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TELUS Convention Centre
Calgary, AB

Foreign Affiliate and Inbound Update

Moderator: Drew Morier, *Osler, Toronto & Calgary*
Panel:
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Discussion Topics

- Foreign Affiliate Dumping Rules

  Jason Durkin

- Back-to-Back Loan Rules and Treaty Shopping Update

  Mark Coleman

- Recently Enacted Foreign Affiliate Changes

  Robert Nearing

- BEPS: Interest Deductibility and CFC Report

  Phil Halvorson

Foreign Affiliate Dumping Rules

Jason Durkin

Foreign Affiliate Dumping Proposals

- Original Foreign Affiliate Dumping (FAD) rules enacted in 2012
- Proposed amendments released on August 16, 2013
- **Royal Assent – December 16, 2014**
- Generally effective from original date the FAD rules were announced (March 28, 2012) unless taxpayer elects to have amendments come into force on August 14, 2012 and some rules effective from the date of announcement.

Charging Provision ("Safe Harbour")

- Amendments narrow the scope of charging provision.
- When CRIC not controlled by "Parent" at the "investment time", the charging provision will only apply if the CRIC becomes controlled by the Parent after the investment time as part of a series and if one of the following three conditions are met:
  1. The Parent and all persons not dealing at arm's length with the Parent collectively own 25% or more of the shares of the CRIC (either votes or value);
  2. The investment is an investment in preferred shares of an FA of the CRIC that is not a wholly-owned subsidiary of the CRIC; or
  3. There is an arrangement in place whereby a person other than the CRIC (or a person related to the CRIC) has a material risk of profit or loss in respect of a property related to the investment.

“Investment” Definition

- Current definition of “investment” in 212.3(10) includes a transaction where an amount becomes owing by the subject corporation (i.e. the FA) to the CRIC.
- An exception to the investment definition is provided where (i) the amount became owing in the ordinary course of business of the CRIC (and is repaid within 180 days) or (ii) where the amount is a PLOI.
- 212.3(10)(c)(iii) is added to exclude a declared but unpaid dividend.

Sequential Investments – 212.3(10)(f)

- **New subsection 212.3(5.1) introduced to ensure an indirect investment (212.3(10)(f)) does not also become subject to the FAD rules where the indirect investment is made after and as part of the same series of transactions or events as a direct investment that was already caught under the rules.**

Corporate Reorganization Exception

- **212.3(18)(a) now provides another exception in respect of certain intercompany transfers of debt where as part of a post acquisition restructuring the transfer would not result in an incremental new investment in a foreign affiliate.**
- Former 212.3(18)(c)(ii) only provided exception for an 87(1) amalgamation of two or more predecessor corporations to form the CRIC. Amendment extends the exception to situations where the corporation formed on the amalgamation is not the CRIC but is instead a corporation resident in Canada of which the CRIC is a shareholder.

Corporate Reorganization Exception – Cont'd

- 212.3(18)(d) is amended to clarify that the exception for shares of the subject corporation received in exchange for a debt owing to the CRIC only applies where a bond, debenture or note issued by the subject corporation is exchanged for shares of the subject corporation and 51(1) would apply to the exchange if the terms of the debt conferred on the holder the right to make the exchange.
- New 212.3(18.1) provides that the corporate reorganization exception does not apply when CRIC's acquisition of property is received as whole or partial repayment of a PLOI.

More Closely Connected Business Activities and Indirect Funding

- Amendments allow officers of a Canadian corporation that does not deal at arm's length with CRIC to qualify as "good" officers.
- Former version of indirect funding exception in 212.3(24) required the "good" affiliate to use proceeds of a loan from the subject corporation (FA) in an active business. Indirect funding exception is expanded to allow situations where all or substantially all of the income from the loan made by the subject corporation (FA) is deemed active business income pursuant to **95(2)(a)(i)** or 95(2)(a)(ii). This should allow indirect funding exception to apply where the "good" affiliate uses loan proceeds to purchase shares of a third affiliate and the loan qualifies for 95(2)(a)(ii)(D).
- Anti-avoidance rules added to 212.3(23) to prevent "good" affiliate from acquiring third affiliate that is a "bad" affiliate.

Dividend Substitution Election (DSE) and Qualifying Substitute Corporation (QSC)

- DSE election in 212.3(3) has been significantly modified to limit the scope to identifying the payer and payee of the deemed dividend under 212.3(2)(a) (see changes to PUC reduction).
- Under the former rules, a QSC must be a Canadian resident corporation controlled by the Parent. 212.3(4)(a) of the QSC definition amended to provide that a Canadian corporation will satisfy the control requirement if it is either controlled by the Parent or by a non-resident corporation with which the Parent does not deal at arm's length.
- Filing requirements are relaxed to (i) replace the requirement that all corporations that are QSC's be parties to the DSE in 212.3(3) with the requirement that only the QSC that is the deemed dividend payer must be a party ("?") and (ii) change the deadline to the filing due date for the CRIC for its taxation year that includes the dividend time.

Dividend Time

- **Former rules deemed FAD consequences to occur at the time of CRIC's investment. Due to series test in charging provision, this could be at a time when the CRIC is not controlled by the Parent and can produce adverse consequences.**
- **Amendments replace "investment time" with "dividend time" (now defined in 212.3(4)).**
- **If CRIC is not controlled by the Parent at the investment time, the dividend time is the earlier of (i) the first time after the investment that the Parent acquires control of the CRIC and (ii) 1 year after the day that includes the investment time.**
- **This may be helpful in cases where the CRIC may have additional PUC after an acquisition of control or the Parent may be entitled to a lower dividend withholding tax rate under a tax treaty.**

Cross-Border Class

- **New definition, added for purposes of PUC reduction rules (212.3(6) and 212.3(7)).**

  "cross-border class", in respect of an investment, means a class of shares of the capital stock of a CRIC or qualifying substitute corporation if, immediately after the dividend time in respect of the investment,

  (a) the parent, or a non-resident corporation that does not deal at arm's length with the parent, owns at least one share of the class; and

  (b) no more than 30% of the issued and outstanding shares of the class are owned by one or more persons resident in Canada that do not deal at arm's length with the parent.

Anti-Avoidance Rule – Cross Border Class

- **Former 212.3(6) is repealed and replaced by an anti-avoidance rule to deal with situations where the funding of an investment is structured to inappropriately reduce the effects of the PUC reduction under 212.3(7) on the cross-border class of shares.**
- **May apply where:**
  i. a non-arm's length Cdn company acquires shares of the cross-border class of shares where one of the main reasons for the investment was to increase the amount of PUC reduction; or
  ii. a non-arm's length Cdn company owns shares of the cross-border class and as part of a series of transactions that includes the making of the investment, the PUC of the cross-border class is increased.

PUC Reduction

- Under former rules, operation of PUC reduction depended on whether a DSE election had been made.
- Under amended rules, 212.3(6) is repealed. Therefore, application of PUC reduction election is automatic yet subject to notification requirement.
- **212.3(7)(a) – allows PUC reduction from investments made in respect of classes of shares held by arm's length persons.**
- **After reflecting any adjustment under 212.3(7)(a),** if the amount of deemed dividend under 212.3(2)(a) equals or exceeds the aggregate PUC of the cross-border classes, the PUC of each class is reduced to nil and the deemed dividend is reduced accordingly.

PUC Reduction – Cont'd

- If deemed dividend is less than the aggregate PUC of the cross-border classes, the deemed dividend is reduced to nil and the amount is used to reduce the PUC of one or more cross-border classes. In determining the reduction for each cross-border class, there is to be allocated such amount as results in the greatest total reduction of the PUC in respect of the cross-border shares owned by the Parent or another non-arm's length non-resident.
- **New paragraph 212.3(7)(d)** also provides a filing requirement. Notification of the PUC reduction must be sent to the CRA on or before the CRIC's filing due date for its taxation year that includes the dividend time.
- For pre-amendment transactions, notification requirement satisfied if filed by later of December 16, 2015 and the filing due date for taxation year that includes December 16, 2014.

