



## Foreign Affiliate Developments

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### Overview

- **December 18, 2009 Proposals**
  - Abandoned Feb 2004 Proposals
  - Tax-Free Surplus Balance
  - Indirect FA Acquisitions
  - Fill the Hole
  - FAPLs & FA Groups - 5907(1.4)
- **Other Submissions to Finance**
  - German Organschafts & Capital Gains
  - Thin-Capitalization & FAPI
- **Comfort Letters**
  - 95(2)(a)(i) & partnerships
  - 95(2)(b)(ii)(B) – services performed by NAL “taxpayer”

## Overview

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- Dec 18<sup>th</sup> Proposals not covered in this presentation
  - 95(2)(a) Regs
  - Capital Gains & “exempt earnings”
  - Surplus Adjustments in General – Reg 5905
  - Partnerships in General – Reg 5908
  - Canadian Dollar Surplus Accounts – 5907(6)
  - Treaty Residence “throughout the year”
  - FAPLs & Reg 5903
  - Regulated Financial Institutions – PE rules
  - Foreign Oil & Gas Levies

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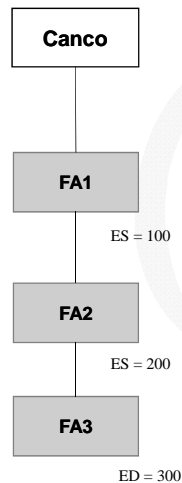
## Abandoned Feb 2004 Proposals

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- Consolidated surplus approach to 93(1) elections
- Interest push-down rules
  - Pushing down interest expense in FA Holdco to a lower-tier FA Opco where interest expense to FA Holdco is re-characterized to its recipient as active business income pursuant to 95(2)(a)(ii)(D)
- Levitation of deficits on liquidation of one FA into another

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## Abandoned Feb 2004 Proposals



### Transaction

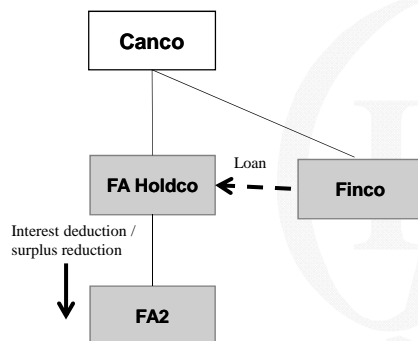
- Canco makes a 93(1) election in respect of the disposition of shares of FA1

### Proposed rule

- The proposed rules would have required the inclusion of the deficit in FA3 in the computation of "consolidated" surplus of FA1

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## Abandoned Feb 2004 Proposals



### Transaction

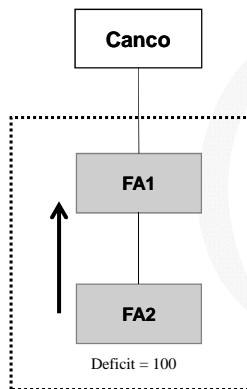
- Finco makes a loan to FA Holdco

### Proposed rule

- Proposed rule was to apply where clause 95(2)(a)(ii)(D) re-characterized income of Finco as active business income
- Result of proposed rule would have been to push down the effect of interest deduction (decrease to surplus) to affiliates owned by FA Holdco (e.g., FA2)

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## Abandoned Feb 2004 Proposals



### Transaction

- FA2 is wound up into FA1

### Proposed rule

- Proposed rule would have required the deficit balance of FA2 to reduce any surplus balance of FA1 and possibly to create a deficit in FA1

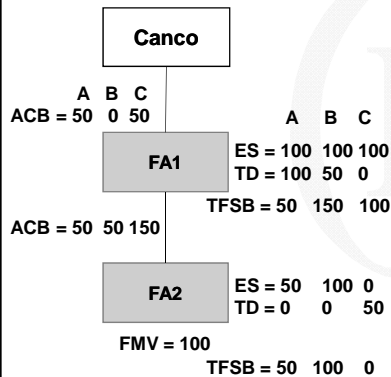
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## Abandoned Feb 2004 Proposals

- **Submissions received by Finance**
  - **Deficit levitation: is it toast or not?**
  - **Amended 93(1) elections**
  - **Elective application of consolidated surplus regime for transitional period**

