HOLDING COMPANIES UPDATE AND REPATRIATION PLANNING

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INTRODUCTION

The use of intermediary or holding companies by Canadian-based multinationals is commonly recognized as one of the fundamental building blocks of international tax planning. This broad topic has been extensively canvassed by commentators in this and other tax publications. In this paper, I briefly review the benefits and considerations in using holding companies and provide an update on certain recent foreign tax developments of interest in common holding company and "source" jurisdictions. I also highlight specific proposed changes to the Canadian foreign affiliate regime that could affect holding companies and repatriation planning.

HOLDING COMPANIES

Structure

The general structure that this paper deals with is reflected in figure 1. A Canadian-based multinational corporation owns one or more foreign affiliates through a common non-Canadian holding company often located in a different jurisdiction from that in which the operating companies carry on business. The paper focuses on dealing with foreign affiliates carrying on an active business; such business may be carried on in a jurisdiction with which Canada has a treaty, a tax information exchange agreement (TIEA) once such agreements have been ratified, or no treaty where the taxes paid may be nominal or, alternatively, may be significantly in excess of the effective Canadian tax rate that would have applied if the income had been earned in Canada.

Benefits of Using Holding Companies

The tax reasons for using intermediary or holding companies can be grouped into three main categories:

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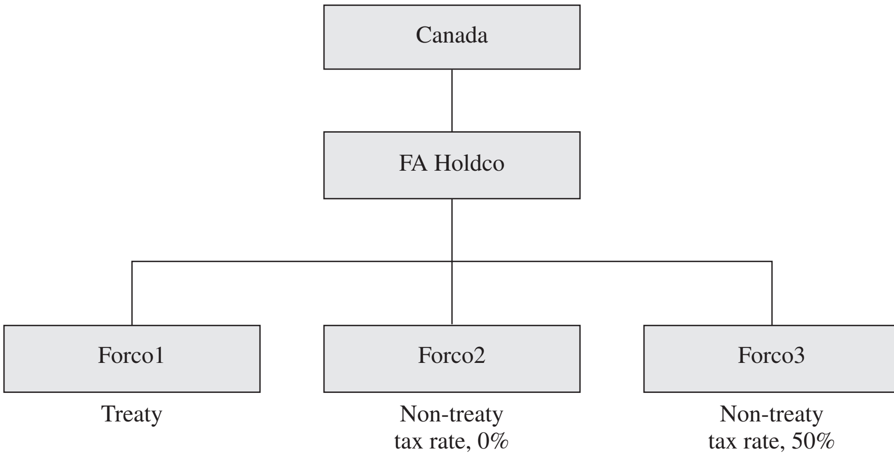
Figure 1



1. to facilitate the redeployment of cash within a foreign affiliate group without resulting in a distribution to the Canadian parent and the attendant tax and compliance implications,
2. to defer Canadian or foreign tax on the sale of foreign affiliate shares, and
3. to reduce foreign (source country) tax withholdings on distributions from and gains on the disposition of foreign affiliate shares.

Holding companies facilitate the redeployment of cash. Foreign subsidiaries can pay dividends to the holding company and the holding company can reinvest the cash in subsidiaries that need cash or use it to acquire new targets. Dividends received by a Canadian corporation from its foreign affiliates are often "exempt" from tax,[1] but this is not the case for subsidiaries that operate in non-treaty/non-TIEA countries and are subject to tax at rates lower than the Canadian rate. In such cases the subsidiaries generate "taxable surplus" that, when distributed as a dividend, is taxable to the Canadian corporation with a grossed-up deduction (an effective credit) for foreign corporate taxes and withholding taxes paid on the related earnings and dividends. Using a holding company in such situations allows the cash generated by these affiliates to be reallocated in the group without causing any immediate Canadian tax.

A holding company can also be used to manage the order of surplus distributions to maximize the use of exempt surplus pools or underlying foreign tax (which gives rise to a grossed-up deduction in Canada), a strategy discussed in more detail below.

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[1] For Canadian tax purposes, dividends from "exempt surplus" are initially included in income and then fully deducted under paragraph 113(1)(a) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

Holding companies are also commonly used to defer Canadian tax on the disposition of foreign affiliate shares. Unlike the treatment of dividends, the Canadian tax system currently does not provide a participation exemption for capital gains realized by a Canadian corporation from the disposition of foreign affiliate shares, although such an exemption has been recommended by the report of the Advisory Panel on Canada's System of International Taxation.[2] An election is available to effectively reduce the gain otherwise taxable by the amount of exempt surplus and taxable surplus accumulated in the affiliate sold and any lower-tier affiliates,[3] but 50 percent of any gain in excess of such surplus is taxable. Furthermore, to the extent a deemed distribution of taxable surplus is elected, such distribution will itself be taxable unless the affiliates have sufficient underlying foreign tax.

On the other hand, if the shares are sold by a foreign holding company, no immediate Canadian tax arises as long as all or substantially all (generally interpreted as greater than 90 percent) of the assets of the subsidiary (and any lower-tier entities) consist of assets used in an active business or assets that generate "deemed"[4] active business income.[5] This treatment allows for the proceeds from the sale to be reinvested without incurring any immediate Canadian tax. The taxable capital gain from such sale is included in taxable surplus and thus will be taxed if ever repatriated to Canada; such repatriation typically can be deferred, particularly if the multinational is expanding internationally.

If a holding company is to be used for this purpose, care must be taken if foreign affiliates are transferred to the holding company for shares, because the rollover provision that typically allows the tax-deferred transfer of one foreign affiliate to another[6] does not apply where the transfer is part of a series of transactions for the purpose of disposing of the shares to a third party that is not a foreign affiliate, where the shares transferred are excluded property.[7] This issue may be avoided if the holding company acquires or forms the operating foreign affiliate from the outset.

A primary reason for using a holding company is to reduce or eliminate tax withholdings in the source jurisdiction on distributions from and gains on the disposition of shares of the foreign operating company. The reduced withholdings typically arise because the holding company jurisdiction has tax treaties with the

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[2] Canada, Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008).

[3] Subsection 93(1). The computation of the surplus balances for purposes of this election can be quite complex if the group disposed of has numerous affiliates. Discussion of this topic is beyond the scope of this paper.

[4] Paragraph 95(2)(a) provides rules that recharacterize certain otherwise passive income derived from interaffiliate payments or related activities as active if certain conditions are met.

[5] Subsection 95(1)—"excluded property." Note that shares of a lower-tier affiliate qualify as excluded property as long as that affiliate itself meets the 90 percent test.

[6] Subsection 85.1(3).

[7] Subsection 85.1(4).

source jurisdictions (or a more favourable tax treaty than the treaty between the source and home jurisdictions). For European operations, the reduced withholdings usually arise because the holding company jurisdiction is a member of the European Union (EU) and thus benefits from the EU "parent-subsidiary" directive apply, which typically results in a zero percent withholding tax rate on dividends paid to another EU country, provided certain ownership and holding period thresholds are met.

Using a centralized holding company can also have non-tax benefits, such as facilitating cash management (through centralized administration) and centralizing certain head office functions that are most efficiently managed at the regional level. These benefits vary from case to case, and identifying them can help establish a non-tax motive and "business substance" for the holding company, which may be important to prevent the application of anti-abuse rules in the source jurisdiction.

Finally, if the Canadian taxpayer is a private company, the use of a holding company to defer the Canadian tax on a sale of the operating companies may not be advantageous if the proceeds are to be distributed to Canadian resident individuals. If the Canadian private corporation is the vendor, the non-taxable portion of the capital gain increases the capital dividend account of the vendor, which can be distributed to Canadian resident individuals free of tax. On the other hand, exempt surplus[8] distributed to a Canadian private company increases the "general rate income pool" that can be distributed as an "eligible dividend." However, such a dividend will still be subject to tax at rates from about 24 to 26 percent when received by a Canadian-resident individual instead of the zero percent rate that applies to a capital dividend.

Considerations in Using Holding Companies

Although holding companies can achieve substantial tax benefits, numerous issues need to be considered from the Canadian, source country, and holding jurisdiction perspectives.

From a Canadian perspective, the key considerations are that the intermediary entity is a corporation applying Canadian legal principles and that "central management and control" of the holding company must be maintained outside Canada. Typically, central management and control refers to the place where the board of directors meets and makes its decisions.[9] If the actual conduct of the taxpayer does not support the location of central management and control, there may be a risk that the holding company is resident and subject to tax in Canada, and thus the anticipated Canadian tax benefits may not be realized. Although treaties may set out residency tie-breaker provisions, many of Canada's treaties with common holding company jurisdictions refer to factors such as "place of effective management"

[8] The non-taxable portion of the capital gain realized by a foreign affiliate holding company is included in exempt surplus.

[9] A review of the case law and administrative positions related to this concept is beyond the scope of this paper.

(akin to the Canadian common-law criterion of central management and control) or leave the determination to the competent authorities. Such treaties do not provide certainty if the location of central management and control is in doubt. As a result, it is recommended that the holding company have a majority of non-resident directors (preferably residents of its country of formation) with the appropriate authority and that board meetings be held regularly and in person in the desired location.

Some source jurisdictions impose specific "substance" requirements in their domestic legislation or tax treaties. These requirements typically aim to prevent the use of a holding company to reduce tax withholdings in those countries, unless the holding company has substantial business operations or is not principally formed to reduce taxes. A well-known example is the "limitation-on-benefits" (LOB) article found in almost all tax treaties to which the United States is party. These articles generally deny treaty benefits to intermediary companies unless:

- the intermediary company (or related companies) carries on an active business in its country of formation and the US source income is derived in connection with or incidental to that active business, or
- the holding company meets a derivative benefits test that generally tests whether a reduction in US withholding tax is achieved by the interposition of the intermediary.