PUC Reinstatement

- Amendment to 212.3(9) appears to clarify that PUC reinstatement applies on distributions of property by CRIC (or QSC) on a redemption of its own shares. Former version appeared to only apply to returns of PUC.
- Original investments that qualify for PUC reinstatement are expanded to include debts owed by the subject corporation. This permits PUC reinstatement when the property received by the CRIC (or QSC) includes interest on the debt, repayment of principal or proceeds from the disposition of the debt.
- Introduces new restriction that a PUC reinstatement is only available if the property received by the CRIC (or QSC) can reasonably be considered to relate to the investment that resulted in the application of the FAD rules.
- Continuity rules are added to ensure a corporation retains its ability to reinstate PUC in certain internal reorganziation transactions (212.3(9.1) and 212.3(9.2)).
- Corporate emigration rules amended to incorporate changes to PUC reinstatement.

Control

- New 212.3(15)(b) was added as an anti-avoidance rule.
- Where no one non-resident corporation has control of the CRIC but two or more related non-resident corporations are “in a position to control” the CRIC, the CRIC will be deemed to be controlled by the member of the related group with the greatest direct shareholding in the CRIC.

Treaty Shopping and Back-to-Back Loan Rules

Mark Coleman

Treaty Shopping Update

- Canada's Treaty Shopping Consultation
  - Budget 2013, August 2013 consultation paper and Budget 2014
  - August 29, 2014 Finance release of draft international tax measures
    - Government to await further work by OECD in relation to BEPS Action 6, Preventing Treaty Abuse

Treaty Shopping Update

- BEPS Action 6 – Preventing Treaty Abuse
  - March 14, 2014 discussion draft
  - September 16, 2014 report "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"
  - November 21, 2014 discussion draft "Follow Up Work on BEPS Action 6: Preventing Treaty Abuse"
  - January 22, 2015 public consultation
  - May 22, 2015 revised discussion draft "BEPS Action 6: Prevent Treaty Abuse"
  - No public consultation meeting will be held on the revised draft

Treaty Shopping Update

- BEPS Action – Preventing Treaty Abuse
  - Final versions of OECD Model and Commentary expected in September 2015
- OECD BEPS Action 11- draft discussion "Improving the Analysis of BEPS" on April 16, 2015
  - Public consultation on May 18, 2015
  - Work on methodologies to collect and analyze data completed by September 2015

Treaty Shopping Update

- Activity in other jurisdictions
  - China, Russia, and Vietnam introduced anti-abuse rules and beneficial ownership rules to restrict treaty benefits in conduit situations
  - Spain strengthened its specific anti-abuse rule for withholding tax exemptions on EU bound interest and royalties
  - EU agreed on an amended “de minimis” anti-abuse rule to be incorporated into the Parent-Subsidiary Directive

Back-to-Back Loan Arrangements

- Budget 2014
  - Announced changes to thin cap rules and Part XIII to address perceived avoidance through "so-called 'back-to-back loan' arrangements"
- Legislative proposals August 29, 2014
- Final legislation released on October 10, 2014, which received Royal Assent and enacted into law on December 16, 2014
- Applies to tax years beginning after 2014 for thin cap purposes and for payments after 2014 for Part XIII purposes

Back-to-Back Loan Arrangements

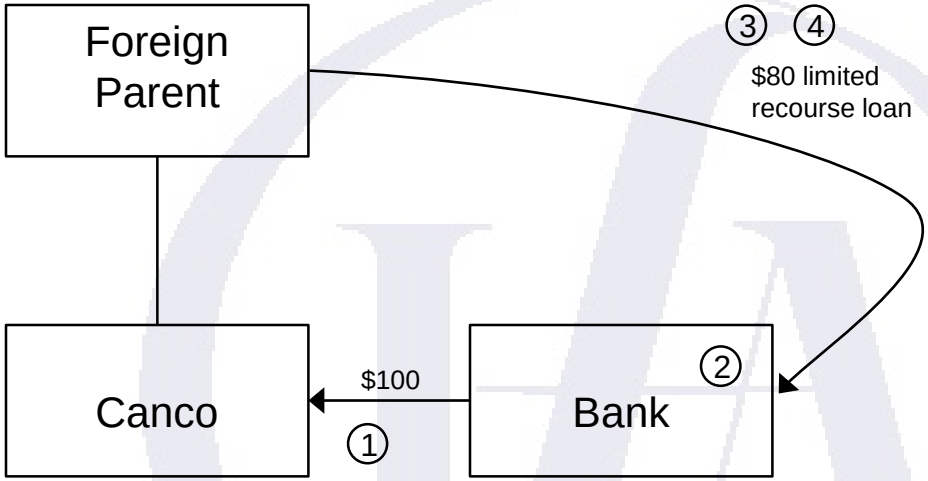
- Thin-cap changes 18(6) and 18(6.1)
- If the 4 conditions in 18(6) apply then 18(6.1) operates for the purposes of 18(4), (5) and Part XIII
  1. Taxpayer has a debt to an intermediary
  2. Intermediary is not (a) a Cdn resident not dealing at arm's length with taxpayer, or (b) a non-resident already captured by the thin-cap rules

Back-to-Back Loan Arrangements

- Thin-cap 18(6) – 4 condition test (cont'd)

3. Intermediary or NAL person has either:
   - a debt owing to an "(a)(i) non-resident" which is either 1) limited recourse to the taxpayer's debt, or 2) "reasonable to conclude"; or
   - a "specified right" (defined 18(5)) in a particular property granted by a non-resident in (a)(i) of def of "outstanding debts to specified non-residents" in 18(5)
4. The 25% *de minimis* rule does not apply

18(6) Basic Example of the 4 Conditions Applying



Back-to-Back Loan Arrangements

- Areas of Caution in Conditions 3 and 4
  - 18(6)(c)(ii) – grant to intermediary by non-resident of "specified right" in a property
  - "specified right" in 18(5) is broad and includes an encumbrance on the property to secure payment of an obligation (but excludes the taxpayer's debt to the intermediary and debts under 18(6)(d)(ii))
  - 18(6)(d) – the *de minimis* rule – provides relief in limited circumstances in group financing with 3rd party lenders

Back-to-Back Loan Arrangements

- If 18(6) applies then 18(6.1) becomes operative
  - Portion of the taxpayer's debt is deemed to be owed to the non-resident, not the intermediary
  - Amount is based on the applicable intermediary debt or FMV of the property in which non-resident granted a specified right
  - Adjusts the interest subject to thin cap on the taxpayer's debt
  - For Part XIII, deems non-deductible interest to be a dividend paid to the non-resident

Back-to-Back Loan Arrangements

- Reflections
  - Reinforces Canada's commitment to true "3rd party" debt not being subject to thin cap
  - In a multinational group need to fully understand arrangements, including security granted, with 3rd party lenders when they are lending to Canadian subsidiaries
  - Rules are broad in nature and highly technical

Back-to-Back Loan Arrangements

- Part XIII Changes – 212(3.1) to (3.3)
  - A Part XIII rule to ensure the WHT paid on arrangements subject to 18(6.1) is a natural extension
  - Want to ensure 212(1)(b) exempt interest is subject to a potential non-212(1)(b) exempt rate if ultimately subject to thin-cap
  - Part XIII rules go beyond being companion rules to thin-cap but become a blunt anti-treaty shopping rule
  - Effective for interest payments after 2014

