May 28, 2015 IFA Conference – CRA Roundtable

Summary List of Questions

1. George Weston: impact on CRA's position re: hedges
2. GAAR and treaty shopping
3. Entity classification
4. Upstream loans – subsection 90(9)
5. Back-to-back loans: interpretation of "because" test
6. 95(2)(a)(ii)(D): reasons behind CRA's reversal
7. FA mergers and deficit double counting
8. 39(2.1) and functional currency tax reporting
9. 95(2)(i): can "proceeds" be something other than cash
10. 111(4)(e) election and 212.3
11. FA borrowing to pay a dividend
12. Swiss Treaty – Article 10

Question 1 – George Weston: impact on CRA's position re: hedges

The Tax Court of Canada recently rendered its decision in the George Weston Ltd. (GWL) case [*George Weston Limited v. The Queen* (TCC) 2015 TCC 42], which considered the income or capital characterization of the taxpayer's gains on foreign currency derivatives.

In 2001, the taxpayer borrowed significant funds to finance the acquisition of a U.S. based business (the "US Operations") by its indirectly held subsidiaries. Due to the risk of currency fluctuations, the taxpayer entered into a series of cross-currency swaps in order to protect against the impact of currency fluctuations on the translated value of the US Operations reported on its consolidated balance sheet. In 2003, the risk of currency fluctuations had been reduced and the taxpayer chose to terminate the swaps. The taxpayer realized a gain on the termination of the swaps and reported the gain on account of capital, which the CRA reassessed as being on account of income. The Court held in favour of the taxpayer finding the taxpayer entered into the swaps to hedge a capital investment and the gain was appropriately reported as being on account of capital.

The GWL case was not appealed. How does this decision impact the CRA's position with respect to foreign currency hedges for net investments in foreign operations and their characterization for income tax purposes?

Question 2 - GAAR and treaty shopping

Considering recent developments, can the CRA outline its position on the possible application of the GAAR to treaty shopping arrangements?

Question 3 – Entity classification

It is our understanding that the CRA generally follows a so-called "two-step" approach in classifying foreign entities or arrangements, as follows:

1. Determine the characteristics of the foreign entity or arrangement by reference to any relevant law and the terms of any relevant agreements relating to the entity or arrangement; and

2. Compare the characteristics of the foreign entity or arrangement to the characteristics of entities or arrangements that exist under Canadian law.

The classification of the foreign entity or arrangement for Canadian income tax purposes is then based on the entity recognized under Canadian tax law (i.e. a partnership, corporation, trust or co-ownership) that the foreign entity or arrangement more fundamentally resembles.

Can the CRA confirm that it still follows this “two-step” approach, and can you update us on any new entities or arrangements that are being considered?

Question 4 – Upstream loans: subsection 90(9) deduction

Part A

Assume the following:

- Canco directly owns all the shares of FA, a foreign affiliate;
- In 2013 FA made a US$100 loan (Loan 1) to Canco;
- FA’s currency for surplus purposes is the US$ and at the “lending time” in 2013 FA had exempt surplus and net surplus of US$100;
- In 2014 FA paid a dividend (Dividend) of US$50 at a time when it had exempt surplus and net surplus of US$150 (no Reg. 5901(2)(b) election is made);
- Loan 1 is not repaid within two years; and
- Canco has nil adjusted cost base (“ACB”) in the FA shares.

In 2014 Canco will have an income inclusion for the Canadian dollar equivalent (assume it’s C$63) of the US$50 dividend. Is Canco able to claim a deduction in each of 2013 and 2014 under clause 90(9)(a)(i)(A) for the Canadian dollar equivalent (assume it’s C$125) at the “lending time” of Loan 1? Will Canco be entitled to a deduction in computing its 2014 taxable income of C$63 under paragraph 113(1)(a)?