The actual conditions are complex and vary from treaty to treaty.[10]

Even in countries that do not have specific anti-avoidance rules, the tax authorities may challenge holding companies under general anti-avoidance rules or doctrines, such as "substance over form," "abuse of law," "abuse of treaties," and similar concepts.

From the perspective of the holding company jurisdiction, the specific requirements to achieve participation exemption need to be carefully considered. Many jurisdictions have minimum ownership thresholds (typically 10 percent or more) and holding period requirements (often 12 months or more[11]) that must be met to achieve exemption. Some jurisdictions also have minimum tax requirements for the subsidiaries (e.g., Luxembourg, Singapore, Spain), rules denying the exemption where "passive" income or assets in the subsidiaries exceed certain thresholds (e.g., Austria, the Netherlands, Spain), or a combination of both. The downside of failing to meet these tests is usually significant because most common holding company jurisdictions have high tax rates for income not benefiting from the participation exemption. These requirements must be carefully considered when choosing a holding company location, and they must be continuously monitored once the holding company is in place.

[10] An analysis of these provisions is beyond the scope of this paper.

[11] In some cases, this period may be met after a distribution is received or the period may include the period of ownership by a related company before the share transfer.

Choice of Jurisdiction

Choice of jurisdiction is influenced by both tax and non-tax criteria and depends greatly on the "source" jurisdictions that are to be held under the common holding company. Some general guidelines are described below.

Tax Criteria

The most important tax criterion in choosing a holding company jurisdiction is that it generally provides for a full exemption for both dividends from and gains on the disposition of shares of the foreign subsidiaries (i.e., a "participation exemption"). Most holding company jurisdictions provide such an exemption, though some only exempt 95 percent of dividends and gains (e.g., Belgium, France, Germany), which can typically be managed by offsetting operating expenses or interest expense.

As noted, there are significant differences across jurisdictions in the criteria to achieve exemption. Most jurisdictions require some sort of minimum ownership threshold and holding period. Some have more extensive requirements, such as minimum tax levels in the operating companies and/or a requirement that no more than a certain percentage of assets or revenues be derived from "passive" activities.

Another important criterion is that the holding company jurisdiction should impose a low or nil withholding tax rate on dividends paid by the holding company to its Canadian parent and on capital gains realized by the Canadian parent from a disposition of the shares of the holding company.

The holding company jurisdiction should have an extensive treaty network or at least have treaties with the countries that are intended to be held by the intermediary. Specific emphasis should be put on which treaties achieve the lowest dividend withholding rates and most favourable capital gains tax treatment for the source country under consideration. Obviously, treaties that allocate the taxation rights for capital gains solely to the residency country (i.e., the holding company) are preferred, though for some countries this may be difficult or impossible to achieve.

Jurisdictions that impose complex requirements on the participation exemption should be avoided due to the additional risk and compliance burden. Such requirements include "minimum tax" requirements, which must often be computed as effective tax rates based on income computed under the tax rules of the holding company jurisdiction and "active business" income or asset requirements.

For the same reason, jurisdictions that have "controlled foreign company" (CFC) rules (i.e., similar to Canada's foreign accrual property income [FAPI] rules) should be avoided, as otherwise there can be multiple layers of tax on the same passive income. Though such rules can initially be managed by managing the type of entities transferred below the holding company, inadvertent tax exposures can be created due to events in the ordinary course of business (such as the accumulation of excess cash) or due to the complexity of such rules.

Although income taxes are typically the primary consideration, indirect taxes also need to be considered, including:

- capital/stamp duties, which are taxes imposed on the issuance of shares and/or an increase in capital (sometimes also a reduction in capital); and
- annual "net worth" taxes, which are an annual levy based on the value of assets or equity.

These types of taxes used to be the norm in most common holding company jurisdictions because they served to raise revenues from companies that otherwise paid no tax (due to the participation exemption). As competition between jurisdictions for the location of holding companies has increased, these taxes have often been reduced or abolished in recent years (e.g., capital duties in the Netherlands and Luxembourg). Some remaining examples include the annual net worth tax in Luxembourg and the stamp duty in Switzerland. Planning or specific exemptions are often available to mitigate the impact of these taxes, but can be complex or involve restrictions such as minimum holding periods. In other cases, a simple solution is to contribute cash to a share premium account rather than to registered capital, which often results in capital duty savings. Before the recently proposed changes to the foreign affiliate rules, this solution often led to uncertainty on the Canadian tax treatment of distributions made from this balance unless the amount was first converted to paid-up capital, triggering the capital duties, or the distribution could be treated as a dividend under foreign tax law.

Finally, the ability to obtain binding tax rulings, the flexibility of the tax authorities in administering rulings, and the tax system more generally are important factors (though generally less so for holding companies than for other types of intermediaries, such as financing companies).

Non-Tax Criteria

A stable political and economic environment is an important factor in selecting a holding company jurisdiction. Stability refers not only to a lack of political and social unrest but also to consistency of the country's policies toward holding companies and multinationals in general. Certain jurisdictions, such as Luxembourg and the Netherlands, have long track records of enacting and maintaining business-friendly tax and commercial legislation and thus there should be relatively little risk of sudden adverse legislative or administrative changes that would require the structure to be unwound.

A related criterion is whether the country has a flexible and business-oriented tax administration and other regulatory bodies. Typically, "traditional" holding company jurisdictions have a tax administration that is generally supportive of foreign investors, which translates into efficient resolution of potential tax issues through rulings or other means.

The presence of well-established service providers, including law firms, banks, and management services companies, is also important. Along the same lines, language is often a consideration and thus often leads to preferences in dealing with a certain

jurisdiction such as using Spain for a holding company for investments into Latin America.

Proximity to either the head office or local operating subsidiaries and ease of travel to and from these locations are also important. Generally, it is better to select a jurisdiction in which the multinational already has operations, which makes it easier to establish "substance" for foreign tax purposes and "mind and management" for Canadian purposes. If this is not possible, then a location close to those countries is still desirable.

Finally, corporate law and other non-tax regulations should be considered. Certain jurisdictions have inflexible corporate laws that make distributions more difficult and create additional administrative costs. These constraints include requirements for statutory audits, inability to pay interim dividends or requirements for interim audits before dividends can be paid, restrictions on payments of dividends in excess of retained earnings, and requirements for court approval for capital reductions, mergers, liquidations, and other corporate actions.

RECENT CHANGES IN SELECTED HOLDING COMPANY REGIMES

This section discusses some recent legislative developments of interest in selected favourable holding company jurisdictions.

United Kingdom

Historically, the United Kingdom was somewhat of an exception within Europe in how it taxed foreign income. Most European countries provide for a full or near-full participation exemption on dividends. The United Kingdom has a foreign tax credit system under which dividends are fully included in income, and a credit against UK tax is provided for any underlying tax paid by the subsidiaries and tax withheld on the dividends.

Due to concerns about the competitiveness of the UK tax regime and certain high-profile corporate "inversions" into Ireland, the United Kingdom introduced a dividend exemption system that took July 1, 2009. The exemption applies broadly, subject to specific exceptions and anti-avoidance rules, and includes portfolio dividends (i.e., no minimum ownership threshold). One exception applies where the dividend is tax-deductible to the payer company, effectively preventing exemption on certain hybrid instruments treated as debt in the payer's country or certain tax regimes (e.g., Luxembourg securitization vehicles) that permit a deduction for dividends. Exemption is generally available where:[12]

1. dividends are paid by a controlled subsidiary (unless the dividend is tax-deductible);

[12] HM Revenue and Customs, "Taxation of the Foreign Profits of Companies," draft provisions, December 2008.

2. dividends are paid on non-redeemable "ordinary shares" (i.e., shares without any preference rights either to distributions or on liquidation);
3. dividends are paid on portfolio holdings (generally, less than 10 percent shareholding); and
4. other dividends are paid where the transactions giving rise to the profit did not have a reduction of UK tax as one of their main purposes.

A specific "targeted anti-avoidance rule" denies the exemption where one of the main purposes is to create a UK tax benefit and one of the following situations is present:

1. common shares are preference shares in substance due to the presence of side arrangements;
2. the dividend is received in return for a payment made or the taxpayer or a related person foregoes the income;
3. goods or services are not charged at an arm's-length price because one party expected to receive a dividend;
4. transactions to achieve the exemption where profits from which the dividend was paid were not subject to the UK controlled foreign corporation rules because the ownership of the foreign company was manipulated; or
5. dividends form part of an arrangement that produces an "interest-like" return for the recipient together with related persons.

Some of these rules have equivalents under the Canadian foreign affiliate regime. For example, situations (1) and (5) are similar to the rules in subsections 258(3) and (5) of the Act, which deem dividends in certain cases to be interest on "term preferred shares" owned by a financial institution and certain "guaranteed" shares. Situation (4) is similar to paragraph 95(6)(b) of the Act, which may deny foreign affiliate status (and thus exempt surplus treatment) where the principal purpose for the acquisition is to permit any person to avoid, reduce, or defer tax.

With the introduction of the participation exemption, the UK proposals also introduce interest deductibility restrictions in the form of a "worldwide debt cap." A discussion of these rules is beyond the scope of this article.

Current UK tax law already provides for a participation exemption for capital gains in the form of the "substantial shareholdings exemption." Furthermore, the United Kingdom does not levy withholding tax on outbound dividend payments to corporate shareholders. As a result, with the introduction of the dividend exemption, the UK tax system now fulfills the basic criteria for a good holding company jurisdiction. The United Kingdom also benefits from a wide treaty network. Accordingly, the United Kingdom should be considered a viable alternative for holding companies. Nevertheless, the UK tax system does have significant downsides, such as comprehensive CFC rules and rules regarding reportable transactions, complicated anti-avoidance rules, and restrictions under corporate law regarding distributions.