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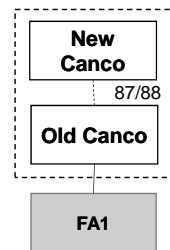
## Tax-Free Surplus Balance ("TFSB")



- There's a new sheriff in town, named TFSB, with several policing responsibilities
- Determined under Regs 5905(5.5) & (5.6):
  - Include
    - excess of ES over TD, plus
    - lesser of grossed-up UFT and excess of TS over ED
  - Determined in respect of each relevant Canadian corporation
  - Determined on an aggregate basis in accordance with 93(1) rule in 5902(1)(a)(i)
- Relevance:
  - Indirect FA Acquisitions
    - Surplus reset: Reg 5905(5.2)
    - Bump limitation: 88(1)(d)(ii) & Reg 5905(5.4)
  - "Fill the Hole" Regs 5905(7.2) & (7.3)
- Submission received by Finance re: UFT

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## Indirect Foreign Affiliate Acquisitions



	A	B
ACB =	40	60
ES / TFSB =	50	70
Shelter =	90	130
FMV =	100	100
5905(5.2)		
- excess =	0	(30)
/ grind		
5905(5.4)		
- "cost gap" =	60	40
- TFSB =	(50)	(40)
- bump =	10	0

- Surplus Reset: Regulation 5905(5.2)
  - Current Regulations do not adjust "excess surplus" on acquisition of control (unlike for excess ACB under 111(4))
  - Proposals to reset surplus balances to eliminate excess of cost amount of FA shares plus TFSB over FMV on AQN
    - no 88(1)(d) bump required
    - cost amount determined after 111(4)
    - mechanism uses "blocking deficit" approach
    - relationship with 95(2)(f)
- Bump Limitation: 88(1)(d)(ii) & 5905(5.4)
  - 88(1)(d) allows "bump" to cost of FA1 shares, subject to "property-specific limitation" in 88(1)(d)(ii)
  - 88(1)(d)(ii) limits bump to gap between a property's FMV on acquisition of control and cost amount before winding-up
  - Proposals to revise 88(1)(d)(ii) to limit the bump by closing the "cost gap" for FA shares by a "prescribed amount":
    - AQNs after AD: 5905(5.4) – TFSB
    - AQNs before then: 5905(5.13) – old proposal (post-AQN tax-free dividends out of pre-AQN exempt or taxable surplus, with full surplus grind under 5905(5.12) for any amount of bump designated)

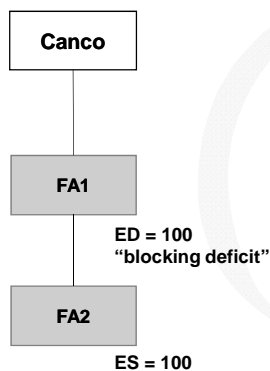
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## Indirect Foreign Affiliate Acquisitions

- Submissions received by Finance
  - 5905(5.2)
    - Related party acquisitions
  - 5905(5.4)
    - Amended 88(1)(d) designations
    - Simplified bump and strip rule

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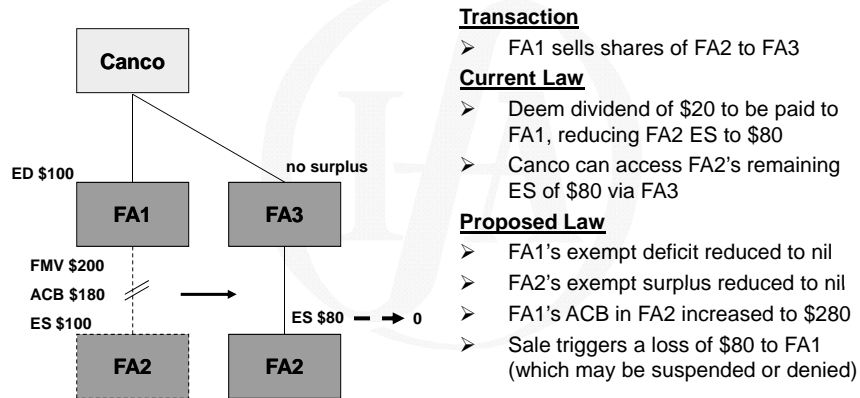
## Blocking Deficits and “Fill The Hole” Rules



