt, new debt is issued in exchange for the existing debt. Often, this new debt "leap-frogs" other existing debt, taking first priority on payments. These debt exchanges have recently been more frequently challenged as being coercive to holders of the debt that is being "leap frogged." For example, in the United States, an exchange of debt was challenged in Reology Freescale Semi-Conductor Inc., and in Canada, a proposal to put new financing ahead of existing bondholders was challenged in Abitibi Bowater Inc. A holder of the debt may be able to effect a tax-free rollover of the debt for new debt under section 51.1 if the terms of the existing debt confer on the holder the right to make the exchange.

Addition of Co-Debtor or Guarantor

In further cases, the security of existing debt is enhanced by the addition of a co-debtor or guarantor. One recent example is the restructuring of Circuit City, a US corporation, where its Canadian subsidiary, Intertan Canada Ltd., was required to provide a guarantee of Circuit City's debt.

Tender Offer

Another example of a restructuring is where the debtor or an affiliate of the debtor purchases the debt from creditors. This alternative is usually used where the debtor can find less costly replacement financing. This issue is discussed further below.

Realization of Security

A final form of restructuring that may be used when all else fails is where the creditor looks to the collateral for payment. This results in the disposition of the collateral by the debtor and the acquisition thereof by the creditor in satisfaction of the debt, giving rise to potential transfer tax and other issues to the debtor and holding or ownership issues to the creditor.

Amendment or New Debt?

Changes in the terms and conditions of a debt obligation may be of sufficient magnitude or significance to result in the disposition of the debt by the holder and a discharge of the debt of the debtor, as well as the acquisition of a new debt in exchange for the old debt by the holder and the issue of new debt by the debtor.

Case Law

The case of *General Electric Capital Equipment Finance Inc. v. The Queen*[6] is the key case that considered whether amendments to certain promissory notes resulted in a disposition of the notes and the creation of new obligations. The issue in the case was whether a former exemption from withholding tax applied, which required that the terms to maturity of a debt obligation be at least five years from the "date of issue."[7]

The Federal Court of Appeal identified fundamental terms of the debt as follows:

- the identity of the debtor;
- the principal amount of the debt;
- the amount of interest under the debt; and
- the maturity date of the debt.

In this case, three of the four terms—the principal amount, the interest rate, and the maturity date—were changed. The court concluded that these were substantial changes that materially altered the terms of the debt and consequently created a new debt. The court further noted that, at common law, a novation is not required for there to be a new debt.[8]

The position in *GE Capital* is consistent with earlier cases dealing with whether an agreement, such as a stock option agreement, has been rescinded or merely varied,[9] and cases dealing with debt obligations.[10] In one of the cases,[11] the Tax Court of Canada held that the extension of the maturity date of a debt was not enough to result in a disposition of the debt.

CRA Position

The Canada Revenue Agency (CRA) has set out its administrative position on when a variation or a recission of a debt occurs.[12] If a debt is renegotiated otherwise than as provided for in its original terms, the determination of whether a change in its terms is a substitution of a debt obligation for another should be made in accordance

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6 2002 DTC 6734 (FCA) ("*GE Capital*").

7 Former subparagraph 212(1)(b)(vii).

8 See *National Trust Co. v. Mead*, [1990] 2 SCR 410 for the key Canadian case on novation at common law.

9 See *Amirault v. MNR*, 90 DTC 1330 (TCC) and *Wiebe v. The Queen*, 87 DTC 5068 (FCA).

10 See *Seaman v. MNR*, 90 DTC 1909 (TCC) and *Quincaillerie Laberge Inc. v. The Queen*, 95 DTC 155 (TCC).

11 *Quincaillerie Laberge*, supra note 10.

12 *Income Tax Technical News* no. 30, May 21, 2004 ("Technical News 30"); *Income Tax Technical News* no. 14, December 9, 1998 ("Technical News 14"); and *Interpretation Bulletin* IT-448, "Dispositions—Changes in Terms of Securities," June 6, 1980 ("IT-448").

with the law of the relevant jurisdiction.[13] *GE Capital* is viewed by the CRA as supporting its position that, at common law, a recission of a debt obligation will be implied when the parties have effected such an alteration of its terms as to substitute a new obligation in its place, which is inconsistent with the old debt obligation to an extent that goes to the very root of it.[14]

The CRA has issued rulings confirming that changes to a debt obligation that included amending the interest from a current payment to a deferral of payment until maturity, amending the security interest, and changing the conversion ratio were considered not to give rise to a new debt obligation.[15] In other rulings, the addition of a purchaser as a debtor to an existing debt obligation on an assumption of debt was held not to result in a disposition of the debt by the creditor, based on the fact that under the laws of the particular US state that governed the debt, the assumption and addition of a co-obligor did not result in a novation, substitution, discharge, recission, or extinguishment of all or any portion of the debt.[16] More recently, the CRA has issued rulings in connection with the replacement of a credit counterparty under credit default swaps, confirming that there was no disposition even though it appears that under the relevant laws, the replaced counterparty is released from its obligations under the swaps.[17]

General Anti-Avoidance Rule

In the recent case of *Lehigh Cement Limited v. The Queen*,[18] the Tax Court of Canada applied the general anti-avoidance rule (GAAR) in section 245 to deny the application of the withholding tax exemption on interest paid to a non-resident. In this case, funds were borrowed by a Canadian debtor from Canadian banks. No withholding tax issue arose because there were no non-resident lendors. The debt was then assigned by the Canadian banks to a non-resident corporation that was related to the Canadian debtor such that withholding tax was payable on payments of interest by the Canadian debtor to the related non-resident corporation. The debt was also restructured such that interest coupons for five years out of ten were "stripped" and sold to an arm's-length non-resident person. The Canadian debtor did not withhold any tax on payments of the interest coupons to the arm's-length non-resident person, on the basis that the exemption for withholding tax in former subparagraph 212(1)(b)(vii) was met.

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[13] Technical News 14. In Technical News 30, the CRA notes that if a debt is subject to Quebec law and if changes in the terms of the debt have resulted in a novation under the Civil Code of Quebec, a new debt is considered to have come into existence for income tax purposes.

[14] Technical News 30.

[15] Technical News 30. See also IT-448, paragraph 6, which states that a change in the underlying security is not usually regarded as a disposition of the debt obligation.

[16] CRA document no. 2007-0252491R3, 2007; see also CRA document no. 2003-0054013, 2003.

[17] CRA document no. 2008-0276431R3, 2008; and CRA document no. 2008-0269981R3, 2008.

[18] 2009 DTC 776 (TCC), appeal to FCA filed May 2009.

The court agreed that the requirements of former subparagraph 212(1)(b)(vii) were met, but concluded that withholding tax was payable as a result of the application of the GAAR. The court held that the GAAR applied because the Canadian debtor did not "access international capital markets,"[19] which it viewed as the purpose of the exemption in former subparagraph 212(1)(b)(vii), but instead restructured an existing loan with a related non-resident corporation so as to qualify for such exemption.[20] That is, the Canadian debtor did not in fact borrow any money from any non-resident lender, such that it abused the exemption by entering into the arrangement whereby the related non-resident corporation sold the interest coupons. Query whether the GAAR would have applied if the original borrowing had been from a related non-resident lender.

Subject to *Lehigh Cement*, the recent elimination of withholding tax on interest for all arm's-length debt will likely give rise to greater consideration of ways to restructure existing non-arm's-length debt to fit within the new rules so that interest is paid free of withholding tax. This will be less the case starting on January 1, 2010 with respect to related-party debt where the non-resident creditor is a resident of the United States and entitled to the benefit of the Canada-US tax treaty,[21] because generally interest on such debt will be free of withholding tax.[22]

US Position

It is understood that in the United States, there are Treasury regulations regarding amendments to debt obligations. These regulations provide specific guidance as to which modifications are considered so significant so as to be treated as a deemed exchange of the original debt for the modified debt. Examples of significant modifications include a substitution of debtor and an extension of the maturity date. However, the determination of whether there has been a significant modification depends on all the facts and circumstances.

Implications for Canadian Debtors

In addition to the economic advantages that a debt restructuring affords to a Canadian debtor—possibly its very existence—there are a number of tax implications to be considered. Certain of these are discussed below.

Debt Forgiveness

Any restructuring of a debt obligation, the result of which is that a debt obligation is settled or deemed to have been settled for an amount less than the principal amount of the debt obligation, potentially gives rise to the debt forgiveness rules in

[19] Ibid., paragraph 39.

[20] The exemption was not available if the interest was paid to a non-arm's-length person.

[21] Canada-United States Tax Convention (1980), as amended by protocols ("the Canada-US tax treaty").

[22] See article XI(6)(b) of the Canada-US tax treaty.

section 80. These rules generally only apply to "commercial debt obligations"[23] to the extent that interest paid or payable by the debtor was or would have been deductible if the Act were read without reference to certain provisions that otherwise impose limitations on interest deductions.[24] A detailed discussion of the debt forgiveness rules applicable to a Canadian debtor is beyond the scope of this part of this paper.[25]

There are a number of issues and potential anomalies that arise in the application of the debt forgiveness and debt parking rules, depending on the manner in which the debt obligation is restructured.[26] The following are a few issues that should be considered when debt obligations of a Canadian debtor are restructured.

Preferred Share Rules

In addition to debt forgiveness rules, the Canadian debtor should consider the application of the preferred share rules on a share-for-debt exchange. If the shares that are issued are "taxable preferred shares" or "short-term preferred shares,"[27] the debtor may be liable to pay part VI.1 tax on any dividends paid on such shares in the future.[28]

Foreign Exchange Gains and Losses

A Canadian debtor who repays or otherwise settles a foreign-currency-denominated debt may realize a gain or loss as a result of foreign currency fluctuations.[29] An exception is provided in paragraph 80(2)(k). It provides that for purposes of the debt forgiveness rules in section 80, where an obligation is denominated in a foreign currency, the "forgiven amount" is to be determined with reference to the relative value of that currency and the Canadian currency at the time the obligation was issued.

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23 Defined in subsection 80(1).