Back-to-Back Loan Arrangements

- If the 5 conditions in 212(3.1) apply then 212(3.2) and (3.3) become operative
  1. Taxpayer pays or credits an amount at that time that is on account of interest in respect of a debt or other obligation to an intermediary
  2. Intermediary is not a Cdn resident not dealing at arm's length with taxpayer

Back-to-Back Loan Arrangements

- 5 conditions in 212(3.1)

3. At any time interest accrued ("relevant period") intermediary or NAL person to the intermediary has either:
   - a debt or other obligation to a non-resident which is either 1) limited recourse to the taxpayer's debt, or 2) reasonable to conclude; or
   - a "specified right" (defined 18(5)) in a particular property granted by a non-resident and either 1) the existence of the specified right is a condition of the TP's debt or 2) it is "reasonable to conclude"

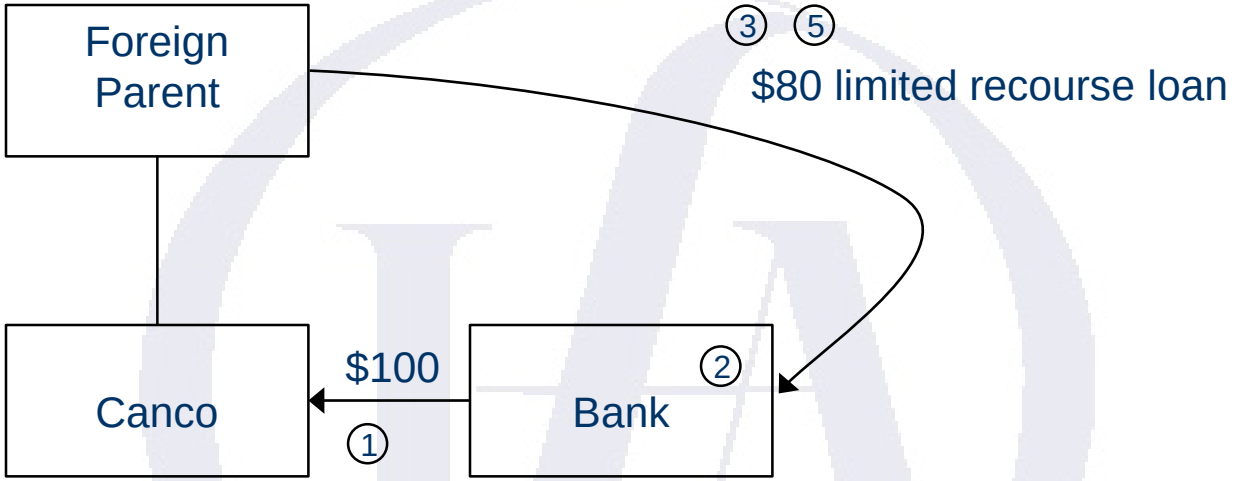
Back-to-Back Loan Arrangements

- 5 conditions in 212(3.1)
  4. The WHT on the interest if paid to the non-resident is greater than the WHT paid to the intermediary
  5. The 25% de minimis rule does not apply
- 212(3.2) deems the taxpayer to pay an amount of interest to the non-resident (not the intermediary) determined by formula
  - Formula carves out 214(16) deemed dividends

Back-to-Back Loan Arrangements

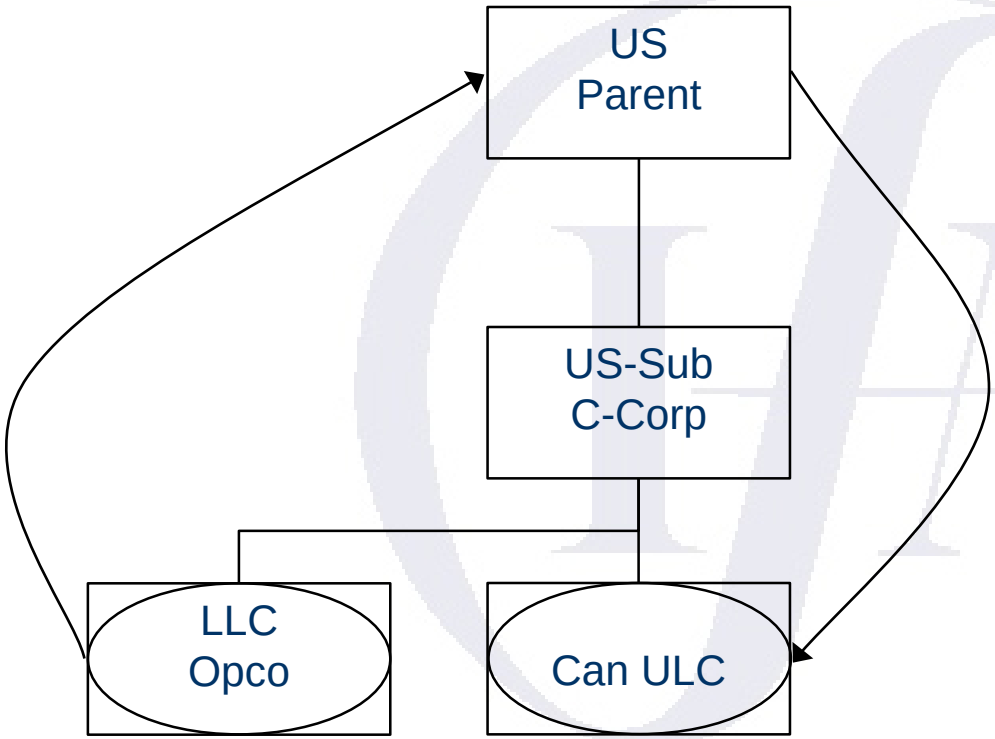
- 212(3.2) can deem taxpayer to pay interest to multiple non-residents on the same debt, thus deemed interest can exceed actual interest paid
- 212(3.3) allows the taxpayer to designate to reduce certain amounts to one or more non-residents where excess interest is determined in 212(3.2)
- Designation must be “reasonable in the circumstances”