Luxembourg

Luxembourg is a traditional holding company jurisdiction due to its long-standing participation exemption, well-established ruling system, and consistent, business-friendly tax policies and administration.

Luxembourg has been made more attractive in the last two years by the abolition of the capital duty that used to apply to share issuances and capital contributions (historically 1 percent, then reduced to 0.5 percent) and, as of January 1, 2009, by the abolition of withholding tax on dividends paid to corporate shareholders resident in treaty countries.[13] The latter exemption does not apply to non-corporate shareholders (such as individuals or trusts) and may not apply to certain corporate shareholders that are treated as tax-transparent in their country of residence (e.g., US S corporations).

Luxembourg offers a favourable participation exemption with relatively few restrictions (e.g., a one-year holding period), no CFC rules, and no requirements that the subsidiaries meet certain income character or asset tests. One potential disadvantage is that for subsidiaries resident outside of the EU, a minimum tax requirement of 11 percent applies. This may make Luxembourg unattractive for holding investments in low-tax entities outside the EU. Another potential disadvantage is that the annual net worth tax of 0.5 percent of the prior year's equity remains in force, though this tax is generally a minor cost for holding companies because investments in qualifying participations are exempt (i.e., only equity in excess of the book value of the investment in participations is exposed to this tax). Although Luxembourg has a broad treaty network, it does not have a treaty with a number of significant countries, and it has less favourable treaties with certain other significant countries than perhaps the Netherlands.

Netherlands

Similar to Luxembourg, the Netherlands has a generous participation exemption with few conditions. Unlike Luxembourg, the Netherlands generally does not impose a subject-to-tax requirement on the earnings of the foreign subsidiary, as long as the subsidiary is active. An exception applies where generally more than 50 percent of the subsidiary's assets consist of "passive" investments and the subsidiary is not taxed at an effective rate of at least 10 percent computed under Dutch tax principles. If these conditions are met, dividends derived from such entities are fully included in income with a credit for underlying taxes paid.

Dividends paid by a Dutch corporation (BV or NV) are subject to withholding tax at a domestic rate of 15 percent, reduced to 5 percent under the Canada-Netherlands tax treaty. This tax can be avoided by using a Dutch co-operative ("co-op") either alone or in between Canada and the Dutch holding company. A co-op is a non-

[13] Even before this abolition, planning was available—and commonly used—to reduce the withholding tax to nil.

corporate association that is treated as a separate legal entity. It is subject to the same tax rules as a regular corporation except that dividend withholding tax does not apply to distributions made by a co-op to its members. A co-op is a flexible business vehicle that can be structured to qualify as a corporation for Canadian tax purposes. The Canada Revenue Agency (CRA) has issued several rulings confirming that the specific co-op under review qualified as a foreign corporation (and thus a foreign affiliate) for Canadian tax purposes.[14] It appears that this characterization is not automatic and depends on the specifics of the articles of the co-op. To achieve the benefits of the holding company,[15] the articles should be carefully drafted to conform to the requirements for corporate status. The Dutch co-op, alone or together with a "regular corporation" subsidiary (if it is uncertain whether the co-op qualifies for benefits under a particular tax treaty), is an efficient and flexible holding vehicle.

Barbados

Historically, Barbados international business companies (IBC) and several types of captive insurance companies have been extensively used by Canadian multinationals. IBCs, which cannot carry on business with Barbados residents, are subject to a reduced corporate tax rate (1.0-2.5 percent) on income, and they are exempt from withholding tax and most indirect taxes. The downside of using IBCs is that they are explicitly carved out of many Barbadian treaties and thus generally cannot be used for treaty-based holding structures. One exception is the current treaty with China, which has contributed to the popularity of using Barbados holding companies for investments in China.

In response to these concerns and to make Barbados more attractive for holding companies that also have active business operations in Barbados, the country introduced a participation exemption regime in 2007 that applies both to regular corporations and IBCs. The regime exempts foreign dividends from tax where the Barbados resident corporation owns shares representing at least 10 percent of the capital of the foreign company, and the shareholding is not a portfolio investment. Furthermore, dividends paid by a regular Barbados company out of foreign-source income (which includes foreign dividends, but not capital gains on the disposition of foreign shares) are exempt from the 15 percent withholding tax otherwise applicable (dividends paid by IBCs were always exempt). Capital gains derived by either type of corporation are not taxable under domestic law. The distinction between capital gains and taxable income is based on judicially developed criteria that are similar to the principles that apply in Canada.

The participation exemption and the related dividend withholding tax exemption facilitate the tax-efficient use of regular Barbados corporations as international

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[14] See, for example, *Income Tax Ruling* 2007-0260861R3, "Entity Classification," 2007.

[15] If the co-op does not qualify as a corporation for Canadian tax purposes, it will presumably be treated as a partnership, and so the Canadian shareholders will be currently taxable on all of the co-op's income.

holding companies and, hence, allow reliance on treaty benefits that are not available to IBCs. This benefit is somewhat limited because an increasing number of Barbados's treaties contain a form of the comprehensive limitation-on-benefits article, which generally denies foreign-owned Barbados corporations access to treaty benefits. Such treaties currently include those with Finland, Mexico, Norway, Sweden, and the United States. With the exception of the Mexican treaty, these treaties do not contain a "derivative benefits" article,[16] which makes their use by foreign-controlled holding companies costly. A potential impediment to using regular Barbados corporations is that they are generally subject to stamp duties and other indirect taxes.

Barbados has been popular as an investment vehicle into China due to the favourable treaty. The current treaty provides for a full exemption from Chinese tax for all capital gains derived from the disposition of shares of a Chinese company, regardless of ownership percentage and the proportion of the value of the Chinese company derived from real estate. In its breadth, this capital gains exemption is unique. The treaty also provides for a 5 percent withholding rate on dividends. The broad capital gains exemption is not consistent with current Chinese treaty policy, and similar benefits in other treaties (e.g., Mauritius, Hong Kong) have been eliminated (in recent treaties, the typical capital gains articles preserve China's taxing rights where either the Chinese company derives more than 50 percent of its value from Chinese real estate or the foreign holding company owns 25 percent or more of the shares of the Chinese company). We understand that the Chinese government is seeking to eliminate the special benefits in the treaty with Barbados to align treatment to its current policy and, thus, the continued existence of the full capital gains exemption may be short-lived. As discussed below, the Chinese tax authorities also seem to be growing more aggressive in challenging holding structures on the basis of lack of substance and treaty abuse. Thus, any multinationals with Barbados (or other) holding structures into China should carefully review their existing structures and evaluate their alternatives.

Malta

Malta has recently amended its participation exemption regime to provide for a direct exemption of qualifying dividends when received by the Maltese holding company. Previously, such dividends were subject to 35 percent tax, and a full refund could be obtained once the related earnings were paid out as dividends to the company's shareholders. The direct exemption at source obviates the requirement for this procedure and the related cash flow cost and delays.

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[16] A derivative benefits article typically allows treaty benefits for dividends, interest, and royalties paid to an intermediary company that otherwise does not satisfy the LOB article, if certain conditions are met. The most important condition is that a high proportion (typically 90 percent or more) of the shares of the intermediary are ultimately owned by residents of countries whose treaties with the source country provide for a withholding rate that is at least as favourable as that between the source country and the intermediary.

Malta's participation exemption applies where the Maltese holding company owns at least 10 percent of the foreign subsidiary, or the cost of the investment is at least €1.2 million, and a 183-day holding period is maintained. Otherwise, the participation exemption is very broad. The only exception occurs when the subsidiary is resident outside the EU, and its income consists principally of passive interest and royalties; in this case, a subject-to-tax requirement applies. No dividend withholding tax applies on distributions by a Maltese company.

Malta is also interesting in its treatment of other foreign-source income. Such income is generally subject to 35 percent tax in the first instance, but 6⁄7 of this tax is refunded on payment of a dividend by the Maltese company, resulting in a 5 percent effective tax rate. Because the refund accrues to the shareholders and not the distributing company, absent provisions in a treaty or otherwise addressing this issue specifically, the Maltese company generally will be considered subject to the full statutory rate for purposes of determining its treaty residency and, possibly, for purposes of determining foreign accrual tax deductions as offset against foreign accrual property income,[17] or their equivalent under other countries' CFC rules.

SOURCE-COUNTRY TAX DEVELOPMENTS

There appears to be increasing awareness among source countries about the use of intermediary companies to save taxes. The last few years seem to have witnessed an increasing willingness of certain countries to broaden the reach of their tax system, whether by specific legislative amendments or more aggressive administrative responses. This response has been more marked in Latin America, Africa, China, and India. These countries may feel they have increased clout in their dealings with multinationals owing to the size and development level of their economies (China and India) or their possession of increasingly scarce natural resources.

Legislation to Tax "Indirect" Sales

Increasingly, jurisdictions are introducing rules to tax gains derived by foreign investors from the disposition of the shares of a foreign entity that derives its value ultimately from assets situated in the source country. This type of legislation is not new to the tax world, and it is by no means limited to developing or resource-rich countries. Notably, Canada has a similar rule embedded in the definition of "taxable Canadian property" that (absent treaty protection) taxes non-residents on gains from the disposition of shares of a non-resident corporation (not listed on a designated stock exchange), where at any time in the five years preceding the sale, more than 50 percent of the foreign corporation's fair market value is derived directly or indirectly from any of a combination of real property situated in Canada, Canadian resource properties, and timber resource properties.[18] The United States has similar rules under its Foreign Investment in Real Property Act.

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[17] The tax treatment to the shareholders of the refunds and the application of anti-avoidance rules must be considered.