24 See, for example, the thin capitalization limitations in subsection 18(4).

25 In addition to the papers listed supra note 5, a reader may wish to refer to Wayne L. Tunney, "Update on Debt Forgiveness," *2003 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2004), 9:1-22; Leonard Glass, "Section 80: An Update," in *2002 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2002), 16:1-37; Jeff C. Black, "Debt Forgiveness and Its Effect on Loss Utilization," in *1999 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1999), 1:1-39; Firoz Ahmed and Jack A. Silverson, "The New Debt-Forgiveness Rules: Planning Opportunities and Traps for the Unwary," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report (Toronto: Canadian Tax Foundation, 1997), at 21:1-38; and Barry W. Pickford and Wayne L. Tunney, "The Tax Treatment of Forgiveness of Debt and Foreclosures: The Proposed New Rules," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 3:1-62.

26 See Thomas A. Bauer, supra note 5, for a detailed discussion of the issues.

27 Each as defined in subsection 248(1).

28 Subsection 191.1(1).

29 As noted above, it is assumed that a functional currency election has not been made such that paragraph 261(2)(b) applies. Additional complexity arises where a functional currency election is made that is beyond the scope of this paper.

Thus, foreign currency fluctuations on foreign-currency-denominated debt after it is issued are ignored for the purposes of section 80.

The interaction of paragraph 80(2)(k) and subsection 39(2) gives rise to interesting issues where there are significant foreign exchange gains on a foreign currency debt and the debtor wishes to defer recognition of these gains. In the context of a tender offer, careful planning may achieve this goal. An example that is generally illustrative of tender-offer transactions is discussed in detail in a recent paper presented at the Canadian Tax Foundation Conference.[30] The example addresses a tender offer by an operating subsidiary of a Canadian corporate debtor to acquire foreign-currency-denominated debt, in conjunction with a solicitation of the consent of the creditors to certain amendments to the terms of the debt. Included in the discussion are some of the key issues such as amendments to debt, foreign exchange gains and losses, and debt parking referred to in this part of this paper.

Acquisition of Control

If debt of a Canadian debtor is exchanged for shares of the debtor, or if the non-resident creditor realizes on the security for a debt, consideration should be given to whether control of the debtor corporation or its subsidiaries is acquired. It should be noted that effective control by a creditor generally would not give rise to an acquisition of control because control for this purpose is de jure control.[31] If control of a corporation is acquired, the rules in section 111 will apply such that there will generally be a limitation on the availability of losses and other tax attributes to the debtor corporation after the acquisition of control. The recently added election under subsection 111(12) may provide relief where the Canadian debtor has foreign currency debt.

In addition, the acquisition of control may affect the tax attributes of foreign affiliates of the Canadian debtor, which will be addressed in the second part of this paper.

Implications for Non-Resident Creditors

In general, non-resident creditors who deal at arm's length with a Canadian debtor will not be subject to Canadian income tax on the disposition of any debt obligations. Furthermore, they will not be subject to any withholding or other tax on interest, premium, or discount on those debt obligations, provided that the interest does not have equity-like participation features that would result in any part of the interest being considered "participating debt interest."[32]

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[30] See Jerald M. Wortsman, Leonard Nesbitt, and Jeffrey T. Love, "Recent Transactions in Corporate Finance: Assumption, Tender Offer, and Other Secondary Market Transactions," in *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Conference Report (Toronto: Canadian Tax Foundation, 2009), 9:1-9:92.

[31] See *Duha Printers (Western) Ltd. v. R*, [1998] 1 SCR 795 for the meaning of "control of a corporation."

[32] As defined in subsection 212(3).

The exceptions include cases where the debt is convertible or exchangeable for shares of the debtor, or where the creditor realizes on the security of assets in Canada. In such cases, the issue of "taxable Canadian property" arises. In general, shares of a corporation resident in Canada that are not listed on a "designated stock exchange," real property situated in Canada, property used or held in a business carried on in Canada, or an option in or an interest in any of the foregoing property, whether or not such property exists, would be "taxable Canadian property,"[33] the disposition of which giving rise to potential tax and reporting requirements if disposed of by a non-resident creditor.[34] In addition, goods and services tax and provincial retail sales tax may arise on the use or subsequent sale of certain Canadian properties and possibly transfer taxes for real property depending on where it is situate.

Furthermore, in connection with interest or payments in lieu of interest, withholding tax may arise under subsection 214(7). This withholding tax may arise if the non-resident creditor were to assign or otherwise transfer the debt obligation to a person resident in Canada with which it did not deal at arm's length at an amount in excess of the "price" for which the obligation was issued. Such excess is generally deemed to be a payment of interest on the obligation, made by the person resident in Canada to the non-resident creditor. The deemed interest is subject to Canadian withholding tax unless the obligation is an "excluded obligation."[35] An "excluded obligation" is defined to include certain medium-term debt obligations, being obligations the interest in which would have been exempt under former subparagraph 212(1)(b)(vii) if it still were law.[36]

An issue that has arisen in the context of convertible debt is whether the difference between the fair market value of the shares issued on conversion and the original issue price of the debt is deemed to be interest at the time of conversion. If so, is such interest "participating debt interest"[37] on the basis that it is computed by reference to "revenue, profit, cash flow, commodity price or *any other similar criterion*"? (Emphasis added.) The concern is that it may meet "or any other similar criterion" because the amount depends on the price or growth in value of the shares.

This issue was raised at this conference and earlier ones,[38] particularly in light of recent cases such as *Tembec*.[39] The CRA has confirmed that where a "traditional"

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33 See paragraphs (a), (b), and (l) of the definition in subsection 248(1).

34 Paragraph 2(3)(c) and sections 115 and 116, among others. See in addition, the discussion below regarding section 79 in the outbound context under the heading "Other Considerations—Section 79."

35 Subsection 214(7) and paragraph 212(1)(b).

36 Subsection 214(8).

37 Subsection 212(3).

38 See CRA Views, Conference 2009-0320231C6, May 1, 2009 and the CRA Round Table in 2008 Conference Report, supra note 30, question 10-3.

39 *Provigo Inc., Tembec Inc. and Cascades Inc. v. MNR*, 2008 DTC 6601 (FCA), leave to the Supreme Court of Canada denied.

convertible debt obligation did not qualify as an "excluded obligation," deemed interest would not arise for purposes of subsection 214(7) and thus there would be no "participating debt interest" and hence no withholding tax. The CRA stated that in its view, "traditional convertible debentures" have, in general, at least the following terms and conditions:

1. The debentures are unsecured subordinated debts.
2. The issuer is a public corporation.
3. The debentures are issued for a fixed amount of money in Canadian dollars (for instance, $1,000) that represents the face value of the debentures. The debentures are issued with no original discount.
4. The debentures bear interest at a commercial fixed rate per year calculated on their face value. The interest on the debentures is paid by the issuer at least annually.
5. The debentures are convertible at any time at the holders' option into the common shares of the issuer prior to maturity. Some debentures have an initial non-conversion period.
6. The terms of the debentures specifically provide either a fixed conversion price (specifying the fixed price paid per common share to acquire the common shares through the conversion of each debenture) or a fixed conversion ratio (specifying the number of common shares that can be obtained for each debenture). The conversion ratio may be determined by dividing the conversion price into the face value of the debenture. In some cases, the security contract may provide for certain changes in the conversion price or conversion ratio over time.
7. The conversion price exceeds the price at which the common shares of the issuer could have been purchased on the market at the time the debentures are issued (for example, with a 25 percent conversion premium).
8. The debentures have a specified maturity date.
9. At maturity, the debentures are redeemable by the issuer at a redemption price of 100 percent of the face value, plus accrued and unpaid interest.

Unfortunately, these terms and conditions are quite narrow, and the risk currently exists that there could be a deemed payment of interest and potentially withholding tax if the terms and conditions set out above are not met. The CRA and Finance have been made aware that this issue requires further consideration.

Asset-Backed Commercial Paper Restructuring

A significant debt restructuring that occurred recently in Canada was the reorganization of the approximately $32 billion third-party asset-backed commercial paper (ABCP) issued by 20 Canadian trusts that held interests in mortgages (including US subprime mortgages), credit default swaps, and other related assets before the

market for ABCP froze in August 2007, at the same time that the US market in subprime mortgages froze. The reorganization, led by the Pan-Canadian Investors Committee, was ultimately approved by the Supreme Court of Canada and closed in early 2009 with the support of a government guarantee of $3.5 billion.

The terms of the reorganization are set out in an information statement issued by the committee dated March 20, 2008, as supplemented by other public documents and press releases.[40]

As illustrated in figure 1, the restructuring pursuant to an arrangement under the Companies Creditors Arrangement Act (CCAA) involved the creation of three new trusts referred to as "master asset vehicles" (MAVs), to which each of 20 existing trusts transferred all of their assets in consideration for the assumption of all of the existing debt, being short-term ABCP in proportion to the assets transferred. Thereafter, an exchange feature was added to the existing debt whereby the creditors were entitled to exchange the existing debt for new debt of the three MAVs, being long-term notes that more closely matched the maturing of the underlying assets held by the MAVs. After the transfers, the 20 existing trusts were released from their obligations under the existing debt so assumed by the MAVs. The CCAA restructuring plan also contained broader releases of those involved in the establishment and operation of the asset-backed securitization structure, the scope of which gave rise to significant discussion in the investor community.

The implementation of the plan was conditional on a favourable advance income tax ruling that was to address certain matters listed in the information statement:[41]

1. the transfer of the assets;
2. the assumption of the ABCP by the MAVs;
3. the addition of the right of exchange of the ABCP;
4. the exchange of the ABCP for notes; and
5. the deductibility of interest on the notes.

Transfer of Assets and Debt Assumption

It is assumed that the transfer of assets by the 20 existing trusts to the three MAVs were not taxable events and effectively a tax-deferred rollover was achieved pursuant to subsection 248(25.1).[42]

In order to qualify for this rollover, there must be a transfer from one trust resident in Canada to another trust resident in Canada where the transfer does not result in

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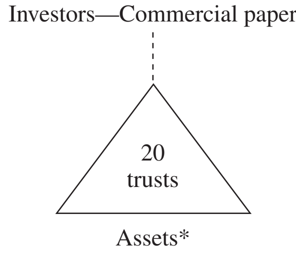
[40] "Proposed Restructuring of Canadian Third-Party Structured Asset-Backed Commercial Paper," March 20, 2008, plan as amended by June 5, 2008 document and related press releases.

[41] Information statement, ibid., at 140.

[42] See Jerald M. Wortsman et al., supra note 30, at 9:15 for a discussion of this issue.