212(3.1) Example of the 5 Conditions Applying



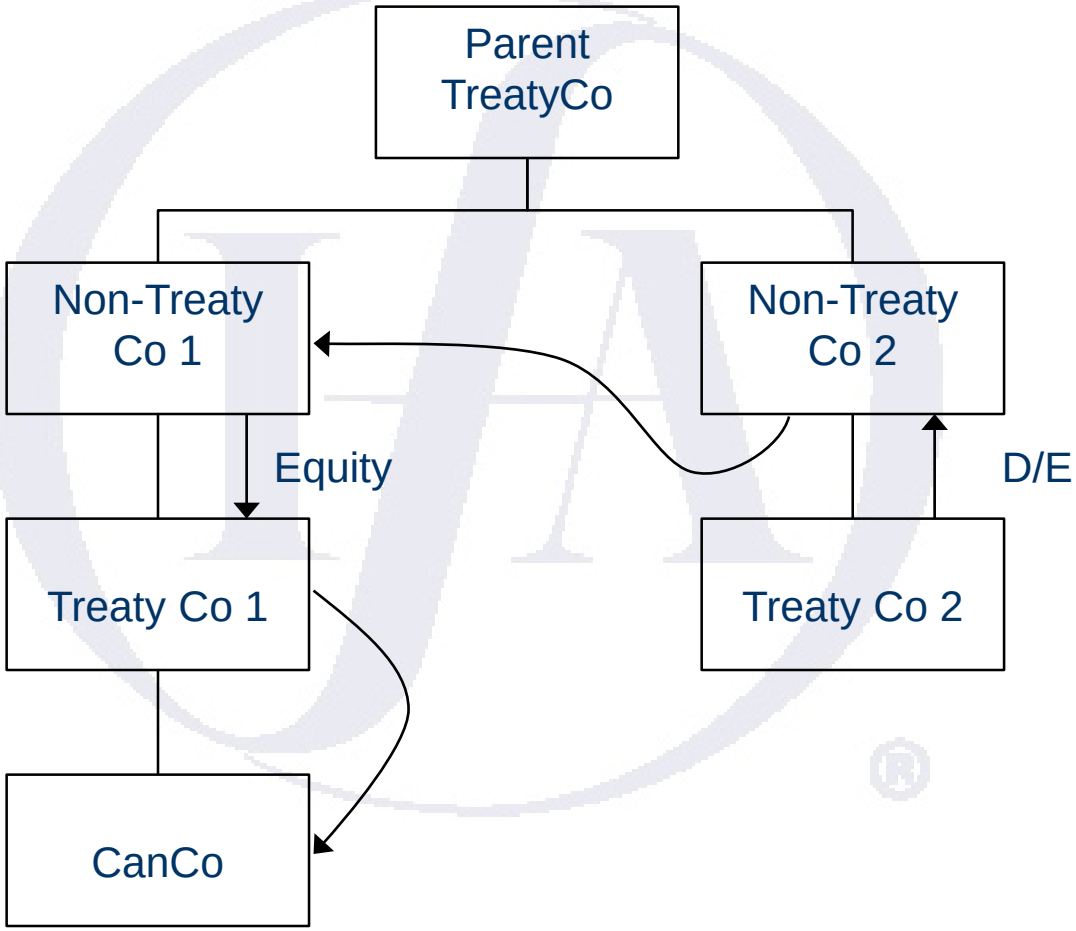
④ Assume WHT on interest to Bank is 212(1)(b) exempt and WHT treaty rate to Foreign Parent is 10%

Examples of Application of 212(3.1) and 212(3.2)

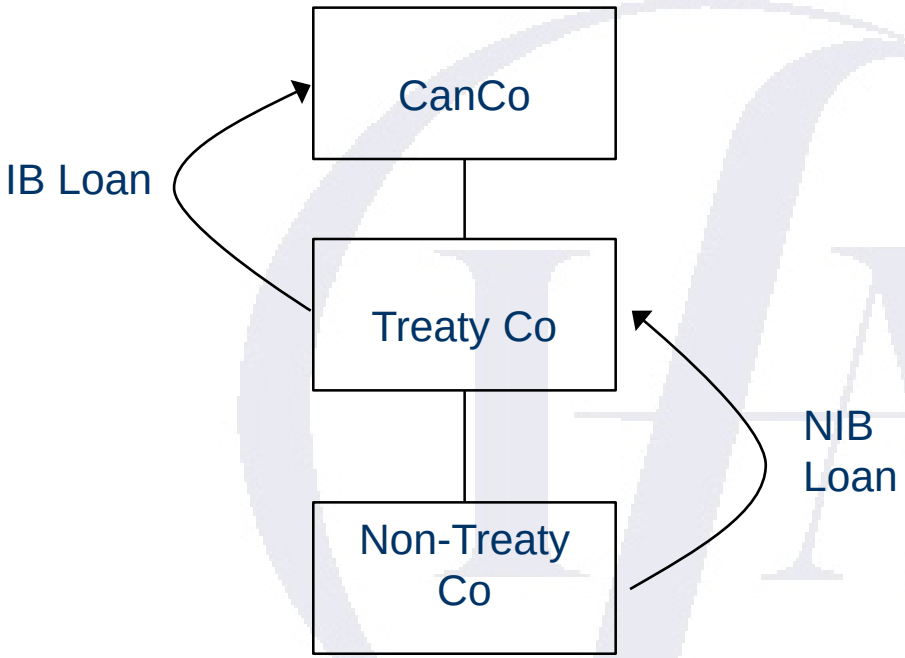


- 25% withholding tax if Can ULC pays interest to LLC due to the hybrid entity clause in Article IV(7) of the Canada-US Treaty

Examples of Application of 212(3.1) and 212(3.2)



Examples of Application of 212(3.1) and 212(3.2)



- CanCo is deemed to pay 25% WHT to Non-Treaty Co per 212(3.2)
- Treaty Co has FAPI
- Non-Treaty Co has the FAT?

Back-to-Back Loan Arrangements

- Part XIII Changes – Reflections
  - Loss of tax neutrality on transactions well outside Canada's jurisdiction – now we care?
  - Should it only be applicable in arrangements that are not captured by existing thin-cap rules, i.e. exclude an intermediary that is a person described in paragraph (a)(i) of the definition of "outstanding debts to specified non-residents" in 18(5) – see 18(6)(b)(ii)
  - Should the Part XIII WHT rate for interest be 10% instead of 25%?
  - Should there be an exception for controlled foreign affiliates?
  - Part XIII blunt anti-treaty shopping rule

Foreign Affiliate Update - Recently Enacted Changes (Bill C-43)

Robert Nearing

Recently Enacted Changes

- Partnerships
- Corporations without share capital, LLCs, and other flow through corporations
- FAT denial rules
- 95(2)(a)(i)
- 95(2)(a)(ii)(D)
- 95(2)(b)

Partnership Rules Improved

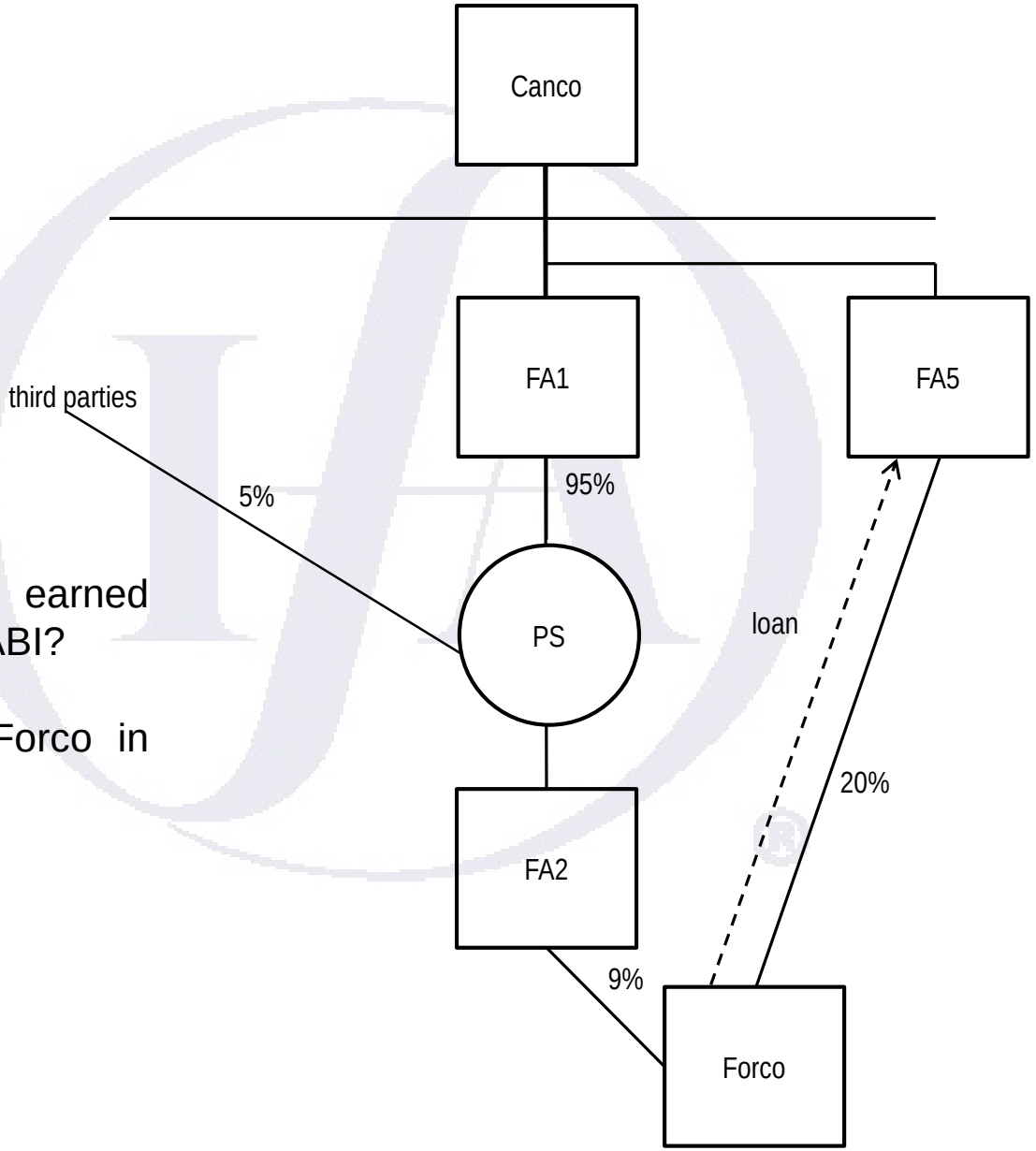
- Tiered partnership rule: subsection 93.1(3) (enacted in June 2013)
- Allows member of “top” partnership to be considered member of, and to have direct rights in, lower tier partnership
- Applies for the purpose of sections 90 to 95 and certain other provisions