[18] Paragraph (e) of the definition of taxable Canadian property in subsection 248(1) of the Act.

Before the introduction of specific rules to tax indirect sales, two-tiered "double holding company" structures were popular for deferring source-country tax on gains from shares where treaty benefits are not available, either because the source country has few, if any, treaties or such treaties generally do not exempt capital gains (as is common in Latin America) or because the type of property is excluded from treaty protection. In the double holding company structure, the source-country corporation is held through at least two tiers of offshore holding companies (typically incorporated in tax-free jurisdictions such as Bermuda, the Caymans, or the British Virgin Islands), and each investment is held in a separate holding company. In case of a sale, the upper-tier holding company sells shares of the lower-tier offshore company instead of shares in the domestic company. This type of transaction usually is not sourced to the source country because the subject matter was shares of a foreign legal entity and the transaction took place wholly outside of the country. The disadvantage of this structure to the purchaser is that it assumes a low tax basis in the shares of the ultimate operating entity in the source country (and hence the potential for a deferred tax liability) and any risk of challenge to the effectiveness of the structure by the tax authorities. The latter disadvantage arises because the source-country legislation typically imposes a withholding obligation on the purchaser and/or the target located in the source country where the vendor is subject to capital gains tax.

In recent years, a number of Central and South American (as well as other) countries have enacted or proposed specific legislation to tax gains from the transfer of shares in a foreign entity that derives a certain percentage of its value ultimately from domestic assets. These countries include (among others) Chile (2003), Suriname, Ghana, the Dominican Republic (2006), Panama (2006), and, most recently, Peru (March 2009). In many of these cases, the tax liability is shared by the local entity whose shares were indirectly sold. In other words, if the vendor does not pay the tax, the tax authorities can assess the local subsidiary for the tax plus applicable interest and penalties. As a result, the risk in such situations appears to rest primarily with the purchaser as opposed to the vendor (see also the *Vodafone* case discussed below).

Multinationals should take note of these developments and monitor the introduction of similar legislation in other countries. Typically, such legislation does not include explicit relieving rules for intragroup reorganizations and, hence, it may be difficult to unwind existing holding company structures once these provisions take effect.

Judicial and Administrative Challenges to Holding Companies

Even where no specific legislation exists to tax transfers of foreign holding companies, tax authorities may use general anti-avoidance rules or similar principles, such as lack of substance or commercial purpose and abuse of law/treaties, to challenge the benefits of holding companies. Two recent examples, one from China and one from India, are discussed below.

China

Denial of Treaty Benefits

In a recent ruling of the State Administration of Taxation (SAT),[19] the SAT endorsed the position of a local tax administration in denying treaty benefits to a Barbados company disposing of an investment in a Chinese company.[20]

The facts of the ruling were as follows:

- The Chinese company (Targetco) was initially established by two Chinese companies in 2003.
- In July 2006, a Barbados-incorporated company (Barbco) acquired a one-third interest in Targetco from one of the Chinese shareholders.
- In June 2007, only 11 months after the initial acquisition, Barbco sold almost all its equity interest back to the Chinese shareholder, realizing a substantial gain.
- All of Barbco's ultimate shareholders were resident in the United States.
- All three of Barbco's directors were US nationals and Barbco did not have any office, employees, or other presence in Barbados.

The Chinese tax authorities denied the claim for treaty benefits on the basis that Barbco did not qualify as a resident of Barbados under the treaty and that the transactions constituted treaty abuse. With respect to the first issue, the ruling noted that:

- Barbco was registered in Barbados but had no place of management there.
- All three of Barbco's directors were US nationals and the company did not have any Barbados resident directors.

The treaty abuse determination was supported by the following facts:

- The entire transaction appeared predetermined pursuant to a prior agreement with Barbco having a "locked-in" gain at the inception of the investment.
- Barbco was established just two months before acquiring its interest in Targetco.
- The short time between acquisition and disposition also suggested that the investment was opportunistic and that Barbco had no intention of participating in the management of Targetco as a joint venturer.
- Barbco's establishment appeared to lack any overall commercial substance or benefits.

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[19] *Guoshuihan*, [2008] No. 1076, issued December 30, 2008.

[20] As noted, the Barbados-China treaty currently provides for a full exemption from Chinese capital gains tax. In the absence of treaty benefits, a 10 percent withholding tax is imposed on the gain.

This case seems rather extreme in terms of the lack of substance in Barbados (i.e., Barbco failed to meet the most basic "mind and management" requirements to be considered resident in Barbados) and in terms of the clearly tax-motivated, preordained series of transactions. It is not clear how far the Chinese tax authorities will go where the holding company has reasonable local substance (including a majority of Barbados resident directors, regular board meetings in Barbados, and a local office and employee) and there is no circular flow of funds or predetermined exit strategy.

China has recently introduced a general anti-avoidance rule (GAAR) and tax treaty abuse has been specified as the GAAR's key target. Recent treaties concluded with Hong Kong and Singapore explicitly provide that China retains its right to apply the GAAR to deny treaty benefits to tax-motivated transactions, including treaty shopping.

Taxation of Indirect Transfer

In another recent case, the Chinese tax authorities applied a "lookthrough" approach to tax the gain derived by an investor in Singapore from the sale of a Singapore-incorporated holding company that held an equity interest in a Chinese company. Because the acquirer was a Chinese company (which could have been expected to acquire the shares of the Chinese subsidiary on an onshore level) and the Singapore holding company was thinly capitalized (having paid-up capital of just SGD100) and carried out no "substantive operational activities," the gain on the disposal of the Singapore entity was deemed to be Chinese source and thus subject to tax.

Again, the apparent lack of substance in the foreign holding company seems to have been fatal to maintaining the desired tax benefits.

These cases show that the use of foreign "shell" corporations to avoid Chinese capital gains tax, either through the application of treaty benefits or by means of an indirect transfer of the foreign shares, is likely no longer effective for Chinese tax purposes. To counteract the perception of treaty abuse, multinationals should be careful to establish a reasonable degree of substance in their holding companies and to document the business reasons for setting up such structures. As these two cases seem to have involved particularly unfavourable facts for the taxpayer and, given the recent introduction of the Chinese GAAR, further developments in this area should be closely monitored.

India: The Vodafone Case

The *Vodafone* case is an example of the tax authorities' attempt to tax the "indirect" sale of an interest in a domestic corporation. Unlike the Latin American countries discussed earlier, India has no legislation to explicitly tax gains from the sale of foreign holding companies that derive their value from investments in Indian companies. The outcome of this case will ultimately set the boundaries of the effectiveness in using holding companies for tax planning into India, at least concerning the taxation of disposals.

The facts in *Vodafone* are straightforward. Hutchison Telecom International (HTIL), a Hong Kong corporation, directly owned the shares of CGP Investments (Holdings) Ltd. (CGP), a corporation incorporated in the Cayman Islands. CGP indirectly (through certain companies incorporated in Mauritius) owned 67 percent of the shares of Hutchison Essar Ltd. ("Indian JV"), an Indian corporation operated as a joint venture with the Essar Group, another Indian corporation. Indian JV operates a mobile phone network in India and was granted a specific operating licence for this purpose.

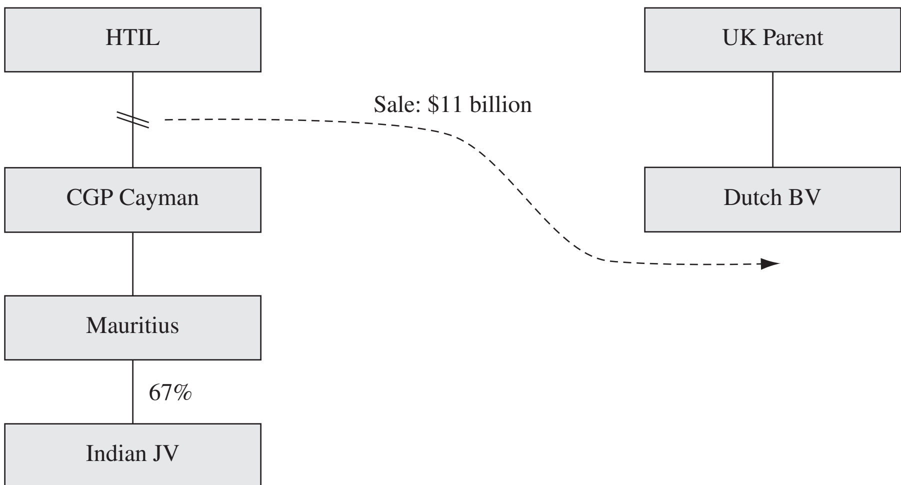
Vodafone International Holding BV ("Dutch BV") is a Netherlands corporation and a wholly owned subsidiary of Vodafone plc ("UK Parent"), a UK public corporation operating in the mobile phone business.

In February 2007, BV and Vodafone plc agreed to acquire all the shares of CGP from HTIL for US$11.1 billion, subject to obtaining Indian regulatory approval for the transfer, which was subsequently granted (see figure 2).

HTIL realized a gain of US$9.6 billion and distributed the proceeds from the sale to its shareholders as a special dividend. BV later entered into a restated shareholders' agreement with the Essar Group, confirming the continuation of the joint venture and providing for the allocation of board seats and the right of first refusal on any sale of the Essar Group's interest in Indian JV. The name of Indian JV was changed to Vodafone Essar Limited.

In September 2007, the Indian tax authorities issued a "show cause" notice to BV and Indian JV demanding that they explain why they should not be treated as an "assessee in default" for failure to withhold tax on the purchase price, as required by Indian legislation for the acquisition of a capital asset situated in India. The tax at stake amounts to about US$2 billion.