Part B

The facts are the same as in Part A except that FA’s exempt surplus balance went down to US$60 as a result of a loss in 2013 and at the time of the Dividend in 2014 Canco’s ACB in the FA shares was equal to C$63 as a result of a share subscription, in 2014 but before the dividend, by Canco into FA. Canco makes an election under Reg. 5901(2)(b) such that the 2014 C$63 dividend is deemed to be paid out of pre-acquisition surplus. Is Canco able to claim a deduction in each of 2013 and 2014 under clause 90(9)(a)(i)(A) of C$125? Is Canco able to claim a deduction in computing its 2014 taxable income of C$63 under paragraph 113(1)(d)?

Part C

The facts are the same as in Part A except that at the lending time in 2013 Canco’s ACB in the FA shares was C$63, no new exempt surplus is generated after Loan 1 is made and, instead of FA paying the US$50 dividend in 2014, FA made a second loan (Loan 2) to Canco of US$50 (which loan is not repaid within two years). Is Canco able to claim a deduction in each 2013 and 2014 under clause 90(9)(a)(i)(A) of C$125? Is Canco able to claim an additional deduction in

2014 of C$63 under clause 90(9)(a)(i)(D) on the basis that it could have made a Reg. 5901(2)(b) election in respect of Loan 2?

Question 5 – Back-to-back loans: interpretation of "because" test

The new back-to-back loan rules in subsections 18(6) and 212(3.1) of the Income Tax Act (the "Act") include a "because" test as the requisite degree of linkage, between a debt owing by the taxpayer to a creditor and a secondary obligation existing between that creditor (or someone not dealing at arm's length with that creditor) and certain non-residents, sufficient to potentially engage subsection 18(6.1) and 212(3.2), respectively. Can the CRA comment on how it interprets the "because" test?

Question 6 – Reasons for CRA's reversal of position on clause 95(2)(a)(ii)(D)

In document no. 2013-0496841I7 (the "First Document") the CRA took the position, in the context of a question from a TSO, that clause 95(2)(a)(ii)(D) did not apply to recharacterize interest on a debt issued to acquire a note that was subsequently contributed to the capital of another foreign affiliate without the receipt of shares. The CRA appeared to reverse that position in document no. 2014-0519801I7 (the "Second Document"), but gave no reasons. Could you now provide us with the reasons for this apparent reversal?

Question 7 – FA mergers and deficit double counting

Assume that Canco owns 100% of the shares of a foreign affiliate ("FA1"), FA1 owns 100% of the shares of a second foreign affiliate ("FA2"), and FA2 owns 100% of the shares of a third foreign affiliate ("FA3"). FA1 and FA2 merge to form "Merged FA" in a merger that qualifies as a "foreign merger" within the meaning assigned by subsection 87(8.1) of the Act, and the shares of FA3 become the property of Merged FA as a consequence of the merger. Further assume that immediately prior to the merger FA1 has an exempt surplus balance of $200, FA2 has an exempt deficit balance of $125, and FA3 has an exempt surplus balance of $150, and, upon the merger, FA2 ceases to exist. None of FA1, FA2 and FA3 has any other surplus/deficit balances. Finally, assume that section 93 has no application in respect of the merger.

Subsection 5905(3) of the Income Tax Regulations (the "Regulations") applies to determine the opening surplus balances of a foreign affiliate of a corporation resident in Canada where the foreign affiliate has been formed as a result of a foreign merger. This determination is based on the surplus balances of the predecessor corporations immediately before the merger. On the other hand, subsection 5905(7.2) of the Regulations applies when an upper-tier foreign affiliate of a corporation resident in Canada has an exempt deficit and any shares of a lower tier foreign affiliate in the same corporate chain are acquired by the corporation or by another foreign affiliate of the corporation. Subsection 5905(7.2) of the Regulations applies to achieve a result comparable with the result that would have occurred had a dividend been paid, immediately before the targeted transactions, to the extent necessary to "fill the hole" in the deficit affiliate.

This is effected by the reduction, under paragraph 5905(7.2)(a) of the Regulations, of the exempt surplus balance of the lower-tier affiliate and the reduction, under paragraph 5905(7.2)(b) of the Regulations, of the exempt deficit balance of the upper-tier affiliate. The latter adjustment is deemed to take place immediately after the acquisition. In the above case, both of the above provisions have application and due to the timing of the adjustments provided for under subsections 5905(3) and 5905(7.2) of the Regulations, it would appear that the deficit of FA2 would reduce not only the opening exempt surplus of Merged FA but the exempt surplus of FA3 as well.