Partnership Rules Improved

- FAPI computation rules: new subsections 93.1(5) and (6)
- Applies where a partnership has FAs and Canco or an FA of Canco is a partner
  - Canco and partnership must be "related", assuming partnership is a corporation with share ownership allocated by reference to FMV
- Allows FAs/QI FAs of Canco to be deemed to be FAs and QI FAs of the partnership
- Applies to post July 12, 2013 TYEs; can elect back to January 1, 2010

Partnership FAPI rule – Example

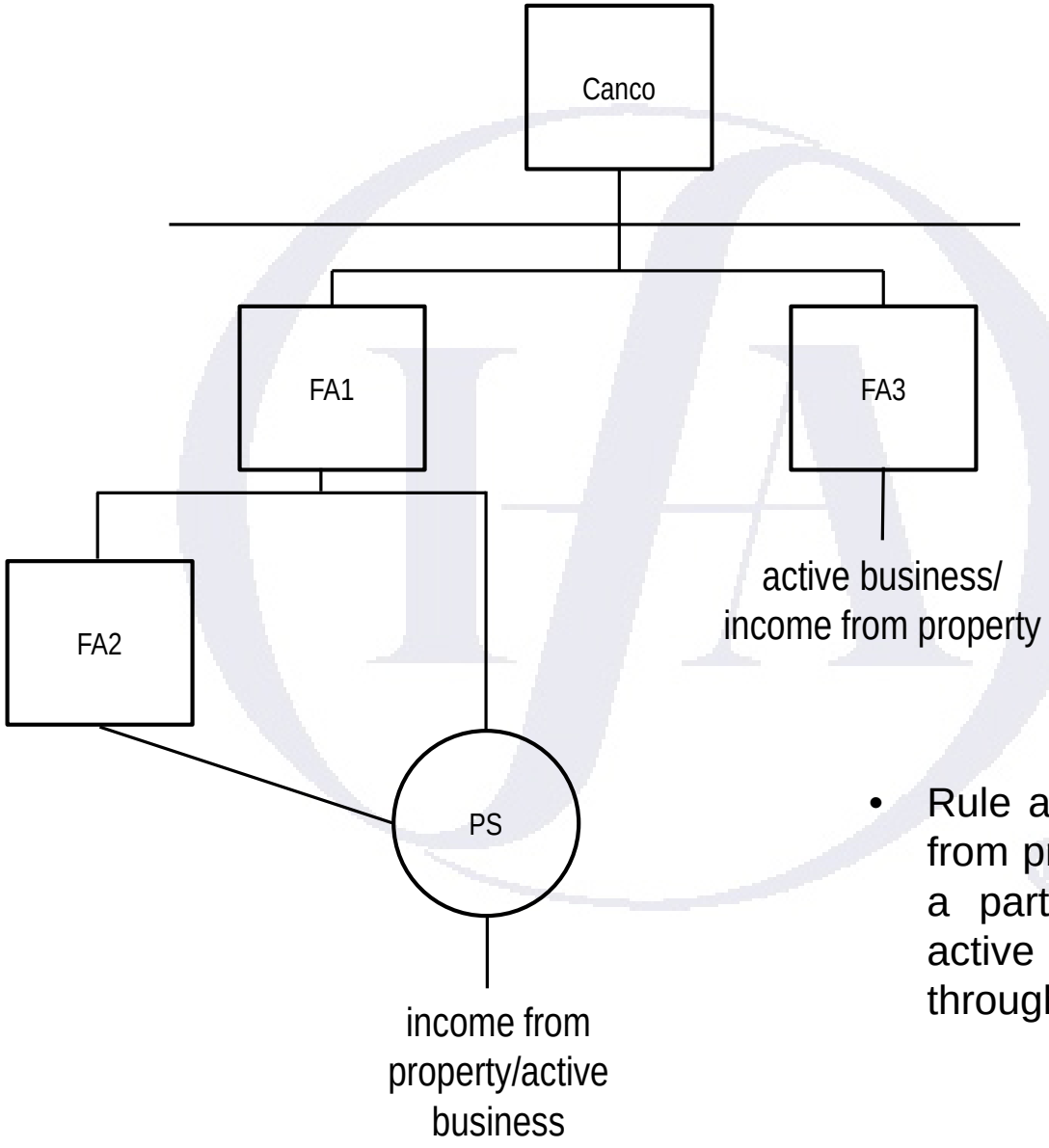
- Is interest income earned by Forco deemed ABI?
- QI FA status of Forco in relation to PS



Deemed active business income – 95(2)(a)(i)

- Applies to income that is directly related to active business activities of another FA
  - Would be included in other FA's active business income if earned by that other FA
- Amended to accommodate partnerships