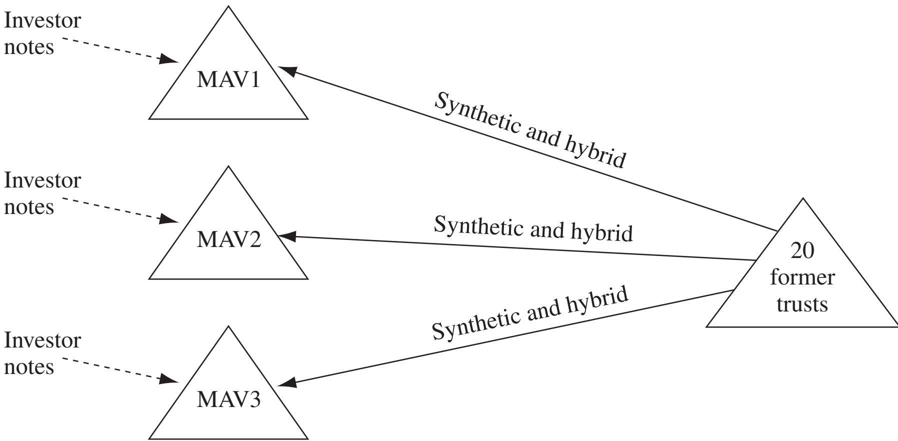
Figure 1 ABCP Restructuring: Before and After

Before



* Receivables, mortgage-backed securities, interests in collateralized debt obligations, and credit default swaps in Canada and the United States.

After



any change in the beneficial ownership of property, provided that the conditions in paragraph (f) of the definition of "disposition" in subsection 248(1) are met.[43] Note that the CRA has previously issued rulings on other trust-to-trust transfers.[44]

The assumption by the three MAVs in consideration for the acquisition of the assets gave rise to complex allocation issues and appears to have resulted in no disposition of the debt to the creditors.[45]

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43 In particular, subparagraph (iv) requires the transferee to be a new trust with no assets and subparagraph (vii) requires that the transfer results in the transferor ceasing to exist as part of a series of transactions.

44 See CRA document no. 2000-0032685 and CRA document no. 2006-0210271R3.

45 See Jerald M. Wortsman et al., supra note 30, at 9:10 for details and at 9:16-25 for a detailed consideration of the basis for the ruling that the assumption of debt did not give rise to a disposition thereof by the creditors.

Exchange of Debt

As noted above, the exchange of the ABCP for notes of the MAVs was effected in two parts. First, the exchange right was added to the existing debt, a step that generally should not give rise to a disposition of the existing debt.[46] Second, the exchange was effected in accordance with the amended terms of the existing debt, which exchange should similarly not give rise to tax on reliance on the deferral contained in section 51.1, provided that the principal amount of the new debt was equal to the principal amount of the existing debt.[47]

Other issues that arose in connection with the exchange that were of relevance to the creditors related to the status of the new debt. In the case of certain Canadian resident creditors such as registered retirement savings plans and deferred plans, the status of the new notes as a "qualified investment" was important. Presumably the existing ABCP had been a qualified investment on the basis that it had an investment-grade rating with a prescribed credit rating agency at the time of issuance or acquisition.[48] The Act was specifically amended as a result of the CCAA restructuring plan developed by the Pan-Canadian Investors Committee to waive the investment-grade rating condition in the case of debt obligations that are acquired pursuant to a court-approved proposal under Canadian insolvency legislation in exchange for debt obligations that previously had an investment-grade rating.[49]

In the case of non-resident creditors, interest on the new notes will generally be exempt from Canadian withholding tax, provided that the creditor is dealing at arm's length, with the exception of certain MAV notes, which were tracking notes and thus gave rise to participating debt interest.

Deductibility of Interest on Notes

The information statement provides no further details on the deductibility to the MAVs of interest on the new notes; however, it is assumed that a favourable ruling was obtained for this issue.

Non-Resident Debtors with a Canadian Business

The main focus of the first part of this paper has been on Canadian debtors, such as Canadian-resident corporations carrying on business in Canada.

The tax implications of debt restructuring for non-resident debtors who carry on business in Canada should generally be the same, because most provisions of the Act apply to determine the income that is subject to Canadian tax. Special considerations that may apply to non-residents carrying on business in Canada are beyond

[46] See *Interpretation Bulletin* IT-448, supra note 12, at paragraph 5.

[47] See Jerald M. Wortsman et al., supra note 30, at 9:25-26 for a discussion of this issue.

[48] See paragraph (c.1) of section 204.

[49] See the technical notes to the February 2009 federal budget.

the scope of this paper. One provision that may be of interest is the one contained in section 76.1. It sets out rules that apply where a debt obligation denominated in a foreign currency of a non-resident debtor that carries on business in Canada either ceases to be or becomes an obligation in respect of the Canadian business. The rules effectively ensure that only currency fluctuations on foreign currency debt that is part of a Canadian business are taxed during the period it is part of the Canadian business. These rules are consistent with the tax treatment generally of non-residents who immigrate to or emigrate from Canada, as contained in section 128.1, which essentially provides a "fresh start" in computing the tax cost of assets on entering the Canadian tax system and a deemed disposition of such assets on departure, each event deeming to occur at the fair market value of the assets.

Canadian Creditors of Non-Resident Debtors

Finally, although the focus of the first part of this paper has been on Canadian debtors with non-resident creditors, the converse situation gives rise to its own complex tax implications.

For example, Canadian resident creditors who own debt of non-resident corporations need to consider whether a debt restructuring gives rise to a realization event for Canadian income tax purposes, resulting in income gains or losses including foreign currency gains or losses.

Furthermore, the terms of the new debt should be considered to determine whether the result is that the creditor acquires a "participating interest" in a "non-resident entity" or a "tracking entity" for the purposes of the proposed foreign investment entity rules.[50] In addition, consideration needs to be given to any equity features or new securities issued on the debt restructuring, which may result in the foreign entity becoming a "foreign-affiliate" of the Canadian creditor.[51]

PART II: OUTBOUND CONSIDERATIONS

This part focuses on certain outbound considerations. In particular, we review the rules and principles applicable in the foreign affiliate context in relation to debt forgiveness, the impact of an acquisition of control, and loss and tax attribute realization and consolidation.

Debt Forgiveness in the Foreign Affiliate Context

A "foreign affiliate" (FA) is, by definition,[52] a non-resident corporation, and its status as such is relevant primarily to the determination of the consequences to its Canadian

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[50] See proposed sections 94.1-94.4, which were first introduced in the 1999 budget and which are still under review.

[51] See the second part of this paper for the tax implications that arise where foreign affiliates are involved.

[52] See the definition in subsection 95(1).

shareholders of acquiring, holding, receiving payments and distributions in respect of, and disposing of, its shares. In this regard, there are two main areas in which debt forgiveness may be relevant. First, the "foreign accrual property income" (FAPI) of a "controlled foreign affiliate" (CFA) may be attributed to its Canadian shareholders at the end of its taxation year.[53] Thus, there is the question of whether or not debt forgiveness gives rise to any FAPI, both on the debtor side and on the creditor side. Second, because the consequences to a Canadian shareholder of receiving payments and distributions in respect of, and disposing of, the shares of a foreign affiliate may depend on the balances of certain tax accounts maintained in respect of the relevant taxpayer, such as the FA's "exempt surplus" or "taxable surplus" accounts, there is the question of whether or not debt forgiveness gives rise to any impact on the determination of any such balances, again both on the debtor side and on the creditor side.[54]

The context for these questions is to be distinguished from that in which a non-resident corporation, which may be an FA and a CFA of a taxpayer resident in Canada, may itself be liable to pay tax under part I or XIII of the Act as a result of a debt forgiveness. In that context,[55] the fact that the non-resident corporation may also be an FA or a CFA is not particularly relevant, although the converse is not the case, in that any such tax paid by an FA or a CFA could be relevant to certain of the balances maintained in its capacity as an FA or a CFA of a relevant taxpayer resident in Canada.

FAPI Consequences

In general, under the description of A in the definition of FAPI, the FAPI of an FA includes its "income for the year from property," its "income for the year from a business other than an active business," and its "income for the year from a non-qualifying business." Pursuant to paragraph 95(2)(f), but subject to certain exceptions, certain "reading rules," and certain specific calculation rules,[56] these amounts should be determined in accordance with the provisions of the Act; and, for these purposes, the FA is "deemed to be at all times resident in Canada" (except to the extent the context otherwise requires!).[57]

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53 Ibid.

54 A broad review of the definitions and determination of the accounts of a FA is beyond the scope of this paper. See Angelo Nikolakakis, *Taxation of Foreign Affiliates* (Toronto: Carswell) (looseleaf).

55 Debt forgiveness in that context is considered above under the heading "Canadian Creditors of Non-Resident Debtors."

56 Many of these rules were revised in 2009. A detailed review of these revisions is beyond the scope of this paper. See *Taxation of Foreign Affiliates*, supra note 54, chapter 3. Some, however, will be considered below.

57 It should be emphasized that the deemed resident rule in paragraph 95(2)(f) does not apply to the computation of an affiliate's active business income. Moreover, some of the rules that are normally applicable to a resident are specifically excluded under clause 95(2)(f.11)(ii)(A): "subsections 14(1.01) to (1.03), 17(1) and 18(4) and section 91, except that, where the foreign affiliate is a member of a partnership, section 91 is to be applied to determine the income or loss of the partnership and for that purpose subsection 96(1) is to be applied to determine the foreign affiliate's share of that income or loss of the partnership." This "reading rule" also contains several other provisions.

Certain of these more specific rules relate to debt forgiveness. In particular, the description of A in the definition of FAPI itself actually provides that an FA's FAPI includes not as such its "income for the year from property," its "income for the year from a business other than an active business," and its "income for the year from a non-qualifying business," but rather the amounts that "would … be" determined in this regard "if section 80 did not apply to the affiliate for the year or a preceding taxation year." Accordingly, while all the implications of a debt forgiveness may not be excluded from the determinations required by the description of A in the definition of FAPI,[58] those that would arise under section 80 are specifically excluded.[59] Thus, a debt forgiveness would not give rise to any section 80 implications with respect to any of an FA's tax attributes or accounts, or give rise to any income under subsection 80(13), that may be relevant in making these determinations.