- Rule applies where
  - FA has an exempt deficit (“Deficit FA”), and
  - Shares of a lower-tier FA (“Acquired FA”) are acquired by Canco or another FA such that Deficit FA’s surplus entitlement in the lower tier FA is diluted
- Results (applied before the sale transaction)
  - The exempt surplus of Acquired FA is reduced
    - If more than 1 FA is acquired, taxpayer must fully allocate the surplus reduction or else risk excessive grind
  - The surplus reduction reduces the exempt deficit of Deficit FA
  - The ACB of the shares of Acquired FA is increased by the amount of its exempt surplus reduction/exempt deficit increase

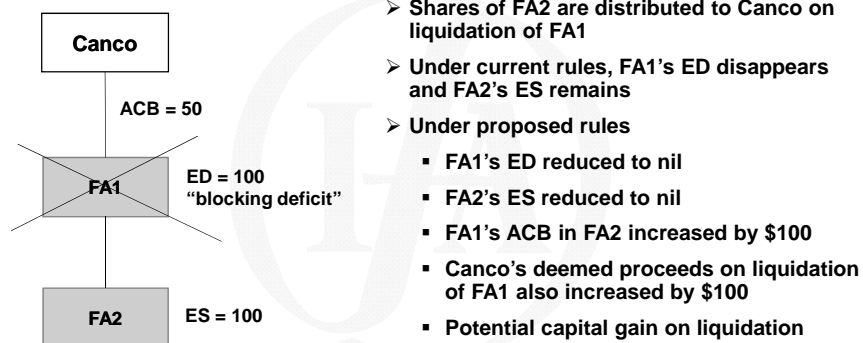
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## “Fill the Hole” - Example



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## “Fill the Hole” – Example



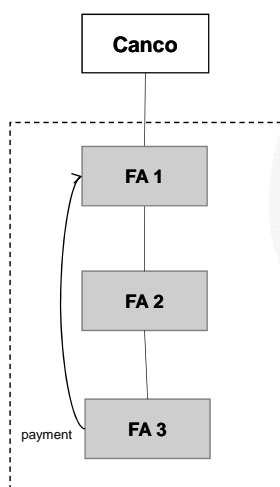
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## **“Fill the Hole”**

- **Submissions received by Finance**
  - **Surplus entitlement percentage where Canadian corporation holds less than 100% of FA group**
  - **Deeming rule where taxpayer makes insufficient designations in circumstances where two or more FAs are transferred at the same time**
  - **Increased basis may create or increase capital gain under 88(3)**

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## **FAPLs & FA Groups – Regulation 5907(1.4)**



- **Regulation 5907(1.3) provides for prescribed “foreign accrual tax” for payments made in context of foreign “consolidation” or “group relief” regimes**
- **Payments must reasonably be regarded as being in respect of income or profits tax that would have been payable by the particular affiliate, on a stand-alone basis, in respect of a particular amount included in computing the taxpayer's income by virtue of subsection 91(1) of the Act**
- **Regulation 5907(1.4) intended to ensure such FAT does not arise where payments made for use of losses other than FAPLs (to be consistent with changes to Regulation 5903, post *Mark Resources*)**

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## FAPLs & FA Groups – Regulation 5907(1.4)

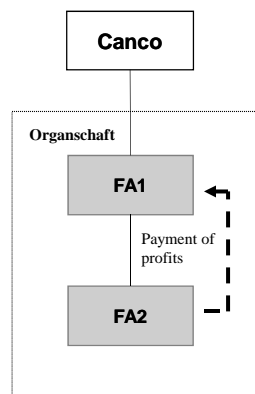
### ➤ Submission received by Finance

#### ➤ Alternative versions:

- March 16, 2001: “does not include” an amount that “can reasonably be considered to be in respect of a loss ... and such loss would not be a foreign accrual property loss”
- December 18, 2009: “shall only include” an amount that “can reasonably be considered to be in respect of a loss ... that would be a foreign accrual property loss”