Figure 2



BV filed a petition to the Bombay High Court to strike out the show cause notice for lack of jurisdiction on the basis that the gain was not taxable in India because it concerned the transfer of shares of a foreign corporation undertaken outside India. In the alternative, even if the gain were taxable, neither BV nor Indian JV were within the classes of persons covered by the withholding tax provision. BV also challenged certain amendments that retrospectively broadened the scope of the withholding tax provision as unconstitutional.

The Bombay High Court dismissed the petition to quash the show cause notice on December 3, 2008.[21] The court noted that the threshold for quashing a show cause notice is high: the court must be satisfied that the notice was entirely non-existent in the eyes of the law for absolute want of jurisdiction of the tax authorities to even investigate the facts.[22] The court held that this threshold was not met in this case for the following reasons:

- On the basis of the facts disclosed to the court, the tax authorities made a strong prima facie case that the transaction was the transfer of a capital asset situated in India and not merely the transfer of shares in a Cayman Islands company. In particular, the interest in Indian JV implied an interest in the Indian Telecom Licence that was held jointly with the Essar Group and also included brand equity, goodwill, and non-compete rights given by HTIL. The asset transferred was the right to operate a telecom business in India, with a control premium.[23]
- The various statements and press releases made by the parties at the time of the transactions clearly identified the subject matter as the Indian business and not the shares of the Cayman company. This included the right to manage the Indian JV by appointing a majority of directors.[24] It would be "too simplistic" to explain away these circumstances by holding that the only asset transferred was "shares of an unknown Cayman Islands Company, which is a shell company and [which] was not even considered in [determining] the enterprise value of [the companies transferred]."[25]
- Shares themselves may be an asset, but, in some cases like the present one, shares may be merely a mode or a vehicle to transfer other assets. In this case, the subject matter of the transfer was not the shares of the Cayman Islands company but the various assets situated in India.[26]

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[21] *Vodafone International Holding B.V. v. Union of India*, 2008-TIOL-602-HC-MUM-IT.

[22] Ibid., at paragraph 170.

[23] Ibid., at paragraph 157.

[24] Ibid., at paragraphs 159 and 160.

[25] Ibid., at paragraph 158.

[26] Ibid., at paragraph 161.

- BV should be considered to have acquired a beneficial interest in the operating licence granted by the Indian Department of Telecommunications (even though the licence was actually granted to Indian JV).[27]
- Because the parties had admitted that HTIL had transferred its interest in Indian JV vis-à-vis their shareholders, the regulators in India, Hong Kong, and the United States, BV could not take a different position vis-à-vis the Indian tax authorities. Because the transaction's "dominant purpose" was to transfer a controlling interest in an Indian company, the transaction was subject to the laws of India, including the Indian Income Tax Act.[28]
- Finally, the court drew an adverse inference from BV's refusal to produce copies of the original agreements between it and HTIL for the tax authorities and the court. In the absence of all the relevant facts, it was not appropriate to entertain BV's arguments that the Indian withholding tax provisions were unconstitutional in their extra-territorial reach.[29]

The court also held that the appropriate procedure for BV would have been to respond to the show cause notice with all the relevant evidence, wait for the decision of the tax authorities, and then appeal any adverse decision through the normal channels. The appeals rights under the Income Tax Act appropriately safeguard BV's interests.

BV sought leave to appeal to the Indian Supreme Court, which dismissed the case on January 23, 2009.[30] The Supreme Court noted that the petition was filed prematurely, because only a show cause notice was at stake. The court also questioned why BV had refused to file the original agreements related to the transactions. The Supreme Court directed the tax authorities to decide, as a preliminary issue, whether it had jurisdiction to proceed against Vodafone, stating that "the substantive question of law raised in the petition is left open." If Vodafone disagrees with the substantive decision of the tax authorities, it could then again appeal to the High Court. As a result, the Supreme Court did not address the High Court's reasons for judgment, and it is unknown whether the Supreme Court agrees with the High Court's broad statements.

The litigation to date has dealt only with procedural matters; the substantive questions of law are still open. Nevertheless, the arguably obiter[31] statements made by the High Court regarding the nature of the transfer and its adoption of a "substance

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[27] Ibid., at paragraph 162.

[28] Ibid., at paragraph 168.

[29] Ibid., at paragraphs 169 and 177.

[30] "Indian Supreme Court Denies Vodafone Appeal" (February 2, 2009) vol. 53 *Tax Notes International* 381 (Doc. 2009-1420).

[31] Given the high threshold required to strike the show cause notice, it was arguably not necessary for the court to make wide-ranging comments about the proper characterization of the transactions for Indian tax purposes. It would likely have been sufficient for the court to find that the situation had enough legal and factual uncertainty such that the notice was not patently without basis.

over form" approach clearly cause concern for similar transactions involving transfers of shares of a foreign holding company with assets situated in India. We understand that the Indian tax authorities have issued show cause notices on the strength of this judgment to a substantial number of taxpayers involved in similar transactions. It remains to be seen how the courts will decide on the substantive matters, once all of the facts and circumstances are properly considered.

SELECTED CANADIAN ISSUES IN REPATRIATION PLANNING

This section summarizes certain specific Canadian tax considerations in planning for the repatriation of foreign earnings. We also highlight some issues and opportunities arising from draft amendments and related guidance regarding foreign affiliate distributions, emphasizing the impact of these amendments on the use of holding companies in repatriation planning.[32]

Optimal Use of Surplus Ordering Rules

The general ordering rule for dividends is that any dividend is deemed first paid from exempt surplus (if any), then from taxable surplus, and lastly from pre-acquisition surplus.[33] Using a common holding company (as shown in figure 3) can help taxpayers optimize the use of this automatic ordering rule. For example, assume a Canadian corporation (Canco) has two foreign affiliates: Opco 1 has excess cash and low-taxed taxable surplus, and Opco 2 has significant exempt surplus but no distributable cash available.

Without further planning, if Opco 1 pays a dividend to Canco, the full amount of the dividend essentially will be taxable.

If Canco instead holds its shares in the two Opcos through a common holding company, Holdco, the cash of Opco 1 can be used to "mobilize" the exempt surplus in Opco 2 and allow for the dividend to Canco to be paid from exempt surplus, thus with no further Canadian tax consequences. In this example, Opco 1 pays Holdco a dividend, which increases Holdco's taxable surplus. Holdco then uses the funds to contribute capital to Opco 2, which in turn uses the cash to pay a dividend to Holdco, thereby increasing Holdco's exempt surplus. Holdco then pays a dividend to Canco. Under the ordering rules, this dividend is deemed paid first from exempt surplus.

In the absence of Holdco, a similar result could have been achieved by Opco 1 making a loan to Opco 2. However, this approach may create foreign tax issues and potential FAPI on any interest paid by Opco 2, and the solution will only be temporary. Using a common holding company in this case facilitates the optimal repatriation of surplus pools.

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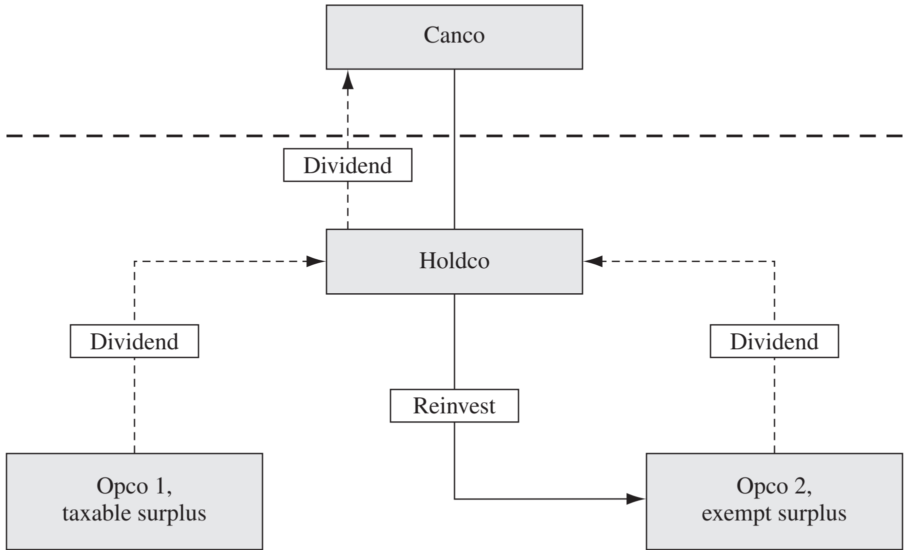
[32] This section is not intended to provide a comprehensive description of the Canadian tax provisions and specific amendments dealing with foreign affiliate distributions.

[33] Regulation 5901(1).

Figure 3



Foreign Tax Mixer

Although Canada has an extensive treaty network, a substantial number of countries, especially in Central America and Africa, still do not have treaties with Canada. Where the Canadian company has foreign subsidiaries in such countries, a foreign holding company can be used to mix taxable surplus with differing levels of underlying foreign tax.