However, there are a number of additional rules that may apply in determining the FAPI implications of a debt forgiveness, such as the rules in the descriptions of A.1, A.2, and G in the definition of FAPI, as well as paragraph 95(2)(g.1). Moreover, the description of A in the definition of FAPI also provides, among other things, that its required determinations are to be made "as if each amount described in clause 95(2)(a)(ii)(D) that was paid or payable, directly or indirectly, by the affiliate to another foreign affiliate of the taxpayer or of a person with whom the taxpayer does not deal at arm's length were nil where an amount in respect of the income derived by the other foreign affiliate from that amount that was paid or payable to it by the affiliate was added in computing its income from an active business."[60] The relevance of this provision in the context of debt forgiveness is considered below.

FAPI Computation Rules

Essentially, the regime established for debt forgiveness in the context of computing an FA's FAPI provides for the recognition of the forgiveness only for the purposes of eroding the FA's foreign accrual property losses (FAPLs)—that is, only to the extent that the "loss" and similar items in the formula in the definition of FAPI (that is, D to F) would exceed the "income" and similar items in that formula (that is, A to A.2). Mechanically, this is accomplished as follows:

- First, as noted above, the application of section 80 is excluded in the determinations required by the description of A.

[58] Parallel determinations (or at least somewhat parallel—see infra note 59), on the "loss" side, are required by the description of D in the definition of FAPI.

[59] Interestingly, the description of D in the definition of FAPI does not contain a parallel "would … be" rule that excludes the application of section 80 in determining the relevant amounts of an FA's "loss." The implications of this are not clear—see below. Moreover, if a debt forgiveness gives rise to consequences under another provision of the Act (for example, paragraph 12(1)(x)), or under general principles (for example, where the forgiveness of a trade debt may give rise to income recognition as such or through a reduction of deductible expenses), then these consequences are not specifically excluded from the determinations required by the description of A or D of the definition of FAPI.

[60] The description of D in the definition of FAPI does contain a parallel provision in this regard.

- Second, the description of A.1 provides for the inclusion of "twice the total of all amounts included in computing the affiliate's income from property or businesses (other than active businesses) for the year because of subsection 80(13)."[61] Thus, the application of section 80 may certainly be relevant in the context of computing an FA's FAPI. Indeed, at this stage of the FAPI computation, a normal section 80 analysis would be required, except that, pursuant to paragraph 95(2)(g.1), the Act must be read as follows:
  - as if the expression "income, taxable income or taxable income earned in Canada, as the case may be" in the definition "commercial debt obligation" in subsection 80(1) were read as "foreign accrual property income (within the meaning assigned by subsection 95(1))," and
  - without reference to subsections 80(3) to (12) and (15) and 80.01(5) to (11) and sections 80.02 to 80.04.

  Thus, a somewhat truncated section 80 analysis is required, with its principal focus being the determination of any amount arising under subsection 80(13).[62] Essential to this analysis is the determination of whether or not a

[61] Interestingly, although the description of A (and of D) was amended with the introduction of the "non-qualifying business" rules, no similar amendment was made to the description of A.1. However, it may be that no such amendment is necessary, if the reference in the description of A.1 to "income from … businesses (other than active businesses)" can include income from a non-qualifying business. It is clear that a non-qualifying business is not an "active business" as defined in subsection 95(1), but it is also clear based on the legislative history that this reference in the description of A.1 was not drafted with the intent of covering income from a non-qualifying business, and the amendment of the description of A (and of D), which also refers to "the affiliate's income for the year from a business other than an active business" (and was amended to add "or the affiliate's income for the year from a non-qualifying business"), suggests to some extent that the drafter thought this was required in that context.

[62] The tax attribute reduction rules in section 80 and various related provisions are not applicable. Interestingly, the application of subsections 80.01(3) and (4) is not excluded. The former applies where "a commercial obligation or another obligation … of a debtor that is a corporation to pay an amount to another corporation (in this subsection referred to as the "creditor") is settled on an amalgamation of the debtor and the creditor." This language seems to be broad enough to include at least certain mergers carried out under foreign law (and the transactions need not qualify as an "amalgamation" to which subsection 87(1) applies, or even as a "foreign merger" as defined in subsection 87(8.1). See, for example, the ruling dated January 1, 2000 (no. 2000-0023953(E)). In contrast, subsection 80.01(4) applies only where "there is a winding-up of a subsidiary to which the rules in subsection 88(1) apply." Because these rules apply only in respect of the winding-up of one "taxable Canadian corporation" (as defined in subsection 89(1)) into another, they cannot apply to the winding up of an FA. Thus, although not excluded, they are not applicable. This raises the question of whether it was ever really intended that subsection 80.01(3) should be applicable in this context, or that subsection 80.01(4) should not be applicable in this context. It is clear that subsection 80.01(3) is omitted from the exclusions in subparagraph 95(2)(g.01)(ii), but so is subsection 80.01(4), and it seems difficult to understand, in policy terms, why the one but not the other should be applicable in the foreign affiliate context. Textually, it also seems difficult if not impossible to conclude that subsection 80.01(4) could be applied to an FA. Any way one looks at this, there would seem to be something wrong with the picture.

particular obligation constitutes a "commercial debt obligation." This matter is considered below. What is also essential is the determination of whether or not any resulting subsection 80(13) income should be considered to be "from" any of the sources referred to in the description of A.1 in the FAPI definition.[63]

In this regard, it should be noted that subsection 80(13) seems to have its own attribution rule, to the effect that the resulting income must be "added, in computing the debtor's income for the year from the source in connection with which the obligation was issued." Accordingly, if the obligation was issued in connection with a source that produces "income from property" within the meaning of the reference in the description of A in the definition of FAPI, then the resulting subsection 80(13) income is to be added in computing the FA's income from that source. Actually, as noted above, the amount to be added is twice any resulting subsection 80(13) income.

The reason for this is not entirely clear. The amount of any subsection 80(13) income is generally set at one-half of the relevant "forgiven amount" (as determined for these purposes), in accordance with paragraph (b) of the description of E in the formula in subsection 80(13). Presumably, the premise here is that, although the amount constitutes an income account item, it should be taxed at capital gains rates. This is similar to other such "hybrid" items, such as the income inclusion resulting under section 14 in respect of "eligible capital amounts," the deep discount deduction provided for under subparagraph 20(1)(f)(ii), and rules such as those relating to allowable business investment losses (ABILs).

So why then revert to income rates in the foreign affiliate context by doubling this amount? The answer—if that it is—seems to lie in the byzantine and not necessarily coherent manner in which the "ordering rules" in section 80 operate, translated to try to fit the foreign affiliate context, which has its own paradoxes. That is, these rules have the effect of applying the forgiven amount to reduce non-capital losses first, then net capital losses, then tax attributes like adjusted cost base (ACB), and finally may result in an income inclusion under subsection 80(13). The application of the forgiven amount to reduce non-capital losses obviously results in taxation at income rates. The application of the forgiven amount to reduce net capital losses or ACB results in taxation at capital gains rates. Although the rules do provide for a degree of flexibility, their application can be arbitrary, in that the forgiveness may result in a reduction of non-capital losses and corresponding taxation at income rates even though the relevant obligation may be on capital account and may relate to the acquisition of non-depreciable property. In that context, it is not entirely

[63] Note here the discussion in note 61, supra.

surprising that subsection 80(13) seems undecided as to what the "right" treatment should be—opting for an income inclusion at capital gains rates.

Of course, in the foreign affiliate context, there is no such flexibility, in that there is only one treatment for a forgiven amount, and that is to run it through subsection 80(13), and then double it to produce the amount referred to in the description of A.1 in the FAPI definition. The effect of this seems to be to produce taxation at income rates in all cases. Although the normal "streaming" rules are not really applicable in the FAPI context (in that income account items and taxable capital gains and allowable capital losses are all combined to produce a single FAPI computation, thereby effectively permitting allowable capital losses to shelter income from property, which is generally not the case domestically under section 3), capital account items are still accounted for in a manner that produces taxation at capital gains rates; for example, it is the allowable capital loss, not the raw capital loss, that is accounted for in the FAPI computation and can be used to shelter income from property. Perhaps it was thought that doubling the subsection 80(13) inclusion would be appropriate in the foreign affiliate context on the theory that this would mirror the application of the forgiven amount to reduce non-capital losses in the domestic context. This would not be surprising, given that the regime was intended to operate in effect only to deny FAPLs.

However, it does not follow that this should be considered appropriate, or that this results in appropriate consequences in all cases. For example, if an FA were to acquire a capital property using borrowed money (say, for $1,000), and then the property lost all of its value and the indebtedness was forgiven, the result would seem to be an inclusion of $1,000 under the description of A.1, and a deduction of only $500 under the description of E in the FAPI definition. This will not necessarily result in positive FAPI of $1,000, because the descriptions of A.2 and G in the FAPI definition (discussed next) should provide an effective reserve of $500 if there were no other relevant items; but if the FA also had a separate capital loss of $1,000, it would lose that one as well. This result seems inappropriate given that, in real economic terms, there is no net economic loss and no net forgiveness, except for whatever arises from the separate loss of $1,000.

- Third, the description of G provides for the deduction of an amount equal to the difference between the amount included by virtue of the description of A.1 (that is, twice the subsection 80(13) inclusion, which is one-half the forgiven amount, so the forgiven amount) and any "loss" items determined under the descriptions of D (that is, certain income account items), E (certain allowable capital losses), and F ("deductible loss"—essentially, undeducted FAPLs from prior years determined in accordance with regulation 5903). Thus, the deduction equals the portion of the forgiven amount that was not applied to reduce the aggregate of any "loss" items determined under the descriptions of D to F. It should be noted that this amount is recaptured in the subsequent year under the description of A.2. Accordingly, the G reserve

> would apply again in the subsequent year except to the extent the A.2 recapture had been offset by other "loss" items arising in that year, and so on in perpetuity until the forgiven amount is fully accounted for.[64]

Commercial Debt Obligation

As noted above, it is essential to determine whether a particular obligation constitutes a "commercial debt obligation," and paragraph 95(2)(g.1) provides that the Act must be read as if the expression "income, taxable income or taxable income earned in Canada, as the case may be" in the definition "commercial debt obligation" in subsection 80(1) were read as "foreign accrual property income (within the meaning assigned by subsection 95(1))." Accordingly, this definition must be read as follows:

> "commercial debt obligation" issued by a debtor means a debt obligation issued by the debtor,
>
> (a) where interest was paid or payable by the debtor in respect of it pursuant to a legal obligation, or
>
> (b) if interest had been paid or payable by the debtor in respect of it pursuant to a legal obligation,
>
> an amount in respect of the interest was or would have been deductible in computing the debtor's *foreign accrual property income (within the meaning assigned by subsection 95(1))* if this Act were read without reference to subsections 15.1(2) and 15.2(2), paragraph 18(1)(g), subsections 18(2), (3.1), and (4), and section 21 (emphasis added).