Is it the CRA's view that Merged FA's opening exempt surplus as determined under paragraph 5905(3)(a) of the Regulations is $75 and, at the time specified in paragraph 5905(7.2)(a) of the Regulations, FA3's exempt surplus is reduced to $25? In other words, is it the CRA's view that in this case FA2's exempt deficit is effectively used to reduce both Merged FA's opening exempt surplus and FA3's exempt surplus?

Question 8 – Subsection 39(2.1) and functional currency tax reporting

Subsection 39(2.1) of the Act applies to reduce a capital gain or capital loss, as determined under subsection 39(2), where a corporation resident in Canada (the "borrowing party"), has received a loan from its foreign affiliate prior to August 20, 2011, a partial or full repayment of the loan is made prior to August 20, 2016, and the borrowing party's capital gain or loss matches the affiliate's capital loss or gain, as the case may be.

Assume that: (i) the borrowing party and its foreign affiliate are calendar year taxpayers; (ii) the borrowing party makes a functional currency election starting in 2014; (iii) the U.S. dollar is both the elected functional currency and the currency of the loan; (iv) the loan is on account of capital; and (v) the loan is repaid in 2015. In these circumstances, subsection 261(10) applies to deem the borrowing party to make a gain or sustain a loss, as the case may be, in 2015 relating to the loan's foreign currency fluctuations, vis-à-vis the Canadian dollar, that occurred in the time preceding the borrowing party's transition to the functional currency tax reporting regime.

Given that the matching condition for the application of subsection 39(2.1) requires that the borrowing party's capital gain or loss be determined under subsection 39(2), will subsection 39(2) apply to a gain that is "made" (by virtue of paragraph 261(10)(a)) or a loss that is "sustained" (by virtue of paragraph 261(10)(b)) in respect of the repayment of the loan?

Question 9 – 95(2)(i): can "proceeds" be something other than cash

Assume that a controlled foreign affiliate ("CFA") of a taxpayer has borrowed money from a bank in a currency other than Canadian dollars and has used all of that borrowed money to acquire a building which it uses at all times in its retail business. When the CFA repays the loan to the bank, a foreign exchange gain or loss may arise relative to the Canadian dollar. Generally,

such a gain or loss would result in foreign accrual property income or loss to the CFA which would be included in the income of the taxpayer on a current basis. However, because the CFA had used all of the money borrowed from the bank to acquire a property that it used at all times in its active business, the foreign exchange gain or loss, if any, would be deemed to be a gain or loss from the disposition of an excluded property and therefore, the CFA would have no resulting foreign accrual property income or loss.

The above result arises because paragraph 95(2)(i) provides that any income, gain or loss of a foreign affiliate debtor (or a partnership of which a foreign affiliate is a member) is deemed to be income, gain or loss from the disposition of excluded property if it arose on the settlement or extinguishment of certain debts. More specifically, paragraph 95(2)(i) applies in circumstances where all or substantially all of the proceeds of a debt of the debtor had been used at all times to earn income from an active business carried on by the debtor or to acquire property that had been excluded property of the debtor at all times that the debt had been outstanding to the debtor.

Given that paragraph 95(2)(i) specifically refers to the use of the proceeds of a debt by a foreign affiliate, it is not entirely clear whether the provision would apply to the settlement of an indebtedness that had not given rise to borrowed money. In the above example, the CFA had received borrowed money on its bank loan and, therefore, had received proceeds from that debt which it used to acquire excluded property. However, would paragraph 95(2)(i) apply if the CFA had acquired the building from a third party by issuing a note?

More generally, in the CRA's view, can paragraph 95(2)(i) apply in respect of an amount payable for property acquired?

Question 10 – 111(4)(e) election and 212.3

Following an acquisition of control, paragraph 111(4)(e) permits a taxpayer to make a designation in respect of certain capital property in order to deem a disposition and reacquisition of that capital property. Generally, this designation may be beneficial to a taxpayer in circumstances where the taxpayer has a capital property with accrued gains and also has capital losses which would otherwise expire after the acquisition of control.