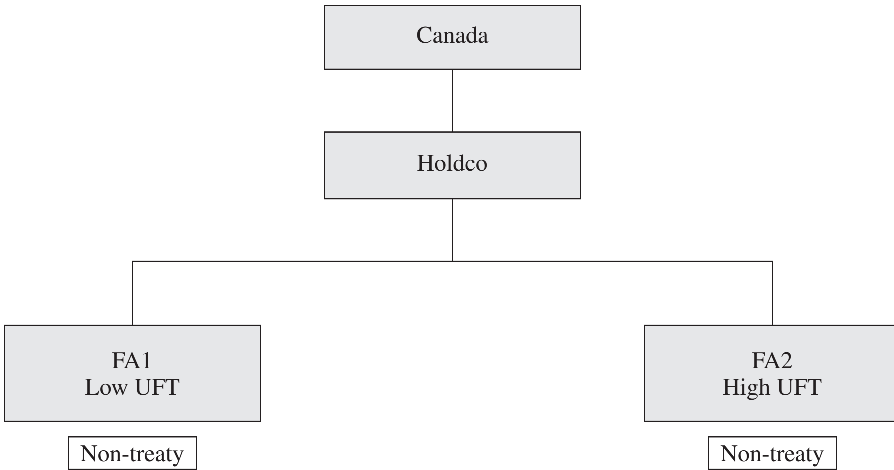
Assume a Canadian taxpayer owns two foreign affiliates, FA1 and FA2, both of which operate in countries that do not have tax treaties or tax information exchange agreements with Canada (see figure 4). FA1 benefits from a tax holiday and thus has no underlying foreign tax (UFT). FA2 has a more mature operation and is subject to a 60 percent tax rate.

If both FA1 and FA2 earn $100 and distribute their after-tax earnings to Canco directly, Canco would have a $100 income inclusion in respect of the FA1 dividend and no net income inclusion in respect of the FA2 dividend.[34]

If instead FA1 and FA2 distribute their after-tax earnings to a common holding company, Holdco, and Holdco pays the net cash to Canco as a dividend, a different

[34] Canco would be entitled to a full paragraph 113(1)(b) deduction computed as $60 × (1/0.29 − 1) = $147 for a $40 income inclusion. Because the paragraph 113(1)(b) deduction cannot exceed the income inclusion for that particular dividend, the "excess" deduction of $107 is lost and cannot be applied to offset the $100 income inclusion on the FA1 dividend, nor can it be carried forward or converted into a non-capital loss (unlike excess non-business income tax eligible for a section 126 tax credit, which can be converted into a non-capital loss under section 110.5 under certain circumstances).

Figure 4



result arises. The dividends result in Holdco having taxable surplus of $140 and underlying foreign tax of $60. Canco will have an income inclusion of $140 and available foreign tax deduction of $147,[35] resulting in a net income inclusion of nil.

Where the averaged foreign tax rate is not enough to fully offset a Canadian income inclusion, the disproportionate tax designation provides further planning opportunities if less than the full taxable surplus is to be distributed. This designation[36] allows the Canadian taxpayer to attribute more than a proportional share[37] of underlying foreign tax to any dividend paid from taxable surplus, within certain limits[38] and under certain conditions.[39] This election can help further defer the low-taxed taxable surplus as the election generally allows tax-free repatriations as long as there is sufficient absolute foreign taxes and only a portion of the entity's taxable surplus is distributed. Using a holding company to aggregate surplus and taxes facilitates this type of planning.

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35 $60 × (1/0.29 − 1).

36 Paragraph (b) of the definition of "underlying foreign tax applicable" in regulation 5907(1). Note that no prescribed form exists to make this designation.

37 Without further action, the portion of underlying foreign tax applicable to a dividend is computed as the amount of the underlying foreign tax times the amount of the whole dividend divided by the opening taxable surplus.

38 The limits are the lesser of the amount by which the taxable surplus dividend exceeds the proportionate underlying foreign tax allocated and the remaining underlying foreign tax available after the proportionate amount has been deducted.

39 One of the following conditions must be met: (1) the foreign affiliate has only one class of shares outstanding, (2) the taxpayer's surplus entitlement is 100 percent, or (3) the affiliate has only one shareholder.

Upstream Loans

Making upstream loans may be an efficient solution if the Canadian parent needs quick access to cash and either a distribution will be taxable in Canada (e.g., low-taxed taxable surplus or insufficient basis and surplus) or foreign tax and compliance issues will arise. Typical reasons for using upstream loans include the following:

- Making a loan instead of a distribution may avoid or defer the imposition of foreign withholding tax. The specific foreign tax law will have to be considered to determine whether a loan could trigger adverse tax consequences, such as a deemed distribution (as under the Canadian rules if the loan remains outstanding for more than a certain period of time).[40]
- Avoiding or deferring the repatriation of low-taxed taxable surplus.
- Counteracting foreign corporate law that may prevent the payment of dividends or interim dividends where there is a lack of distributable reserves. It is not unusual in many countries that dividends cannot exceed the retained earnings in the prior year's audited financial statements, which precludes the distribution of current earnings.
- Lengthy delays in obtaining approval for capital reductions or other distributions, such as where court approval is required (e.g., Hungary).
- Uncertainty about the surplus accounts and/or adjusted cost base of the distributing affiliate and hence uncertainty about the Canadian tax implications of a distribution (and a lack of time to complete the necessary calculations).
- Regulatory or business restrictions on repatriations such as limitations on distributions imposed by an underfunded pension plan.

Interestingly, the CRA has repeatedly confirmed that an upstream loan should not result in adverse Canadian tax consequences, even if the loan represents taxable surplus. In a 2007 technical interpretation,[41] the CRA considered the following facts:

- Canco, a corporation resident in Canada, holds all the shares of Foreignco, a corporation generating business income in a non-treaty country.
- Instead of paying a dividend, Foreignco makes interest-free loans to Canco.

The CRA provided the following comments:

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[40] In the Canadian inbound context, the combination of subsection 15(2) and paragraph 214(3)(a) prevents this type of planning by deeming the loan to be a benefit subject to withholding tax. An exception is available under subsection 15(2.6) where the loan is repaid within one year after the lender's taxation year-end and the repayment is not part of a "series of loans and repayments."

[41] Conference 2007-0243301C6, "Prêt par une société étrangère sans intérêt," dated October 5, 2007.

- Subsection 15(2) of the Act, which includes shareholder loans in the income of the borrower, does not apply to corporations resident in Canada. No other specific provision in the Act allows the CRA to tax a corporation resident in Canada on the amount of a loan received from a subsidiary.
- Subsection 80.4(2), which imputes a deemed benefit to the borrower in a non-interest-bearing loan where the borrower is a shareholder, also does not apply to a corporation not resident in Canada.
- It would usually be inconsistent with the spirit of the Act to apply the more general transfer-pricing rules to impute interest income (and hence FAPI) to the foreign affiliate on a loan to the corporation resident in Canada.
- The CRA's GAAR committee has studied this type of transaction, which allows the repatriation of funds from a foreign affiliate by way of an interest-free loan rather than a dividend, and has established that the GAAR did not apply to this type of transaction.

The CRA came to a similar conclusion in two earlier rulings.[42] The Canadian tax implications of an upstream loan thus seem well settled.

It is generally recommended to make these loans non-interest-bearing and denominated in Canadian dollars to eliminate any FAPI exposure. If the loan is interest-bearing, the interest income is included in the Canadian shareholder's FAPI.[43] Additionally, if the loan is denominated in foreign currency, a tax exposure arises regardless of the movement of the foreign currency. If the foreign currency appreciates, the Canadian borrower will have a capital loss and the foreign affiliate will have a taxable capital gain included in FAPI, but the capital loss cannot offset the FAPI income inclusion. In the converse situation, the Canadian borrower will have a taxable capital gain and the foreign affiliate a FAPI loss, which again cannot be offset.

Matters are not so simple if the lender affiliate is resident in a taxing jurisdiction. In that case, making a non-interest-bearing loan may cause adverse foreign tax consequences, including imputed interest income (under transfer-pricing rules), recharacterization of the loan as a deemed distribution (and thus withholding tax), and foreign exchange exposures (if not denominated in local currency). It may be more efficient to make the loan interest-bearing. If it is not and income is imputed in the foreign country, the associated tax cost is a pure leakage because it creates neither a deduction in Canada nor any foreign accrual tax or underlying foreign tax. If the loan bears interest, Canadian withholding tax will arise (typically at a rate of 10 percent for a treaty country), and the interest income will be FAPI. However, the combination of Canadian withholding tax and foreign tax often creates enough foreign accrual tax to fully offset the FAPI income inclusion. Assuming that the

[42] *Income Tax Ruling* ATR9807063, "Foreign affiliate—loans of taxable surplus," and *Income Tax Ruling* ATR9826443, both dated 1998.

[43] Paragraph 95(2)(a.3).

Canadian withholding tax is fully creditable in the foreign country, no net tax leakage arises. Furthermore, subject to the thin capitalization rules and the use of the funds, the Canadian borrower generally is entitled to an interest deduction that can be used to offset other income.

The Canadian thin capitalization rules need to be considered in this type of planning; they may fully deny the interest deduction if the Canadian borrower has a controlling shareholder (e.g., if the borrower is not the ultimate parent company or if the parent company has a controlling shareholder, such as in a closely held company) and does not have retained earnings (on an unconsolidated basis) equal to at least 50 percent of the loan principal.[44]

As noted, if an upstream loan is made in a currency other than the Canadian dollar, a taxable capital gain or FAPI will arise, no matter which way the currency moves. Making the loan in Canadian dollars is always preferable from a Canadian tax perspective, but the foreign tax implications must also be considered. In many jurisdictions, foreign exchange gains are considered fully taxable ordinary income, and so the potential foreign tax exposure may be much higher than the Canadian exposure, because only 50 percent of a foreign exchange gain is included in income as taxable capital gain or FAPI. One potential way to eliminate foreign exchange exposure for all parties involved is to have the Canadian borrower/parent make a functional currency election to adopt the same tax currency as the lender/foreign affiliate. Obviously, the eligibility of the Canadian corporation and the other effects of making the election should be considered.

"Fresh-Start" Rules and Holding Companies

The implications of making distributions in the context of the proposed "reverse" fresh-start rules introduced in the February 2004 foreign affiliate amendments have been rarely considered. The current fresh-start rule[45] is a relieving provision that provides for a step-up in the cost of assets and related crystallization of surplus when the status of a foreign affiliate's business changes from an active business to a business generating FAPI. The amendments replace this single provision with a comprehensive set of rules dealing with the conversion of an active business into a FAPI business and vice versa.