However, paragraph 95(2)(g.1) applies only "in computing the foreign accrual property income of a foreign affiliate of a taxpayer," not necessarily in computing all aspects of its earnings or surplus accounts. Thus, in any context other than computing FAPI, the interest (or hypothetical interest) on the obligation must be deductible in computing the debtor's "income, taxable income or taxable income earned in Canada, as the case may be."

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[64] There are also certain reserves that can apply under section 61.3 or 61.4 in respect of insolvent corporations (see also the corresponding recapture provisions under section 56.3). Interestingly, although subsection 61.3(1) sets out a reserve for resident corporations, and subsection 61.3(2) sets out a reserve for non-resident corporations, the context of computing FAPI suggests that the resident corporation reserve would be the more appropriate, if either is indeed applicable. The problem in the latter regard is that these reserves speak of deducting amounts "in computing the income for a taxation year" of a corporation. This would seem to be a reference to the overall section 3 computation, not necessarily to (though also not necessarily not to) a more specific paragraph 3(a) or (d) calculation by generic source. There is considerable uncertainty with respect to the relationship between section 3 and subdivision e of division B of part I of the Act, and their interaction with the foreign affiliate rules. See the discussion in Angelo Nikolakakis, "The Taxation of Foreign Affiliates in the Resource Sectors," in *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Conference Report (Toronto: Canadian Tax Foundation, 2009), 29:1-70.

Obligations Relating to Active Operations

An important, but somewhat obscure question is whether a foreign affiliate may have any such "income, taxable income or taxable income earned in Canada, as the case may be," assuming it has no activities in Canada. If the debt obligation does relate to a foreign affiliate's Canadian activities—for example, a Canadian business—then it seems to be a "commercial debt obligation," assuming the interest is (or would be) deductible in computing the affiliate's "taxable income earned in Canada." Interestingly, if the Canadian activities give rise to active business income rather than FAPI, then the debt obligation would seem to be a "commercial debt obligation" for all purposes other than in computing FAPI. If, instead, the debt obligation relates exclusively to a foreign affiliate's foreign active business activities, then the affiliate would not have any deduction in computing "taxable income earned in Canada," so one question would be whether it had any deductions in computing "income" or "taxable income." Under subsection 2(1), only residents are taxed on their "taxable income." Moreover, a taxpayer's "income," as such, is never the taxpayer's base. Nevertheless, it is arguable that all taxpayers can—and, in theory, must—compute their "income," even if not taxed on this amount.[65] On this basis, unless the context otherwise requires,[66] it seems that a debt obligation issued by a foreign affiliate in relation to a foreign active business could perhaps be regarded as a "commercial debt obligation" for purposes other than its FAPI computations.

The published administrative practice in this regard is not entirely consistent. In a technical interpretation dated December 5, 2003,[67] the CRA took the view that a debt forgiveness would not have any consequences in the computation of a debtor affiliate's surplus and other accounts except to the extent that the debt relates to a source that gives rise to FAPI, and putting aside foreign exchange implications. In this case, the facts assumed were that the debtor affiliate had used the relevant borrowings to make loans that give rise to active business income under subparagraph 95(2)(a)(ii), and to acquire shares of other active foreign affiliates. Thus, the (incorrect) premise of the technical interpretation was that no amount of interest on the debt obligation would be deductible in computing FAPI (see discussion below). Moreover, the CRA took the following position:

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[65] See, for example, section 250.1, which provides: "For greater certainty, unless the context requires otherwise (a) a taxation year of a non-resident person shall be determined, except as otherwise permitted by the Minister, in the same manner as the taxation year of a person resident in Canada; and (b) a person for whom income for a taxation year is determined in accordance with this Act includes a non-resident person."

[66] A contextual argument can be made that the references in the definition of "commercial debt obligation" to "income" and "taxable income" are intended to apply only in relation to a resident, and that only the references to "taxable income earned in Canada" are intended to apply in relation to a non-resident.

[67] No. 2003-0165195(E).

> There is nothing in the "exempt earnings" or "taxable earnings" definitions that would pick up forgiveness of a commercial debt obligation that did not relate to FAPI. Furthermore, the adjustment to "earnings" in paragraph 5907(2)(f) would not be available because this provision applies to revenue, income or profit derived from an active business carried on by a foreign affiliate. Therefore, while such income may be computed for a foreign affiliate, there appears to be nothing in the Regulations that would allow it into exempt or taxable surplus.

Interestingly, the factual assumption was that the foreign affiliate was a holding company, and did not in fact carry on an active business. Thus, it seems appropriate for the CRA to have concluded that regulation 5907(2)(f) was not applicable in the circumstances, but a different conclusion may be warranted in other circumstances. For present purposes, what seems relevant to determining whether there is a "commercial debt obligation" is the CRA's statement that "such income may be computed for a foreign affiliate"—referring to an affiliate's "revenue, income or profit … from such business carried on in that country." If this is correct, and subject to certain other considerations, a debt forgiveness may have surplus implications even in the active context. This matter is discussed below.

Mixed-Use Obligations

This technical interpretation also deals with certain other aspects of the analysis. That is, the following statement is made:

> If a portion of the debt had been used to earn FAPI, and the remainder to earn active business income, we are of the view that the whole debt would be a "commercial debt obligation," not just the portion that related to the earning of FAPI. In answer to your question (a), if any amount in respect of interest on the CFA1 debt would have been deductible in computing CFA1's FAPI had interest been paid or payable thereon, the income inclusion attributable to the forgiveness of the whole debt would be brought into the computation of FAPI. However, based on the above hypothetical facts, the forgiveness of the CFA1 debt does not affect the computation of FAPI because all of the debt was used to earn dividends from subsidiaries and interest income that was deemed active business income pursuant to subparagraph 95(2)(a)(ii) (i.e. items of income not included in the FAPI computation). Accordingly, the CFA1 debt would not be a "commercial debt obligation" for the purposes of computing FAPI and there would be no impact arising on the forgiveness of the CFA1 debt on the computation of FAPI.

Each of these two elements of the analysis is discussed below.

First, there is the question of characterizing a mixed-use obligation. That is, should section 80 (and paragraph 95(2)(g.1)) be applied to each portion of the obligation as a function of the use of the proceeds? These technical interpretations take the position that any "tainted" portion of an obligation taints the whole obligation. However, there is also subsection 248(27), which provides as follows:

> (27) For greater certainty,
>
> (a) unless the context requires otherwise, an obligation issued by a debtor includes any part of a larger obligation that was issued by the debtor;
>
> (b) the principal amount of that part shall be considered to be the portion of the principal amount of that larger obligation that relates to that part; and
>
> (c) the amount for which that part was issued shall be considered to be the portion of the amount for which that larger obligation was issued that relates to that part.

This provision casts a significant degree of doubt on the correctness of the position in this regard reflected in this technical interpretation.

Obligations Relating to Active Shareholdings

Second, there is the question of characterizing an obligation (or part thereof) that relates to the acquisition of shares of another foreign affiliate. Where clause 95(2)(a)(ii)(D) applies in respect of any interest income on the obligation, then the exclusion in respect of such income in the descriptions of A and D in the definition of FAPI would seem to preclude the obligation from being a "commercial debt obligation" in accordance with the modified definition in paragraph 95(2)(g.1), because no such interest would be deductible in computing FAPI (or a FAPL). However, where this exclusion does not apply, it would seem that the interest would be deductible even though the dividends from the relevant shares would be excluded from the computation, such that the obligation (or part) would seem to be a "commercial debt obligation" even though no FAPI would normally arise from a dividend on those shares.

This understanding is reflected in a technical interpretation dated March 9, 2004,[68] where the following statements are made to reverse the position expressed in the technical interpretation referred to above:

> In the Earlier Letter we indicated that based on the above hypothetical facts, the forgiveness of the CFA1 debt would not affect the computation of FAPI. The rationale given was that under the provisions of section 80 of the Act as modified by paragraph 95(2)(g.1), the CFA1 debt would not be a "commercial debt obligation" for the purpose of computing FAPI. This analysis is incorrect. In applying the definition of "commercial debt obligation" in subsection 80(1) as modified by paragraph 95(2)(g.1), had interest been payable in respect of the CFA1 debt, an amount would have been included in the computation of the amount described in "D" of the definition of FAPI in subsection 95(1). In computing CFA1's income from the shares of other foreign affiliates of Canco, any dividend derived by CFA1 from those shares would be excluded from the amounts described in "A" and "D" of the

[68] No. 2004-0062171E5(E). See also the technical interpretation dated February 10, 2004 (no. 2004-0062175 (E)).

> definition of FAPI. However, the interest expense incurred on money borrowed to acquire those shares would nevertheless be deductible in computing its income or loss from such property. Accordingly, the CFA1 debt is a "commercial debt obligation" under the provisions of section 80, as modified by paragraph 95(2)(g.1), for the purpose of computing FAPI.

In the circumstances under consideration, the exclusion for interest governed by clause 95(2)(a)(ii)(D) was not applicable because the creditor was resident in Canada, not another foreign affiliate.

Possibility of a Subsection 15(1) Benefit

As noted above, the implications of section 80 are rather circumscribed in the foreign affiliate context. However, that is not the only rule to worry about in computing FAPI. In a technical interpretation dated August 30, 2004,[69] the CRA took the position that a subsection 15(1) benefit could be considered to have been conferred where a loan receivable of a wholly owned foreign subsidiary from its foreign parent is settled without payment on the winding-up of the wholly owned foreign subsidiary into the foreign parent. In that case, the subsidiary's only asset was the receivable from the parent, and the value of the parent's only assets other than its shares of the subsidiary was less than the amount of the loan.[70] The technical interpretation also notes that the amount of any such subsection 15(1) benefit would reduce the debtor's "forgiven amount" under paragraph (b) of the description of B in that definition in subsection 80(1).