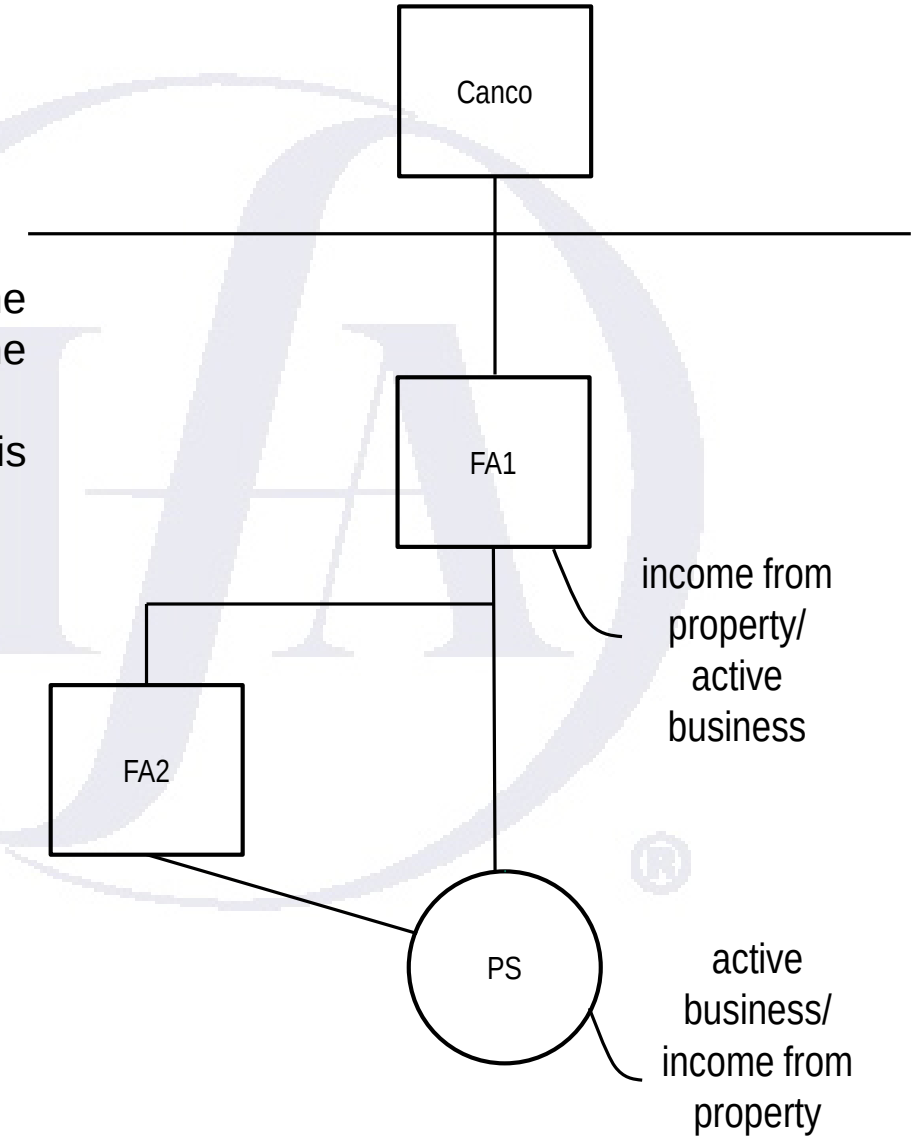
95(2)(a)(i) – Example 1



- Rule applies where the income from property is earned through a partnership and where the active business is carried on through the partnership

95(2)(a)(i) – Example 2

- Rule also applies where the income streams are in the same affiliate
- No “hypothetical” test in this scenario



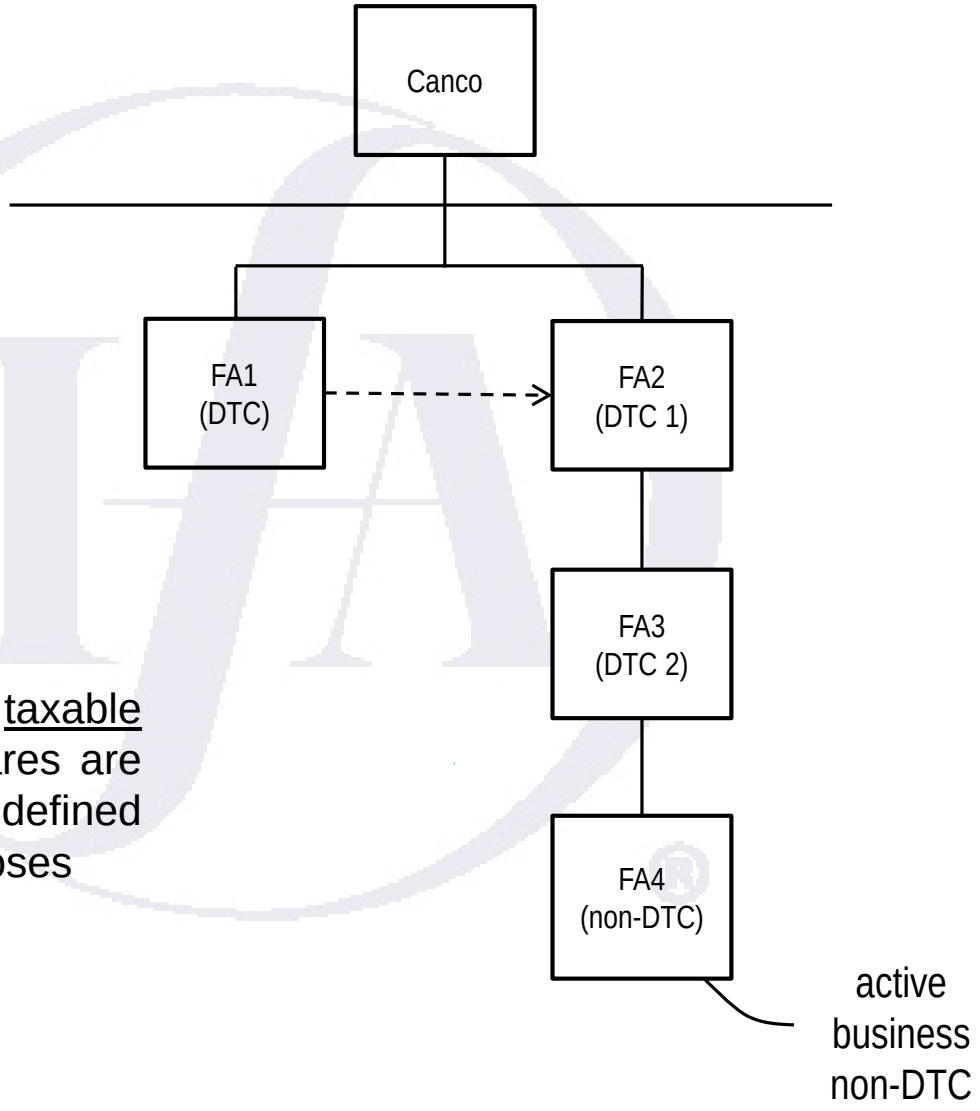
Deemed active business income – 95(2)(a)(ii)(D)

- Applies to interest paid to an FA by a "second affiliate" on
  - borrowed money used for the purpose of earning income from property, or
  - an amount payable for property acquired for the purpose of gaining or producing income
- The "property" must be excluded property shares of a "third affiliate"
- "Same country" requirement eliminated

Deemed active business income – 95(2)(a)(ii)(D)

- Second and third affiliates may now be resident in different countries
  - "subject to income taxation" requirement remains
- In order for deemed active business income to be included in exempt earnings:
  - each of the first, second and third affiliates must be resident in a designated treaty country; and
  - the excluded property test is read to refer to:
    - property used or held in an active business carried on in a treaty country; and
    - property that generates deemed active business income that is included in exempt earnings