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## German Organschaft and Capital Gains



### The Profit and Loss Pooling Agreement

- FA1 and FA2 are resident in Germany and have concluded a Profit and Loss Pooling Agreement (to form an Organschaft for German tax purposes)
- FA2 must transfer all of its profit to FA1 and FA1 will compensate FA2 for any loss

### Canadian Tax Treatment

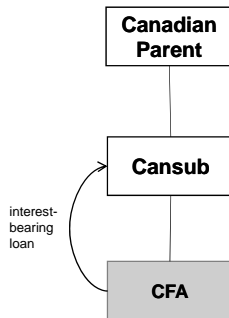
- 95(2)(a)(ii) should apply to the payment by FA2 to transfer its profits to FA1 to the extent the payment is reflected in FA2's earnings from an active business (Rulings 2001-0093903)

### Issues

- What if the payment from FA2 to FA1 is not reflected in FA2 earnings from an active business?
  - For example, what if FA2 earned capital gains?
  - See CRA interpretation 2009-0347881C6

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## Thin-Capitalization & FAPI



- Thin-Capitalization rules in 18(4) deny interest deductions:
  - deny interest deductions on debt exceeding a 2:1 debt-to-equity ratio, counting “outstanding debts to specified non-residents”
  - Canadian parent is a “specified shareholder” of Cansub
  - CFA is “a non-resident person ... who was not dealing at arm's length with a specified shareholder” of Cansub
  - “equity” excludes PUC of Cansub shares
- FAPI would likely include CFA's interest income, which would have nullified the deduction but now creates positive income
- WHT would apply to interest payments (but counts as FAT and UFT)

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## Comfort Letter – June 4, 2009

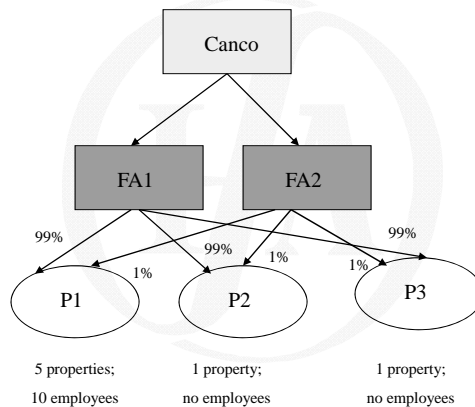
### 95(2)(a)(i) (“mothership” rule): application to partnerships

- Taxpayer's submission
  - Taxpayer has a foreign affiliate (FA1) that is a member of a number of partnerships
  - One partnership (P1) has a bunch of employees, the others hold a single property that is serviced by employees of P1
- CRA's position is that each partnership carries on a separate business

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## Comfort Letter – June 4, 2009

### 95(2)(a)(i) (“mothership” rule): application to partnerships



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## Comfort Letter – June 4, 2009

### 95(2)(a)(i) (“mothership” rule): application to partnerships

#### ➤ Comfort letter

- Recommend amending Act so partnerships on same footing as corporations

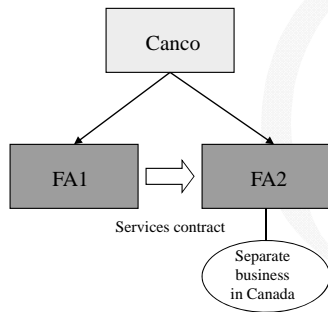
#### ➤ Possible solution

- Have been asked to consider providing a deemed corporation rule similar to that in “excluded property” definition
- If one were to apply the same rule for many other partnership situations, it could simplify legislation
- Finance invites comments on this approach

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## Comfort Letter – March 23, 2010

### 95(2)(b)(ii)(B): services base erosion rule



- Services performed outside Canada by non-residents?
- 248(1) “taxpayer” vs *Oceanspan Carriers*
  - Is this well-settled law?
- Recommend amendment such that only non-residents that perform the relevant services in the course of a business carried on in Canada will be caught (in addition to Canadians and subject to N-A-L and FA conditions)
- Retroactive election to February 2004
- Follow-up submission
  - “Where the revenue from such services would be included in computing income from a business carried on in Canada (other than a treaty-protected business)”