It is interesting to think about ways in which this possibility might be averted, and what that says about this interpretation. For example, in the facts assumed for purposes of this interpretation, the parent had an obligation of $100 and had access to only $50 of cash. What if the parent had repaid $50 of the obligation using the cash, and then the creditor affiliate, wholly owned by the parent, had paid a $50 dividend to the parent, which then used that $50 to repay the balance of the obligation, leaving the $50 again in the creditor affiliate?[71] It seems difficult to conceptualize a shareholder benefit analysis in this context, except perhaps by recharacterization under the GAAR, but it may be equally difficult to conceptualize an "abuse" analysis

69 No. 2003-0001351E5(5).

70 It seems somewhat curiously settled that a subsection 15(1) benefit should be included in computing FAPI, given that subsection 15(1) does not specifically attach the resulting inclusion to a particular source—and simply states that "the amount or value thereof shall, except to the extent that it is deemed by section 84 to be a dividend, be included in computing the income of the shareholder for the year." However, the rule is in subdivision b of division B of part I—Income from a Business or Property.

71 The repayment of the second $50 balance may not even be necessary, assuming the $50 of cash is first distributed back to the parent, since the balance would equal the value of the parent's assets other than its shares in the creditor affiliate.

in this regard,[72] although that would be a question of fact.[73] If the distributing affiliate had no positive surplus balances, then the distribution of the first $50 could result in a deemed gain under subsection 40(3). However, the shares might at that time be "excluded property," such that no FAPI should arise.[74] Even if a $50 gain does arise, the amount of the FAPI inclusion would be $25, which is half of the amount of the potential shareholder benefit inclusion under subsection 15(1).[75]

Foreign Exchange Implications

Paragraph 80(2)(k) provides that "where an obligation is denominated in a currency (other than Canadian currency), the forgiven amount at any time in respect of the obligation shall be determined with reference to the relative value of that currency and Canadian currency at the time the obligation was issued." Thus, foreign exchange implications are excluded from the section 80 analysis (assuming the obligation is not denominated in Canadian dollars).[76] However, where a debt obligation is forgiven (or otherwise settled), any foreign exchange position reflected in that obligation would seem to be realized, from both the debtor's and the creditor's perspective.[77]

Where the debt obligation is owing between "qualified foreign affiliates" as defined in paragraph 95(2)(g), then this rule would apply to deem to be *nil* the amount of any income, gain, or loss resulting in reference to the obligation "because of a fluc-

[72] See, for example, *Advance Income Tax Ruling* ART-66, "Non-Arm's Length Transfer of Debt Followed by a Winding-Up and a Sale of Shares," April 20, 1995. See also the subsequent administrative practice, including a ruling dated January 1, 2004 (no. 2004-0081691R3(E)).

[73] See the technical interpretation dated October 5, 2001 (no. 2001-0093185(F)), and other documents, where the CRA took offence to similar planning involving a non-resident corporation. There is a useful summary of some of the back-and-forth on this issue in the technical interpretation dated September 25, 2003 (no. 2003-0022357(E)).

[74] Whether or not the shares would be "excluded property" as defined in subsection 95(1) will depend on the underlying asset mix at the relevant time, arguably excluding the distributed cash, because the characterization is to be done after the receipt of the dividend that reduces the adjusted cost base resulting in the gain. Moreover, it should be noted that, under proposed amendments to the description of B in the definition of FAPI, a deemed gain under subsection 40(3) could result in a FAPI inclusion even if the shares are "excluded property"—if the deemed gain were to arise "under subsection 40(3) in respect of a share because of a dividend on the share referred to in subparagraph [95](2)(e.3)(iv) or (e.4)(v)." However, if the shares are excluded property, the taxpayer should be able to elect (or, under subsequent comments made by the Department of Finance, the revised rules may default) to eliminate the deemed gain.

[75] That assumes the other $50 in the creditor affiliate can then be extracted separately without triggering another gain or income inclusion—perhaps through a transaction governed by paragraph 95(2)(d.1).

[76] Strange things can happen—and there is also the application of section 261 to contend with, which is beyond the scope of this paper.

[77] Issues from a creditor's perspective are considered below in a separate section.

tuation in the value of the currency of a country other than Canada relative to the value of Canadian currency." Thus, from the debtor's perspective, any gain arising because of the application of subsection 39(2)[78]—say, where the Canadian dollar has appreciated relative to the foreign currency—would be deemed to be *nil*, such that there would be neither FAPI implications, nor surplus implications on that account.

Interestingly, again from the debtor's perspective, where paragraph 95(2)(i) is applicable, subsection 39(2) would be applied with reference to the debtor's "calculating currency," which may be different from the currency in which the obligation is denominated. If the obligation is not denominated in Canadian dollars (such that paragraph 95(2)(g) is likely not applicable), then it seems to be possible for the debtor affiliate to realize a foreign exchange gain or loss on the forgiveness,[79] which would then have surplus implications, to which we now turn.

Surplus Implications

Where the forgiveness does have foreign exchange implications, it is accepted by the CRA that there should be a corresponding adjustment to surplus accounts, to that extent. However, as noted above, it is not clear whether any adjustment arises where the indebtedness is denominated in the debtor affiliate's "calculating currency" and paragraph 95(2)(g.1) is not applicable. Where the debt obligation relates to an active business carried on by an affiliate in a foreign country, then the relevant foreign tax law may apply to produce an adjustment to "earnings," computed in accordance with subparagraph 95(2)(a)(i) or (ii) of the definition "earnings" in regulation 5907(1). However, this might not be the case, because the relevant foreign tax law might not produce such an adjustment.

In either case, an analysis will be required with respect to the potential application of regulation 5907(2). Paragraph 95(2)(f) refers to "any revenue, income or profit" (other than an amount referred to in paragraph (f.1), (h), or (i)) of the affiliate derived in the year from such business carried on in that country to the extent that such revenue, income, or profit is not otherwise required to be included in computing the "earnings amount" of the affiliate for any taxation year by the income tax law that is relevant in computing that amount, and does not arise with respect to a disposition (other than a disposition to which subsection (9) applies) by the affiliate of property to another foreign affiliate of the taxpayer or to a person with whom the taxpayer does not deal at arm's length, to which a tax deferral, rollover, or similar tax postponement provision of the income tax law that is relevant in computing the

78 See, among other items, the discussion in the technical interpretation dated December 5, 2003 (no. 2003-0165195(E)).

79 Ibid. See also paragraphs 95(2)(f) to (f.15).

earnings amount of the affiliate applied. This language[80] seems to be broad enough to encompass a subsection 80(13) inclusion.[81]

It is an interesting question as to whether or not the attribute reduction rules could be applied in the context of an adjustment under regulation 5907(2)(f). They are excluded where the "earnings" computation is made directly in accordance with Canadian rules (see below), but there is no exclusion as such under regulation 5907(2)(f). On the other hand, many of the attribute categories in section 80 may be irrelevant to a foreign affiliate, given subsection 111(9), which restricts a non-resident's attributes to those with a Canadian nexus. See also regulation 1100(3), which excludes from "depreciable property" all property of a non-resident that is situated outside Canada, except for the purpose of determining FAPI. Moreover, the rule for eligible capital property in subsection 80(7) has its own limitation for non-residents (to Canadian business items). Perhaps the most relevant items would be those that provide for adjusted cost base reductions on non-depreciable properties. Nevertheless, assuming that a subsection 80(13) inclusion arises at the end of the day, it seems arguable that it should be regarded as "income" within that reference in regulation 95(2)(f).

Where the affiliate's "earnings" are to be computed directly under Canadian tax rules in accordance with subparagraph (a)(i) or (ii) of the definition of "earnings" in regulation 5907(1), the matter is clear because the provision reads as follows:

> (iii) in any other case, the amount that would be the income from the active business for the year under Part I of the Act if the business were carried on in Canada, the affiliate were resident in Canada and the Act were read without reference to subsections 80(3) to (12), (15) and (17) and 80.01(5) to (11) and sections 80.02 to 80.04,

Thus, the application of subsection 80(13) is specifically contemplated, and the attribute reduction rules, among others, are specifically excluded.

Of course, in either case, the application of subsection 80(13) would only result in a surplus adjustment equal to half of the "forgiven amount," which is not consistent with the amount of the FAPL erosion where paragraph 95(2)(g.1) is applicable. It may also be the case that this amount does not properly match the amount of distributable property in the debtor affiliate, taking into account the adjusted cost base of its shares and any adjustments thereto that may be relevant. On the other hand, it

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[80] There remains the issue of whether a debt obligation could be regarded as a "commercial debt obligation" for these purposes, given the non-application of paragraph 95(2)(g.1) and the terminology issues under that definition in subsection 80(1). See the discussion above.

[81] The language is even simplified under proposed amendments: "(f) any revenue, income or profit (other than an amount referred to in paragraph (f.1), (h), or (i)) of the affiliate derived in the year from such business carried on in that country to the extent that such revenue, income or profit is not otherwise required to be included in computing the earnings amount of the affiliate for any taxation year by the income tax law that is relevant in computing the earnings amount."

is stated in the technical interpretation dated December 5, 2003[82] that a forgiveness by a parent would result in a "contribution of capital" to its subsidiary debtor affiliate the amount of which can be added to the adjusted cost base of the shares of the debtor affiliate pursuant to paragraph 53(1)(c). This would be separate from any surplus adjustment, such that what might be regarded as an excess of total attributes might arise if there is also an "inside" adjustment to the surplus accounts. However, any loss also realized by the creditor affiliate, and the surplus implications of that, would also have to be taken into account in determining whether the overall value-to-attribute picture makes any sense.

Arguably, given all the uncertainties and inconsistencies mentioned above, it would not be a waste of time to revisit and perhaps rewrite some of these rules, assuming we continue to maintain surplus accounts for affiliates.

Creditor's Perspective

From the creditor's perspective, the forgiveness would have the usual consequences where the creditor is a resident taxpayer. Where the creditor is a foreign affiliate, the consequences would depend largely on whether or not the receivable is "excluded property," determined in the usual manner.[83] If it is, then any gain or loss, including any foreign exchange gain or loss under subsection 39(2), would be determined in its "calculating currency," which may be different from the currency of the obligation. Interestingly, it seems that 100 percent of any such gain or loss would be allocated to the "exempt" accounts.[84] If it is not, then there do not appear to be any FAPI or surplus implications because of foreign exchange fluctuations—assuming the application of paragraph 95(2)(g), but there may be other implications. In particular, it seems that the forgiveness should be considered to result in a disposition of the receivable giving rise to a gain or loss to the creditor as a function of any difference between its proceeds of disposition and its adjusted cost base. It seems that any such loss should result in an allowable capital loss as contemplated by the description of E in the definition of FAPI, and corresponding surplus account implications.[85] None of the so-called stop-loss rules seems to be applicable, assuming an income-earning purpose.