95(2)(a)(ii)(D) – Example 1

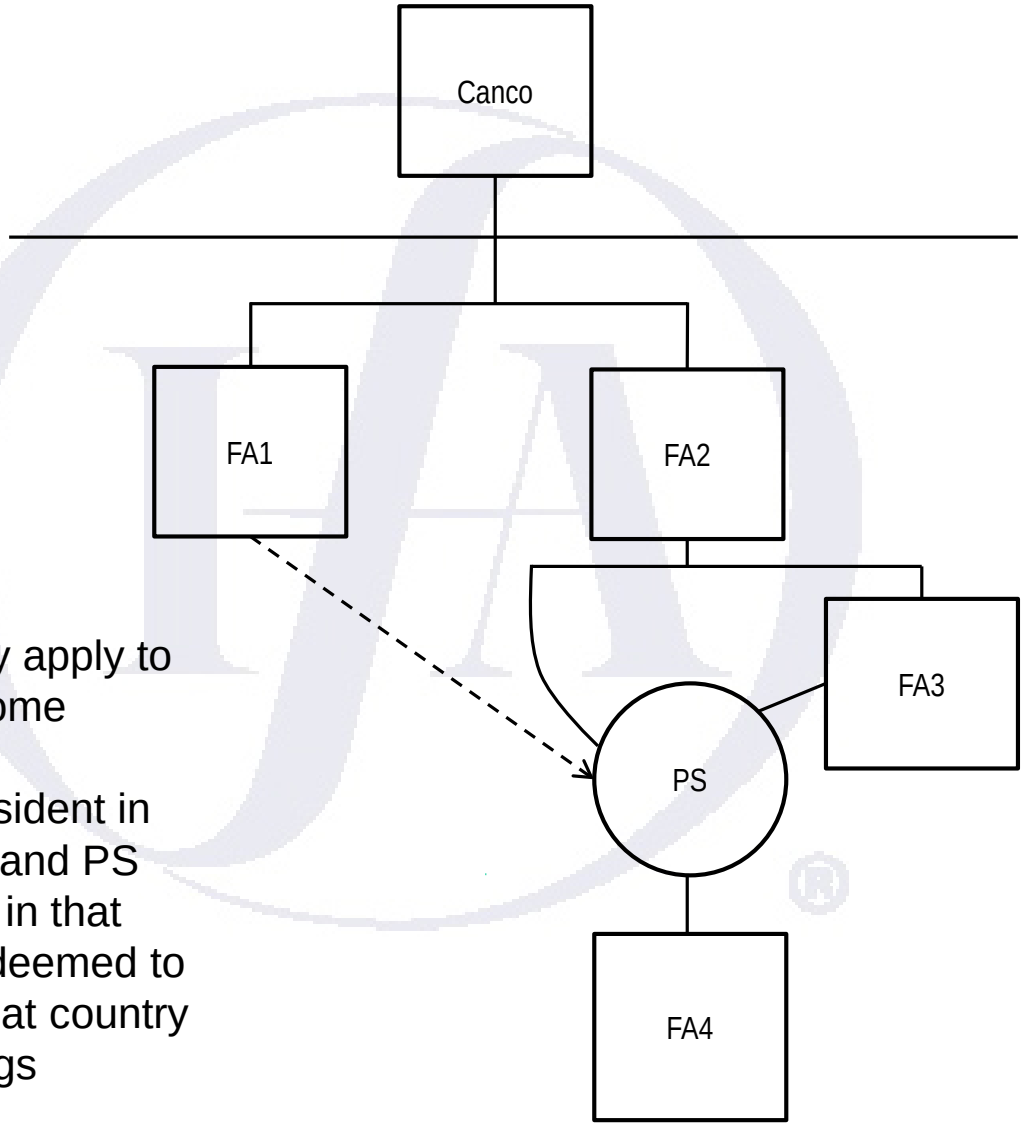


- 95(2)(a)(ii)(D) applies
- FA1's interest income is taxable earnings since FA3's shares are not excluded property as defined for exempt earnings purposes

Deemed active business income – 95(2)(a)(ii)(D)

- Partnership borrowing now accommodated: new subsection 93.1(4)
  - All the members of the partnership must be FAs of the taxpayer
- For the purpose of applying 95(2)(a)(ii)(D) to a payment by a partnership to another FA of the taxpayer (that is a member of the partnership or not)
  - the partnership is deemed to be a corporation without share capital, and the member interests are equity interests; and
  - the partnership is deemed to be resident in a country if all of the members are resident in that country and the partnership carries on business only in that country

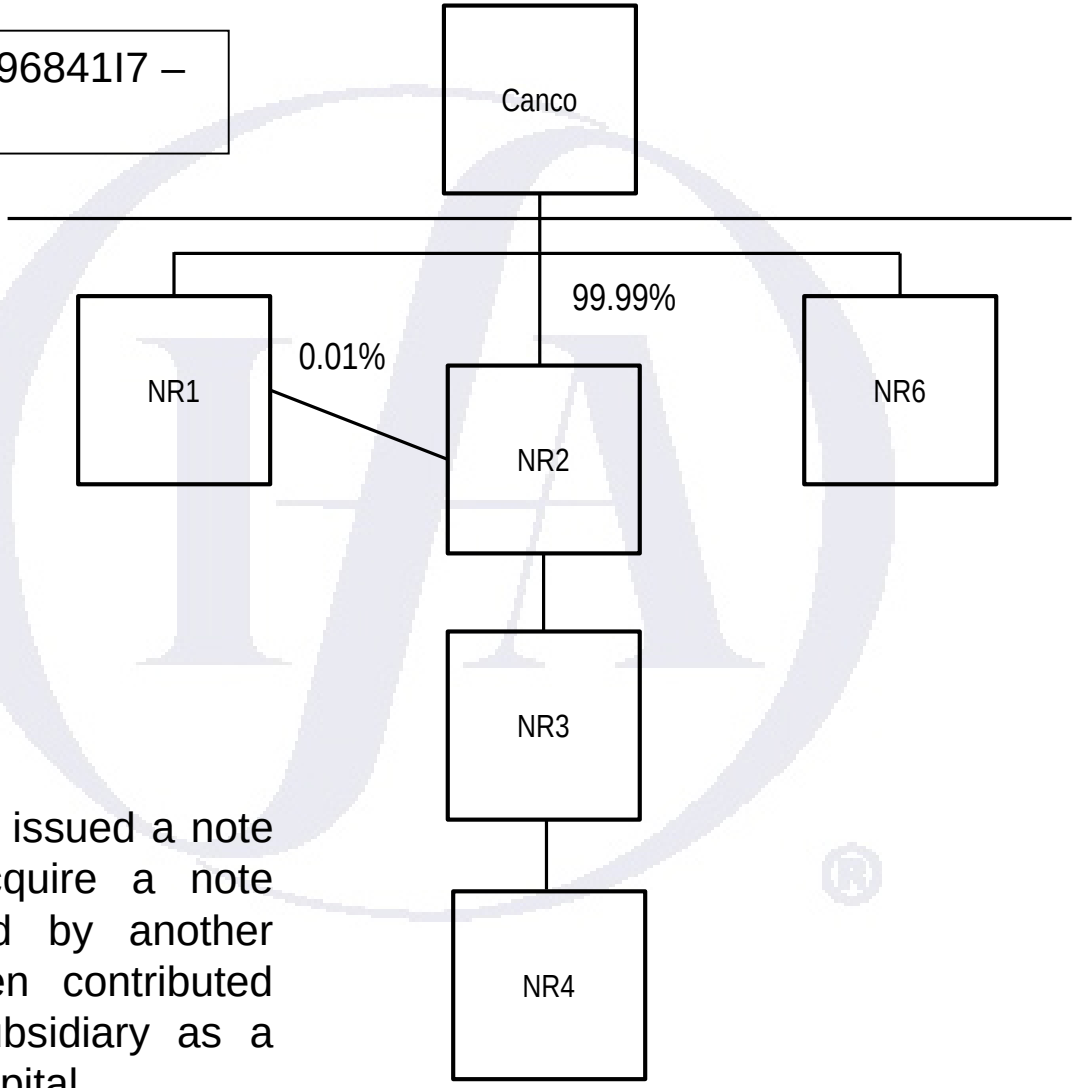
95(2)(a)(ii)(D) – Example 2



- 95(2)(a)(ii)(D) may apply to FA1's interest income
- If FA2 and FA3 resident in the same country and PS only has activities in that country, then PS deemed to be a resident of that country for exempt earnings purposes

Deemed active business income – 95(2)(a)(ii)(D)