Subject to certain exceptions, the foreign affiliate dumping rules in section 212.3 are designed to deter Canadian subsidiaries of foreign-based multinational groups (herein "foreign controlled CRICs") from making investments in non-resident corporations that are, or become as a result of the investment or a series of transactions that includes the investment, foreign affiliates ("FAs") of the foreign controlled CRICs in situations where these investments can result in the inappropriate erosion of the Canadian tax base. In general terms, the application of the foreign affiliate dumping rules results in deemed dividends paid by the foreign controlled CRICs subject to non-resident withholding tax or in reductions of the paid-up capital of cross border shares of the foreign controlled CRICs.

Assume that, prior to an acquisition of control of a taxpayer, the taxpayer was controlled by a non-resident corporation ("old parent") such that it was a foreign controlled CRIC. Assume further that it held the common shares of an FA. Following the acquisition of control of the

taxpayer, the taxpayer made a paragraph 111(4)(e) designation in respect of the common shares of the FA such that the taxpayer was deemed to have disposed of, and reacquired, the FA shares immediately before the time that is immediately before the time of the acquisition of control.

In the CRA's view, would the deemed reacquisition of the common shares of the FA by the taxpayer result in the application of the foreign affiliate dumping rules?

Question 11 – FA borrowing to pay a dividend

Paragraph 95(2)(a) of the Act re-characterizes, in various circumstances, amounts that would otherwise be income from property of a foreign affiliate as income from an active business. Provided all the other requirements for the application of clause 95(2)(a)(ii)(B) are satisfied, it applies to income derived by a foreign affiliate from amounts paid or payable by another foreign affiliate provided the amounts paid or payable were for expenditures that were "deductible" by that other affiliate in computing the amounts prescribed to be its earnings or loss from an active business.

Assume that a foreign affiliate (the "Borrower FA") of a taxpayer resident in Canada carries on an active business in a country other than Canada. Borrower FA does not carry on any other income earning activity. Borrower FA borrows money from another foreign affiliate (the "Lender FA") of the taxpayer to pay a dividend. The amount of the dividend does not exceed the accumulated profits of Borrower FA which are currently used by Borrower FA to earn income from its active business. Assuming all other necessary conditions for clause 95(2)(a)(ii)(B) are met (e.g., qualifying interest, etc…), does the CRA view the interest as deductible by Borrower FA in computing the amount prescribed to be its earnings or loss from an active business such that the interest will be included in computing the active business income of Lender FA?

Question 12 – Canada-Switzerland Tax Convention: Article 10(2)(a)

Article 10(2)(a) of the Canada-Switzerland Tax Convention (the "Swiss Treaty") restricts Canada's right to tax dividends paid by Canadian-resident companies to Swiss-resident companies to a maximum of 5 per cent of the gross amount of the dividends if, *inter alia*, the dividends are paid to a company that "owns at least 10 per cent of the voting stock and of the capital of the company paying the dividends". However, in the French version of the Swiss Treaty, which is stated to be "equally authentic", the rule seems to read differently. Specifically, it appears that the company receiving the dividends needs to "contrôle directement ou indirectement au moins 10 pour cent des droits de vote et au moins 10 pour cent du capital de la société qui paie les dividendes", meaning that the Swiss-resident company needs to "control directly or indirectly at least 10 per cent of the voting rights and of the capital" of the Canadian-resident company.

Assume a corporation resident in Switzerland (“Swissco”) owns all of the shares of another corporation (“Holdco”) which, in turn, owns all of the shares of a corporation resident in Canada (“Canco”). Assume further that paragraph 214(3)(a) of the Act applies to deem Canco to pay a dividend to Swissco. It appears that the rate of withholding tax would be 15% if one applies the English version of the Swiss Treaty but it would be reduced to 5% if one were to apply the French version.

Could the CRA provide us with its views as to the proper application of Article 10(2)(a) of the Swiss Treaty in these circumstances?