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[44] The thin capitalization rules in subsection 18(4) apply to debts outstanding to, inter alia, a non-resident person that does not deal at arm's length with a specified shareholder of the borrower (in this case, a person owning 25 percent or more of the voting rights or value of the borrower). Where the Canadian borrower has a controlling shareholder (whether non-resident or not), the foreign affiliate is controlled by such shareholder and thus deemed not to deal at arm's length with such shareholder. Where the Canadian borrower has no specified non-resident shareholders, only the borrower's retained earnings count toward the thin cap debt-to-equity formula. The CRA confirmed this interpretation in a 1992 technical interpretation (no. 9209635), in which the CRA stated that because it was "not clear whether [the thin cap rule] was intended to apply in the above circumstances," the CRA would bring the matter to the Department of Finance's attention. However, no legislative amendments or comfort letters have been issued to date to provide relief in this scenario.

[45] Paragraph 95(2)(k).

Specifically, the new rules apply where, in the preceding year, the foreign affiliate has an investment business and, at any time in the current year, all or substantially all the fair market value of the property used or held in the business is attributable to excluded property.[46] For example, assume Canco owns a single foreign affiliate holding company, Holdco, whose only significant asset is the shares of a single operating company, Opco. Opco generates significant excess cash from its business; as at December 31, 2008, the excess cash represents more than 10 percent of Opco's assets. During 2009, Opco pays the excess cash as a dividend to Holdco, which in turn distributes the cash to Canco. To satisfy the "substance requirements" in Opco's country, Holdco has a board of directors that regularly meets in Opco's country and actively supervises Opco's operations and financial performance.

Applying the tests in proposed paragraph 95(2)(k.2), given its level of activity and the low threshold set out in case law, Holdco may be considered to carry on a business. Because the principal purpose of that business is to generate dividends and other returns from its investment in Opco, the business is an investment business. Furthermore, after the excess cash is paid as dividends to Canco, Holdco's only asset is the shares of Opco, which, after the distribution, become excluded property. As a result, the test in paragraph 95(2)(k.2) seems to be met, because Holdco's business was an investment business in the preceding taxation year and, at some time in the current year, all or substantially all the property used in the business (i.e., the shares of Opco) is excluded property.

Consequently, all of Holdco's property is deemed disposed of and reacquired for fair market value proceeds at the end of the preceding taxation year.[47] Because, at that time (December 31, 2008), the shares of Opco were arguably not excluded property due to the presence of the excess cash, the gain realized resulted in FAPI to Holdco. Canco is allowed to file an election to defer the recognition of the FAPI gain as a result of the deemed disposition.[48] However, this elective deferral ends on the first subsequent disposition of the shares of Opco, whether or not that disposition will otherwise occur on a rollover basis through, for example, an interaffiliate transfer.

This fresh-start rule can have several adverse implications, even if the taxpayer timely files the deferral election. Since the deferral ends with any subsequent disposition of the property, Canco cannot undertake any transaction that will cause an actual or deemed disposition of these shares. Such transactions include otherwise tax-deferred reorganization transactions such as share-for-share transfers or a merger or liquidation of Holdco. Furthermore, on any eventual sale of the shares of Opco, the deferred FAPI gain is triggered and taxable to Canco even if the shares of Opco at that point are excluded property. This treatment often entails the inability to "purify" the shares of Opco before a sale because any such purification (by way

46 Proposed subclause 95(2)(k.2)(iv)(A)(II).

47 Proposed subparagraph 95(2)(k.3)(ii).

48 Proposed subparagraph 95(2)(k.3)(iii).

of distributing excess assets) is likely to trigger the application of the fresh-start rule and thus the crystallization of accrued FAPI. Another unfavourable aspect of the rules is the asymmetrical treatment: there is no crystallization of the excluded property (non-FAPI) gain when the asset composition of Holdco changes from all or substantially all excluded property to less than substantially all excluded property (e.g., because the accumulation of cash causes the Opco shares to lose their excluded property status). In this scenario, the fresh-start rule applies only if, in the current year, the affiliate's business is an investment business or other deemed FAPI business and, in the preceding year, the business did not fall into any of these categories. In Holdco's case, its business remains an "investment business" even if all the property used in the business is excluded property.

Thus, where the status of the Opco shares switches back and forth from excluded property status due to the accumulation and distribution of excess cash, essentially all the appreciation is swept into FAPI even if it occurs while the shares are excluded property. Each switch from non-excluded to excluded property status crystallizes the accrued gains up to the end of the previous year into FAPI, while the switch from excluded to non-excluded property status does not trigger any crystallization. One way to avoid these adverse consequences would be for Opco to distribute excess cash continuously so the shares never become non-excluded property or, at least, are excluded property at year-end (when the deemed disposition otherwise occurs). However, this may not be possible where the jurisdiction's corporate law does not allow for the payment of interim dividends from current earnings.

Whether the Department of Finance intended the fresh-start rule to apply in this manner is unclear. Hopefully, the next round of amendments will resolve this uncertainty.

Changes to Foreign Affiliate Liquidation and Distribution Rules

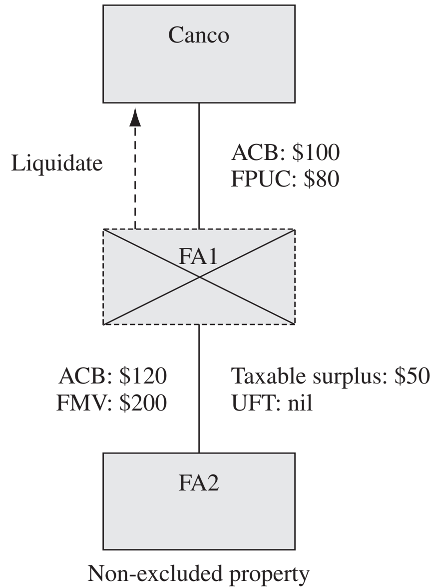
The February 2004 foreign affiliate amendments and subsequent comments by the Department of Finance propose to significantly change the rules governing foreign affiliate liquidations and distributions. As confirmed by Finance in several comfort letters, until the next round of amendments are released, taxpayers will have some flexibility in choosing which set of rules to apply. Reorganizations should be carefully planned to keep in mind the current and proposed sets of rules, along with the changes promised in Finance's comfort letters.

First-Tier Liquidations

The most sweeping proposals amend subsection 88(3), which governs the liquidation of a foreign affiliate into its Canadian shareholder. The impact of these changes—and the three sets of rules that potentially apply—are best illustrated by way of example.

Assume Canco owns all the shares of FA1, which in turn owns all the shares of FA2. The shares of FA2 are non-excluded property, their adjusted cost base (ACB) is $120, and their fair market value (FMV) is $200 (as illustrated in figure 5). FA1

Figure 5



has $50 of taxable surplus with no underlying foreign tax from a previous sale of a foreign affiliate (the corresponding exempt surplus has already been distributed to Canco). Canco has an ACB of $100 in the shares of FA1, whose paid-up capital is $80. Canco plans to liquidate FA1.

Under current law, the shares of FA2 are deemed disposed of for proceeds equal to their ACB, or $120.[49] This amount is also Canco's deemed proceeds of the FA1 shares.[50] As a result, Canco realizes a capital gain of $20 on the liquidation ($120 deemed proceeds less $100 ACB), resulting in an income inclusion of $10. The taxable surplus of $50 in FA1 simply disappears and has no tax consequences unless Canco files an election under subsection 93(1) to deem a portion of the liquidation proceeds to be a dividend. Given that the taxable surplus has no underlying foreign tax and there is no exempt surplus, filing this election is not beneficial.

The rules under the February 27, 2004 amendments are similar, with one important exception. Because the shares of FA2 are not excluded property, they are deemed disposed of for proceeds equal to fair market value.[51] This results in FAPI of $40,[52] which is taxable to Canco, as well as exempt and taxable surplus of $40 each. The $40 in FAPI increases the ACB of the FA1 shares.[53] Canco is deemed to have

49 Paragraph 88(3)(a).

50 Paragraph 88(3)(b).

51 Proposed paragraph 88(3)(b).

52 ($200 FMV – $120 ACB) × 1⁄2, which assumes that the shares of FA2 are capital property.

53 Paragraph 92(1)(a).

disposed of the FA1 shares for $200, which results in a capital gain of $60.[54] Canco should file a subsection 93(1) election equal to the exempt surplus, or $40, to reduce the gain to $20, the same as under current law.[55] Canco thus suffers a net income inclusion of $50 instead of $10 under current law. In return, Canco obtains shares of FA2 with a tax cost of $200 instead of $120, but this may provide no immediate benefit.

Under further changes proposed by Finance in its comfort letters,[56] Canco meets the conditions to elect to treat the liquidation as a "qualifying liquidation and dissolution."[57] The main benefit of making this election is that the FA2 shares will be deemed sold at their cost amount, thus avoiding any FAPI. The liquidating distribution received by Canco is no longer treated as proceeds of disposition of the cancelled shares but instead as a return of "foreign paid-up capital" (FPUC), and thus a tax basis reduction, to the extent of such capital on hand, and a deemed dividend for any excess. In this case, $80 of the distribution is deemed a return of capital and reduces the ACB of the shares of FA1. The remaining $40 is deemed a taxable surplus dividend and is included in Canco's income. Canco also has a $20 capital loss from the disposition of the FA1 shares (since there is $20 in tax basis remaining and nil proceeds of disposition), but this capital loss is deemed nil. Thus, Canco suffers a total income inclusion of $40 (versus $10 under current law), and its tax cost in the shares of FA2 is $120, as under current law.