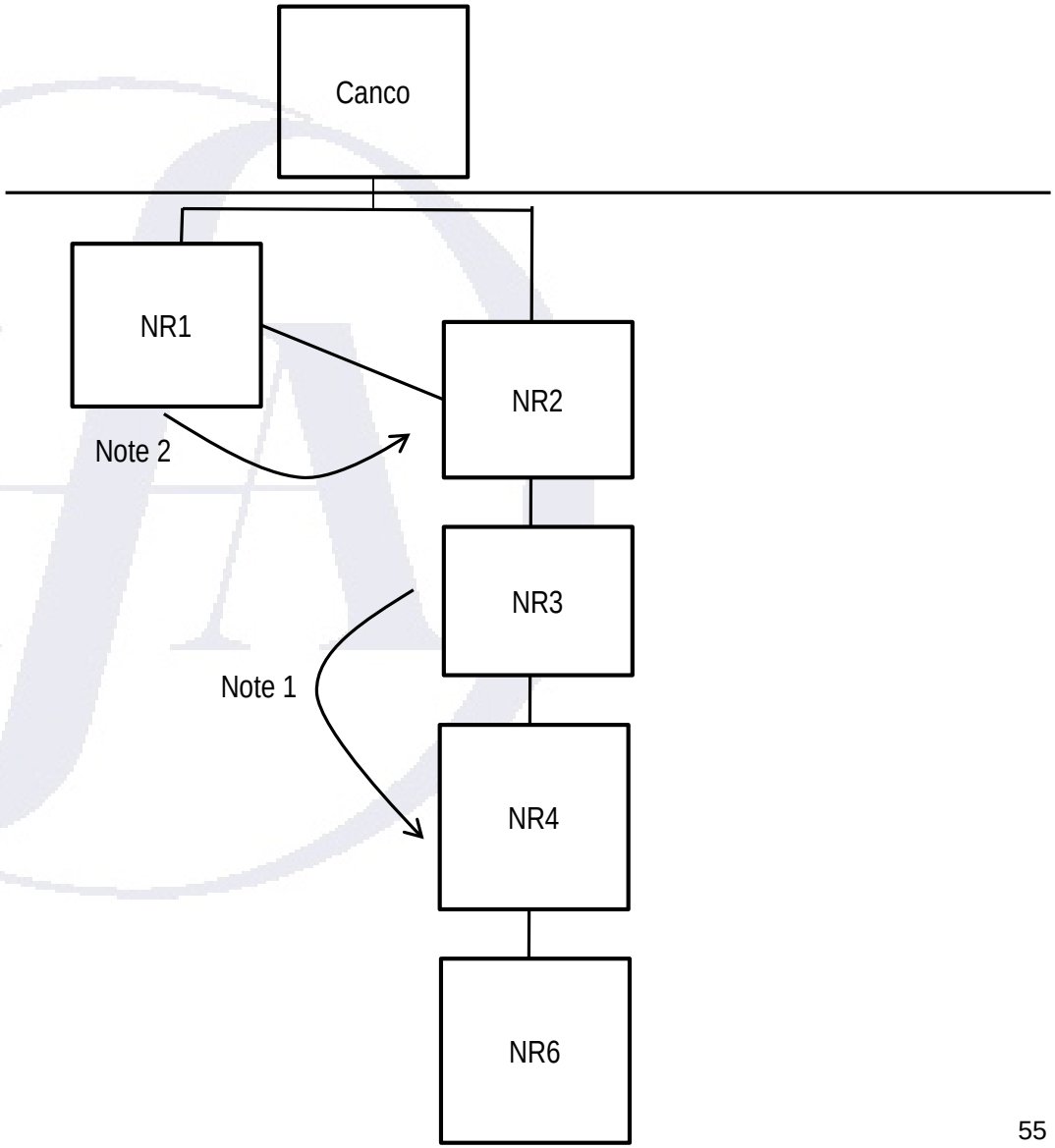
CRA Doc # 2013-049684117 – Beginning Structure



- A foreign affiliate issued a note (Note 2) to acquire a note (Note 1) issued by another affiliate and then contributed Note 1 to a subsidiary as a contribution to capital

Deemed active business income – 95(2)(a)(ii)(D)

CRA Doc # 2013-049684117 – Ending Structure



- CRA originally concluded Note 2 does not represent borrowed money and Note 2 is not paid for property that is FA shares (cont. to capital of NR3)
- CRA Doc # 2014-051980117 states "*Upon further consideration, we are of the view that subclause 95(2)(a)(ii)(D)(II) … applies" to the interest on Note 2*

BEPS: Interest Deductibility and CFC Report

Phil Halvorson

BEPS Action 4: Interest Deductions

- Objective:
  - "Develop recommendations regarding best practices in the design of rules to prevent [BEPS] through the use of interest expense…" (underline added)
  - "… The work will evaluate the effectiveness of different types of limitations." [1]

1. OECD (2013), Action Plan on Base Erosion and Profit Shifting

BEPS Action 4: Unanswered Questions

- What is the true objective?
  - Recommendations for ***best practices*** or ***minimum standards***?
- What would a "successful outcome" look like?

BEPS Action 4: Scope of Rules

- Who should rule apply to?
  - Multinational groups √
  - Domestic groups √
  - “Connected groups” √
  - Related parties / structured arrangements √
  - Stand-alone entities √ (?)

BEPS Action 4: Scope of Rules

- Apply to what debt?
  - Intra-group cross-border debt? √
  - 3rd party cross-border debt? √
  - Domestic intra-group or domestic 3rd party debt? √
  - "Debt-like" instruments or "interest-like" payments? √ (?)
  - Gross position or net position? *Consensus is net basis

BEPS Action 4: Ch VIII to X – Meat of the Report

- Various interest limitation options considered
- "Group-Wide Approaches":
  - Group-wide interest allocation rule
  - Group ratio rule
    - Income Statement or Balance Sheet approach?

BEPS Action 4: Ch VIII to X – Meat of the Report

- "Fixed-Ratio Approaches"
  - Balance-sheet approach (e.g., based on debt-to-equity fixed ratio)
  - Income-statement approach (e.g., based on level of interest-to-EBITDA or interest-to-assets fixed ratio)

BEPS Action 4: Ch VIII to X – Meat of the Report

- "Combined Approach"
  - Group-wide as a "primary rule" with a "fixed-ratio" secondary rule fallback
  - Fixed-ratio as primary rule with group ratio as fallback

BEPS Action 3: Strengthening CFC Rules - Overview

- Objective:

  "Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary." [1]

- Draft Report Released 3 April 2015
- Public Discussion forum 12 May 2015

1. OECD (2013), Action Plan on Base Erosion and Profit Shifting

BEPS Action 3: Structure of Report

- Discusses “building blocks” of CFC rules:
  - Definition of a CFC
  - Threshold requirements
  - Definition of control
  - Definition of CFC income
  - Rules for computing income
  - Rules for attributing income
  - Rules to prevent or eliminate double taxation

BEPS Action 3: Big Ticket Issues for Canada

- *Issue #1*: Scope
  - Paragraphs 18 & 19:
    - CFC rules should focus on "foreign-to-foreign" base stripping as well as stripping of the parent tax
  - How does this reconcile with Canada's rules?
  - How does this reconcile with footnote 49 in paragraph 101?

BEPS Action 3: Big Ticket Issues for Canada

- *Issue #2*: U.S. Proposal for Excess Profits Tax
  - Addresses BEPS by characterizing as CFC income *excess profits* in *low-tax jurisdictions*
  - Treats any portion of a CFC's income for a year that exceeds a "normal return" as attributable income (i.e., FAPI)
  - Purportedly targets returns from intangibles
  - Primary & secondary rule approach

BEPS Action 3: Big Ticket Issues for Canada

- *Issue #2*: U.S. Proposal for Excess Profits Tax (cont'd)
  - Points to be resolved:
    - What income is in scope?
    - How to define excess profits?
    - What is a "low-tax jurisdiction"?