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[82] No. 2003-0165195(E).

[83] Under recent amendments to paragraph 95(2)(i), this rule now applies only to a debtor, and not to a creditor.

[84] See the definitions of "exempt earnings" and "net earnings" in regulation 5907(1).

[85] Any gain—say, because of an acquisition of the debt for less than the debtor ultimately pays off—will result in a taxable capital gain contemplated by the description of B in the definition of FAPI.

Impact of Acquisition of Control

Surplus Implications

An acquisition of control of a foreign affiliate can arise where creditors of the foreign affiliate or of its Canadian parent acquire a controlling interest in the affiliate, directly or indirectly, as part of a debt restructuring or other compromise arrangement. Under existing rules, the acquisition of the control of a foreign affiliate is normally not considered to result in material tax consequences under the foreign affiliate rules.[86] However, under proposed amendments to the Regulations, where this is combined with a designation under paragraph 88(1)(d) in respect of the shares of a foreign affiliate, in any amount, the accounts of the affiliate and of other affiliates in the relevant corporate chain can be reset to *nil*. More specifically, proposed regulations 5905(5.1) and (5.2) would apply, respectively, where there has been an amalgamation described in regulation 5905(5)(b) to which subsection 87(11) of the Act applies, or a winding-up described in regulation 5905(5)(c), and in respect of that amalgamation or winding-up an amount has been designated in respect of shares of a particular corporation that was, immediately before the amalgamation or winding-up, a foreign affiliate of the corporation referred to as the "subsidiary corporation" for purposes of the corporate combination (or designated in respect of an interest in a partnership that holds such shares). Where either rule is applicable, it would affect the application of the surplus adjustment rules otherwise applicable under regulations 5905(5)(d) to (h).

The drafting of these proposals is somewhat obscure, but the thrust seems to be to "reset" the relevant accounts to *nil* as at the date of the acquisition of control, and to then recognize and adjust only amounts that arise after that date. The theory behind this approach seems to be that otherwise there could be effective tax attribute duplication, in that the value of the affiliate's shares as at the acquisition of control date, which would set the upper limit for a cost designation under paragraph 88(1)(d), would already reflect the undistributed surplus of the affiliate, such that an increase to such cost without a corresponding reduction to surplus would result in duplicative shelter against future proceeds from the disposition of the shares.[87] However, as alluded to above, there is no "to the extent" mechanism in these rules. A single dollar of cost designation seems to be sufficient to completely "reset" the accounts, which could be unfair from a taxpayer's perspective, although it could also be advantageous where it results in the elimination of a net overall deficit in the accounts.[88]

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[86] There is a degree of controversy in this regard. See, among other sources, the technical interpretation dated December 15, 1997 (no. 9642275(E)).

[87] See also proposed paragraph 88(1)(d.4), which would effectively equate to cost for the purposes of subparagraph 88(1)(d)(ii) certain surplus items distributed after the acquisition of control. It is expected that this proposed amendment will be reworded in numerous respects.

[88] The previous version of this type of proposal, released on December 20, 2002, did attempt to operate on a "to the extent" mechanism, but that seems to have proven to have been too complicated to implement.

It is also important to note the possibility of further amendments in this regard. In the Explanatory Notes that were released on February 25, 2009 in connection with Bill C-10 that introduced new paragraphs 95(2)(f) to (f.15) and related provisions, there was the following comment in the discussion of these rules:

> Note that it is expected that the *Income Tax Regulations* will be amended to provide that the surplus balances of a foreign affiliate of a designated acquired corporation would be reduced in appropriate circumstances, and without regard to whether a "bump" is claimed under paragraph 88(1)(d) of the Act. Such an amendment is expected to be prospective from the date of the announcement of the details thereof.

What this suggests is that further amendments are in the works that seem to be aimed at ensuring there are no overall excess tax attributes remaining after the acquisition of the control of a foreign affiliate.

Carve-Out Rule—Paragraphs 95(2)(f) and (f.1)

It should also be noted that paragraph 95(2)(f) has been rewritten, and new paragraph 95(2)(f.1) now contains the "carve-out" rule in respect of pre-foreign affiliate items. However, the scope of this rule is limited in certain respects. The rule applies only in respect of the items described in paragraph 95(2)(f)—namely, "each amount that is a foreign affiliate's (i) capital gain, capital loss, taxable capital gain or allowable capital loss from a disposition of a property, or (ii) income or loss from a property, from a business other than an active business." Moreover, the "carve-out" rule is articulated as follows:

> (f.1) in computing an amount described in paragraph (f) in respect of a property or a business, there is not to be included any portion of that amount that can reasonably be considered to have accrued, in respect of the property (including for the purposes of this paragraph any property for which the property was substituted) or the business, while no person or partnership that held the property or carried on the business was a specified person or partnership in respect of the taxpayer referred to in paragraph (f).

What is not at all clear is whether this language could encompass an accrued foreign exchange gain that was present in respect of any indebtedness of a foreign affiliate at the relevant status-change time.[89] Can it properly be concluded that any such gain "accrued"—versus being the product of the deeming rule in subsection 39(2)?

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[89] It should be noted that, based on the various definitions and supporting rules that apply for this purpose under subsection 95(1), including the definition of "specified person or partnership" and the supporting rule in subsection 95(2.6), the relevant time in general for the purposes of the application of paragraph 95(2)(f.1) is the time that the affiliate first becomes a foreign affiliate of the relevant taxpayer, which may not be the same time as that at which the taxpayer acquires the control of the affiliate—for example, in a two-stage acquisition, or where a significant historical minority shareholder subsequently acquires control.

Moreover, the language suggests that the gain must have *accrued in respect of a property*—indeed, "the property." Under subsection 39(2), putting aside the possible problem that the gain may be an amalgam of several gains and losses, even if there is only one item, "the property" that is deemed to have been disposed of is fictitious currency. This raises a further issue—which relates to the description of the accrual period—being "while no person or partnership *that held the property* or carried on the business." The emphasized language suggests an expectation that this property (or substituted property) has been held by some person or partnership during the accrual period, which does not seem to be the case in respect of fictitious currency. Thus, the only recourse may be to paragraph 95(2)(g), if it applies, or if it can be made to apply—for example, by having a foreign affiliate acquire debt owing to a non-foreign affiliate before it is repaid.

It also seems difficult to fit any subsection 80(13) income arising from a debt forgiveness into this "carve-out" rule. Can it properly be concluded that any such income can be considered to have "accrued"? On the other hand, it seems that if this particular analytical hurdle can be overcome, it might be easier here than in the context of a foreign exchange gain to get comfortable that the "carve-out" rule can apply—because there could be a property or business held by the affiliate (or another relevant person) in relation to which the obligation was issued. However, the issue still remains as to whether any subsection 80(13) income arising from the forgiveness should be regarded as having accrued "in respect of" the relevant property or business—versus having accrued in respect of an *obligation*. If it is the latter, then the "carve-out" rule would not have any effect.

Loss and Attribute Realization and Consolidation

Troubled times sometimes give rise to unusual requirements or opportunities. Where the taxpayer has an accrued loss on a receivable from, or on the shares of, a foreign affiliate, the taxpayer may be able to realize that loss.

Accrued Losses on Receivables

As noted above, from the creditor's perspective, a forgiveness (or other disposition) would have the usual consequences where the creditor is a resident taxpayer, and would depend largely on whether or not the receivable is "excluded property," determined in the usual manner, where the creditor is a foreign affiliate. In either case, a forgiveness or settlement of the indebtedness could produce valuable shelter, although perhaps in different amounts because of paragraph 95(2)(g).

Accrued Losses on Shares

The analysis becomes more complicated in cases where there is an accrued loss on the shares of a foreign affiliate. If a resident taxpayer has such a position, it may be more difficult to realize the loss—though not impossible. Where the loss is on the shares of what might be referred to as a "simple finco"—say, where a foreign affiliate had been established for the purpose of making a single loan—it may be relatively

straightforward to realize an accrued loss on its shares, by simply dissolving the affiliate, subject to any applicable stop-loss rule, such as that in subsection 93(2).[90]

However, where the loss is accrued on the shares of an affiliate that the taxpayer does not want to dissolve, this simple alternative would not be available. Nevertheless, it does seem to be possible for the taxpayer to first "roll" the shares to a new foreign affiliate under subsection 85.1(3), and then to have those shares disposed of by that new foreign affiliate (say, to a related party) for fair market value non-share consideration, followed by the dissolution of the new foreign affiliate. This would seem to realize the loss, subject to the application of any stop-loss rules and the GAAR.[91]

Another possibility might be for the taxpayer to consolidate its tax attributes reflected in the accrued loss—by simply "rolling" the shares with an accrued loss (again under subsection 85.1(3)) into a foreign affiliate that has an accrued gain on its shares, if the taxpayer has such another foreign affiliate. In this case, the accrued loss would average out with the accrued gain, assuming the same class of shares is used, with the result that this loss would give rise to additional overall cost base, which would be useful if those new shares are to be disposed of.[92]

Inversions

Full Inversions

As noted above, troubled times can give rise to unusual opportunities. One of these opportunities can be to export a corporation from Canada—and, hence, from the Canadian tax net—at a time when asset values or other circumstances are such that the "exit tax" cost would be low. A number of structural alternatives would be conceivable in this regard.

One series of alternatives would involve a "taxable" cross-border dissolution or other distribution by a resident corporation. In that context, the corporation would dispose of its assets and would presumably settle its liabilities, resulting in the potential realization of gains and losses, which would be expected to be minimal and potentially offsetting. For example, an accrued foreign exchange gain on indebtedness might be offset by an accrued loss (or lower gain) on an investment denominated in

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[90] A detailed review of the stop-loss rules is beyond the scope of this paper. It will be noted, however, that there exist proposals to limit the application of the stop-loss rule in subsection 93(2) as a function of a corresponding foreign exchange gain realized by the relevant taxpayer, as well as planning that avoids the application of the rule. See the discussion below concerning "inversions."

[91] See in this regard the decision in *Donohue Forest Products Inc. v. The Queen*, 2001 DTC 823, where the Tax Court of Canada accepted similar planning.