This example illustrates that electing rollover treatment under the qualifying liquidation and dissolution rules may not always be advantageous. In this example, the income inclusion in the third scenario ($40) is less than the inclusion in the second scenario ($50), but the additional $10 in income "buys" an additional $80 in tax basis in the shares of FA2. The unfavourable result in the third scenario arises because the new rules force a distribution of taxable surplus on hand if there is not enough FPUC to cover the full distribution. Under current law, the value inherent in the taxable surplus can be realized as a capital gain, subject to only a 50 percent income inclusion. The ACB of shares will often exceed the FPUC because transactions such as internal and external share purchases, tax basis step-up on an acquisition of control,[58] and others increase the ACB but may not increase FPUC though it is not yet clear how FPUC will be defined.

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54 Proposed paragraph 88(3)(c). $200 deemed proceeds – ACB of ($100 + $40).

55 Claiming a higher subsection 93(1) election does not provide additional benefits. Although Canco could file the election for $60 and the resulting $20 taxable surplus dividend could be fully offset with a subsection 91(5) deduction, subparagraph 92(1)(b)(ii) would reduce the ACB of the shares by $20 and so the net gain would remain the same.

56 See letter from the Department of Finance dated April 12, 2006.

57 In order to qualify for this treatment, Canco must hold shares in FA1 that provide it with at least 90 percent of the voting rights and Canco must receive at least 90 percent of the fair market value of all properties distributed on liquidation in satisfaction of the shares of FA1.

58 "Bump" under paragraph 88(1)(d) or election to increase basis by using accrued losses otherwise expiring under paragraph 111(4)(e).

Whether these rules will ultimately be enacted is uncertain in light of the comments by the Advisory Panel on Canada's System of International Taxation and others; nevertheless, taxpayers should generally consider all three sets of rules when undertaking foreign affiliate reorganizations.

First-Tier Distributions

Under current law, the characterization of distributions from a foreign affiliate for Canadian tax purposes generally follows the foreign corporate law and concepts established by the Canadian case law, particularly in distinguishing a dividend from a return of paid-up capital.[59] If the distribution qualifies as a return of paid-up capital (which the case law has rather narrowly defined), it reduces the ACB of the shares[60] and, if in excess of ACB, triggers a deemed capital gain.[61] If the distribution is a dividend, its tax treatment depends on the surplus pools available. Often the character of the distribution is not obvious; many corporate laws provide for distributions from equity accounts which are neither stated capital nor retained earnings and which are referred to as distributions of "additional paid-in capital," "contributed surplus," "share premium," or similar terms. There has been some concern that such distributions could represent a fully taxable shareholder appropriation under subsection 15(1), which does not permit using surplus pools or tax basis. In the author's view, a distribution that is made to shareholders in compliance with the applicable corporate law of the foreign affiliate should not be considered a taxable shareholder appropriation. Instead, on the basis of the broad concept of dividend established in the case law (which has explicitly contemplated distributions from equity accounts other than retained earnings), such distributions should likely be treated as dividends.

Finance's comfort letters[62] state its intention to decouple the Canadian tax treatment of foreign affiliate distributions from the corporate law treatment. The default treatment for distributions is dividend treatment. To the extent the affiliate has sufficient FPUC on hand and notifies its shareholders that it is making a distribution as a return of all or a portion of its FPUC, the amount, up to the FPUC balance attributable to the particular class of shares, will be treated as a basis reduction and not a dividend.

59 See *Cangro Resources Ltd. v. MNR*, 1967 CarswellNat 204; [1967] Tax ABC 852. The case law has generally established that any corporate distribution should be treated as a dividend unless it is undertaken on a formal reduction of legal stated capital in compliance with all required corporate law procedures.

60 Paragraph 53(2)(b).

61 Subsection 40(3).

62 Dated June 9, 2006.

Lower-Tier Distributions

The proposed changes to the lower-tier distributions rules[63] may cause traps for the unwary taxpayer. The new rules deem FAPI to arise even where the shares concerned are excluded property. Again, the issue is best illustrated with an example.

FA2 has cash of $150 available but no surplus. Its shares are excluded property and have an ACB of $120. Thus, the entire distribution is deemed a preacquisition surplus dividend, which reduces the ACB of the shares and results in a deemed capital gain of $30 to FA1. Under current law, no FAPI arises (because the shares are excluded property), and FA1 has $15 in exempt surplus and $15 in taxable surplus.

Under proposed law, the same $30 deemed capital gain arises. However, the taxable capital gain of $15 is deemed to be FAPI whether or not the shares are excluded property.[64] If the FA2 shares are excluded property, Canco can elect to reduce the preacquisition surplus dividend and reduce or eliminate the gain otherwise triggered, thus reducing or eliminating the FAPI.[65] The election must be filed in prescribed form on or before Canco's tax return filing deadline for the year that included the FA1's taxation year-end for the year of FA1 in which the transaction occurred.[66] Because the provision is still in draft form, no prescribed form is available and so Canco may be required to attach a written statement to its tax return indicating its wish to file the election and the elected amount. We hope that, if this provision is ultimately enacted, taxpayers will have a transitional period from the date of royal assent to file elections for all transactions affected by this provision. However, this relief is not currently set out in the draft legislation.

Lower-Tier Redemptions

Under current law, the redemption of shares held by another foreign affiliate is treated as resulting in proceeds of disposition and potential capital gains or losses. The February 2004 proposals introduce the concept of a "dividend-like redemption,"[67] which applies where:

- the shares redeemed are excluded property, and
- the redemption does not change the surplus entitlement percentage of the Canadian corporation.[68]

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63 New paragraph 95(2)(e.3).

64 Proposed paragraph B(c) of the definition of FAPI in subsection 95(1).

65 Proposed subparagraph 95(2)(e.3)(iv).

66 Proposed regulation 5916.

67 Defined in proposed subsection 95(3.2).

68 Surplus entitlement percentage, defined in regulation 5905(13), is a measure of the Canadian corporation's share of the surplus of the particular foreign affiliate, on the assumption that distributions are made throughout the chain of foreign affiliates below and above the particular affiliates. If each affiliate in the relevant chain of ownership has only one class of shares, the surplus entitlement percentage is equal to the direct and indirect equity percentage. If there are several classes of shares, the computation is more complicated.

Proposed paragraph 95(2)(e.4) sets out the tax consequences of a dividend-like redemption and may have unexpected results. For example, assume FA1 owns preferred shares in FA3 while another affiliate, FA2, holds FA3's common shares. FA3 has exempt surplus of $100, and both the ACB and the FMV of the preferred shares is $100. If FA3 redeems the preferred shares for $100, under current law, FA1 has proceeds of $100, resulting in no gain or loss and no change to FA3's surplus accounts. This result seems to be appropriate because the preferred shares have full basis and do not participate in FA3's distributable earnings.

Under the proposed law, the result is markedly different. The cash received by FA1 is deemed to be a dividend received on the preferred shares.[69] Because FA3 has exempt surplus of $100, the full dividend is deemed paid from exempt surplus and thus increases the exempt surplus of FA1. The preferred shares are also deemed disposed for an amount equal to their cost amount, resulting in no gain or loss.[70] The tax basis of the preferred shares thus simply disappears and has no tax effect, while the full exempt surplus of FA3 is distributed on the preferred shares, even though they have no current dividend entitlement. Thus, under the proposed rules, lower-tier redemptions can lead to the loss of tax basis and the unexpected movement of surplus accounts.

Summary: Changes to Liquidation and Distribution Rules

In summary, the proposed legislation, if enacted, will significantly change the tax treatment of foreign affiliate liquidations and dissolutions. However, the legislation is still in flux. Recent comfort letters confirm that the proposals are under review and further changes are possible. The same comfort letters also promise transitional provisions to maintain the benefits of previously announced legislative changes up to the date of any announcement of further revisions.

One area that is not addressed in the comfort letters is the treatment of liquidations and dissolutions where the conditions for a "qualifying liquidation and dissolution" are not met or where the taxpayer chooses not to elect for such treatment. The transitional rules will likely maintain the treatment applicable under the February 2004 version of subsection 88(3) if further changes are ultimately made. Another area not covered in the comfort letters is the integration of the lower-tier distribution and redemption rules (paragraphs 95(2)(e.3) to (e.5)) with the FPUC rules and changes to subsection 88(3) and paragraph 95(2)(e.1).

Taxpayers undertaking transactions within the scope of these rules should consider all three versions—current law, February 2004 proposals, and further changes announced or implied in the comfort letters—to ensure that none of the versions will produce unexpected tax consequences.

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[69] Proposed subparagraph 95(2)(e.4)(iii).

[70] Proposed subparagraph 95(2)(e.4)(iv).

CONCLUSION

Foreign affiliate holding companies offer significant tax and non-tax benefits. This article highlights some of these benefits and certain disadvantages and concerns in using these structures. A number of holding company jurisdictions have recently improved the attractiveness of their regimes. A number of important source jurisdictions, on the other hand, have become more aggressive in limiting or denying the benefits of intermediaries, whether by introducing legislation to tax gains on offshore “indirect” sales, renegotiating treaties to eliminate certain exemptions and introduce limitation-on-benefits provisions, or mounting administrative and judicial challenges to perceived tax avoidance created by holding companies. As a result, it is becoming increasingly important for a holding company to show substance and commercial purpose beyond tax efficiencies.

This article has also highlighted certain implications of changes to the Canadian tax rules governing repatriations, which are currently in a state of flux. Some of these changes are favourable, while others are not. Taxpayers should plan to mitigate the impact of the unfavourable changes before any further announcements, because existing transactions will probably only be grandfathered up to the date that the changes are announced.