[92] A contemplated disposition of the shares of the new foreign affiliate would not seem to engage the application of subsection 85.1(4), nor arguably should it, because this rule is intended to prevent the accomplishment of indirect consequences that cannot be produced directly, and this series of transactions would produce only direct consequences and would not produce indirect consequences.

the same currency. The cross-border distribution would be treated in the usual manner, in accordance with the rules in section 84, and part XIII.

Another alternative might involve an emigration of the relevant resident corporation. Emigrations are governed by the rules in sections 128.1 and part XIV.[93] Interestingly, although these rules are designed broadly to replicate the consequences of a cross-border dissolution, they differ in certain material respects. First, the deemed disposition rules in paragraph 128.1(1)(b) apply only with respect to "property." Thus, where the emigrating corporation has an accrued foreign exchange gain or loss on its indebtedness, this gain or loss would not be realized as a result of the emigration. Second, whereas part XIII would impose withholding taxes at rates as a function of the residence of the recipient(s), part XIV would impose a broadly equivalent tax as a function of the country to which the emigrating corporation has immigrated,[94] which may be a very different rate.

Mini-Inversions

The structural objective of a full inversion would be to extract from Canada everything other than Canadian branch operations (which, of course, could remain in a Canadian subsidiary). By the reference to a "mini-inversion," what might be contemplated is a reorganization that is designed, essentially, to manage foreign exchange exposure, leaving the group headed by a Canadian parent.

More specifically, it seems to be possible to conceive of a series of transactions that could be implemented by a Canadian resident parent corporation that has an accrued foreign exchange gain on third-party indebtedness that is coming due, with the simple objective of avoiding an immediate realization of the gain. The reorganization seems to have to involve certain preliminary transactions intended to remove from the debtor corporation all assets exceeding the value of the relevant debt. In principle, it should be possible to design a reorganization that accomplishes this on a non-recognition basis in accordance with section 55. This would leave the group headed by a new Canadian parent, with two Canadian subsidiaries, one being the former parent with the debt and corresponding assets, and the other being the transferee corporation that acquired the balance of the former parent's assets.[95] The next set of transactions would be intended to export the former parent, making it a foreign affiliate of the new parent. As noted above, it should be possible to achieve this through an emigration without any tax cost, assuming there is no accrued gain on the property of the emigrating corporation. Once that corporation becomes a foreign affiliate, it seems to be possible to then arrange for its indebtedness to be acquired by another foreign affiliate of the new parent, and to be settled thereafter, such that

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[93] A cross-border merger might also be an option. See, among other provisions, section 128.2.

[94] See sections 219.3 and 219.3.

[95] The new parent might also perhaps acquire the balance of the old parent's assets, such that there would only be one subsidiary after the reorganization, being the old parent.

paragraph 95(2)(g) should be applicable to eliminate any foreign exchange gain computed as a function of the Canadian dollar.

Whether or not any such planning could be considered to result in "abusive tax avoidance" as required for the application of the GAAR depends on the particular circumstances, among other considerations.

Other Considerations

Depending on the particular circumstances, asset value and exchange rate volatility may occasion other considerations that may be relevant in the context of a debt restructuring or other reorganization. Moreover, important considerations that have not been reviewed above may arise with respect to proactive efforts to manage volatility—such as the implementation of various types of hedging arrangements. Other forms of planning may also be conceived that seek to capitalize on Canadian losses for the benefit of non-resident entities, or simply to capitalize on differences between Canadian and foreign rules. A detailed review of these considerations is beyond the scope of this paper, although some will be mentioned below.

Section 79

A potentially interesting way in which appreciated property might be extracted from a resident corporation on a non-recognition basis involves the application of section 79. In general terms, this provision applies where property is "surrendered" as contemplated by subsection 79(2)—meaning, for these purposes, where the beneficial ownership of the property is acquired or reacquired at a particular time from a debtor by a creditor and the acquisition or reacquisition of the property was "in consequence of" the debtor's "failure to pay all or part of one or more specified amounts of debts" owed by the debtor to the creditor immediately before that time. Under subsection 79(3), the debtor's proceeds of disposition are limited to the "specified amount" of the relevant debts, which is defined in subsection 79(1) as a function of the unpaid principal amount thereof and interest thereon. If these do not exceed the debtor's adjusted cost base in the "surrendered" property, then no gain would arise.[96]

Paragraph 20(1)(f)

The consequences of the application of section 79 may be contrasted to the consequences that may arise in connection with a transfer of property pursuant to the terms and conditions of an "exchangeable debenture"—where it is not clear that any deduction would be available under paragraph 20(1)(f) in respect of the amount, if any, by which the value of the transferred property exceeds the amount for which the debenture was issued (which deduction might serve to shelter any corresponding gain from the disposition of the property).[97]

[96] Foreign exchange implications are also essentially excluded under subsection 79(7).

[97] There is considerable debate in this regard, and the administrative position appears to be evolving.

The uncertainty associated with the application of paragraph 20(1)(f) in the context of an exchangeable debenture is compounded by the uncertainty associated with determining the debtor's proceeds of disposition in such a context, particularly where the parties are not dealing at arm's length at the time of the transfer. One of the reasons for this is the position reflected in the decision of the Tax Court of Canada in *Gee-Gee Investments Ltd. v. MNR*,[98] where the court held that section 69 can apply to override contractual pricing (in that case, under a purchase option) between non-arm's-length parties even if the terms of the contract reflect arm's-length dealings at the time it was concluded, assuming the value has changed since that date. If this is correct, it would defeat an argument, based on general principles, to the effect that the debtor's proceeds of disposition are to be contractually determined as the amount of the outstanding indebtedness. In addition, this case is important in the cross-border context because the court held that a subsection 15(1) benefit arose to the extent of the differential between the contract price and the value of the property at the time of transfer.

Although the court's conclusion on the application of section 69 is debatable, it seems very difficult to understand the court's conclusion on the subsection 15(1) issue. This seems to be purely a question of fact to which the deemed proceeds rule in section 69 would have no application. There is also the possibility that the relevance of this case in the cross-border context has now been displaced by section 247. However, what seems odd in this regard is that section 247 does not seem to fully displace section 69. Subsection 247(8) provides as follows:

> (8) Where subsection (2) would, if this Act were read without reference to sections 67 and 68 and subsections 69(1) and (1.2), apply to adjust an amount under this Act, sections 67 and 68 and subsections 69(1) and (1.2) shall not apply to determine the amount if subsection (2) is applied to adjust the amount.

Curiously, where the terms of the contract are consistent with arm's-length dealings, there could be no adjustment under subsection 247(2), such that the application of section 69 would not be displaced. This would lead to a somewhat ironic result if the decision in *Gee-Gee Investments* is correct.

Exporting Canadian Losses

Arrangements involving the "importation" of a foreign affiliate's losses have been the subject of considerable debate, including the decision of the Tax Court of Canada in *Mark Resources Inc. v. The Queen*,[99] and the introduction of proposed amendments to the rules governing the use, carry-forward, and grouping of FAPLs, under proposed regulations 5903 and 5907(1.4).[100] A different set of considerations

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[98] 94 DTC 1419 (TCC).

[99] 93 DTC 1004 (TCC).

[100] There is also a detailed code of regulations governing the usual arrangements between members of a US-style consolidated group of foreign affiliates, or a group that benefits from UK-style group relief provisions, under regulations 5907(1.1) to (1.3), and proposed regulation 5907(1.4).

arises with regard to circumstances involving what might be referred to as the "exportation" of Canadian losses or other tax attributes.

For example, a Canadian corporation can receive a prepayment for the provision of goods or services that it can amortize under paragraph 20(1)(m) over the term of the contract. If the payer's jurisdiction permits a more accelerated recognition, then there will be a timing arbitrage. Timing and other arbitrages can also arise because of differences in depreciation rates, or because of differences in "anti-churning" rules such as paragraph 13(7)(e). Indeed, depending on the circumstances, it may be advantageous for members of an international corporate group to exchange assets, even if this means that the result will be (at least for some time) that entities in one jurisdiction will end up owning and operating assets in another jurisdiction.

Even where there is no real Canadian arbitrage to capitalize on, it may be that there are Canadian losses that would otherwise expire that could be used to shelter interest or royalty income from foreign affiliates—thereby avoiding the trouble and expense of using a foreign finance or licensing affiliate. Somewhat conversely in practical terms, it may be that the circumstances would justify adding further complexities to the foreign structure—for example, in order to introduce arrangements that capitalize on purely foreign attributes or arbitrages—say, a loss consolidation or refresher arrangement, or even a double-dip, between two foreign jurisdictions. Although there is no Canadian tax avoidance in such a context (at least not in that regard), it is of course possible to trip over traps and other pitfalls arising under our income recharacterization rules in paragraph 95(2)(a) and the related (though not yet promulgated!) Regulations. Thus, any such arrangement should be approached with caution and certainly through the rubric of a detailed Canadian analysis even though there is no real Canadian tax benefit.

Conclusions

This part of this paper considers the principal implications of debt forgiveness in the foreign affiliate context, as well as a number of other considerations that may be relevant or present pitfalls or opportunities in difficult or volatile economic environments. The implications of section 80 are reviewed, as are many foreign exchange and surplus account implications, from both a debtor's and a creditor's perspective. Certain of the implications of a debt restructuring are also considered—in particular, the implications of a resulting acquisition of the control of a foreign affiliate.

We have also considered a number of planning arrangements that might give rise to significant benefits in relation to the realization of accrued losses or the consolidation of tax attributes, as well as certain more ambitious types of planning that could perhaps be implemented in order to "export" a resident corporation without a material "exit tax" cost, or to simply manage foreign exchange exposures. Mention has also been made of various specific considerations that may arise in particular circumstantial contexts—including the potential application of section 79, the potential application of paragraph 20(1)(f) to exchangeable debentures, and issues

relating to arrangements to "export" Canadian losses or tax attributes, among other internationally oriented arrangements.

What this overview demonstrates, if nothing else, is that the rules that are relevant in this regard are not necessarily consistent—even internally—let alone across borders. Accordingly, this is an area in which one cannot operate based on rules of thumb and intuition, but rather one must operate based on a detailed and careful review of the relevant analytical and avoidance considerations that arise under the laws of each relevant jurisdiction, with a view to navigating through to the most preferable reasonable alternative(s).