Outbound Developments

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Overview

- Foreign affiliate amendments – August 2010 Changes
- FTC Generator Proposals Update
- TIEA Update
- Beneficial Ownership
- Recent CRA Rulings / Interpretations

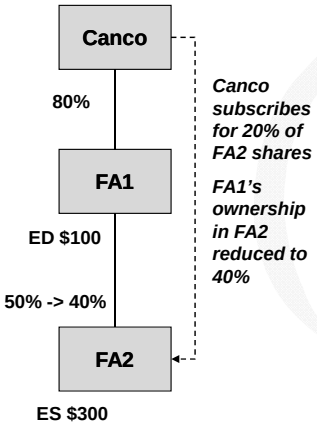
Foreign affiliate amendments – August 2010 Changes

- Fill-the-Hole (FTH) Rules
  - Less than wholly-owned affiliates
  - Split Ownership Chains
  - Underallocations
- Acquisition of Control (AOC) Rules
  - Amended Bump Designations
  - Expanded Disproportionate UFT Designations
  - Other Issues
- Other Changes
  - Modified Excluded Property Test
  - Tax Sharing Payments & FAPLs
  - SEP Adjustments
  - Transitional 93(1) Elections

Still to Come in the Future

- 88(3) Liquidations and Foreign Paid-Up Capital
- FA Merger and Liquidation Rules
- Suspended Surplus and FAPLs
- Fresh Start Rules

FTH Rules – Less than Wholly Owned



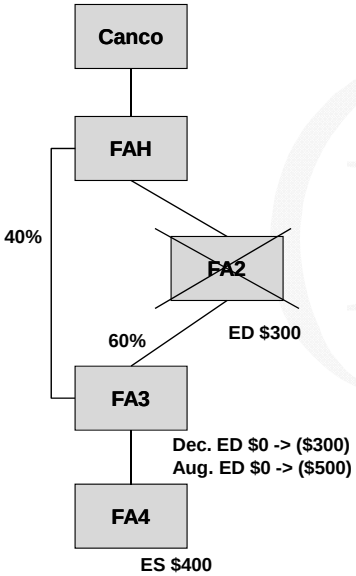
December Proposals

- Formula results in excessive surplus grind where Canco's SEP in FA2 < FA1's SEP in FA2
- FTH amount = FA1's ED/Canco's SEP in FA2 = $100/40% = $250
- FA2's ES reduced to $50, Canco's entitlement = $20 (was $40)

August Proposals

- FTH amount = FA1's ED/FA1's SEP in FA2 = $100/50% = $200
- FA2's ES reduced to $100, Canco's entitlement = $40
- FA2's surplus reduction should equal amount "blocked" by FA1's deficit if dividends paid by FA2 up the chain

FTH Rules – Split Ownership



December Proposals

- Formula results in excessive surplus grind where Canco's SEP in acquired FA > deficit FA's SEP in acquired FA
- FTH amount = FA2's ED/Canco's SEP in FA3 = $300/100% = $300
- FA3's ED = $300, Canco's entitlement in FA4 = $100 (was $160)

August Proposals

- FTH amount = FA2's ED/FA2's SEP in FA3 = $300/60% = $500
- FA3's ED =$500, Canco's entitlement = ($100)
- FTH amount should be $240 = amount FA2 would have received if dividends paid by FA4 up the chain

FTH Rules - Underallocations

- Taxpayer can choose allocation of the surplus grind among acquired affiliates
- Anti-avoidance rules in Regulations 5905(7.3) and (7.4) prevent taxpayer from not fully allocating FTH amount
  - Under December proposals, automatic designation equal to entire tax-free surplus balance of each acquired affiliate, effectively re-setting their surplus to nil
  - Under August proposals, amount designated for each acquired affiliate is amount determined by Minister
- It appears that determination made by Minister is fully discretionary and cannot be challenged by taxpayer, except under general administrative law principles

AOC Rules – Amended Bump Designations

- Transitional rules
  - Taxpayer has a choice between bump and surplus
  - If bump claimed, any pre-AOC surplus/deficit balances of bumped affiliate and any lower tier affiliates re-set to nil
- Proposed rules
  - Surplus comes before bump and taxpayer does not have a choice
  - Bump room is reduced by tax-free surplus (TFS) of affiliate at time of AOC
  - If ACB and TFS exceed FMV of FA shares (regardless of bump) → surplus grind

AOC Rules – Amended Bump Designations

- August changes
  - Clarify that surplus grind does not apply on a related party AOC (ss. 256(7))
  - Taxpayer can amend bump designation within 10 years of regular filing due date where
    - Taxpayer made "reasonable efforts" to determine TFS in original bump designation; and
    - In opinion of Minister, it is "just and equitable" to allow amended designation
    - Technical Notes clarify that standard is met where surplus requires adjustment because of CRA or foreign tax audits/reassessments

Expanded Disproportionate UFT Designation

- Current rule
  - Taxpayer can claim a disproportionate amount of UFT in relation to a TS dividend
  - Not available for a subsection 93(1) election
  - Other conditions required (affiliate is wholly-owned with only 1 class of shares)
- August proposals
  - All restrictions removed
  - Disproportionate designation can now be made on a subsection 93(1) election
    - Achieves "matching" of bump grind for TFS (which includes grossed-up UFT) with use of UFT to shelter gain
  - Additional flexibility to use UFT in other situations
  - Applicable to dividends paid after December 18, 2009

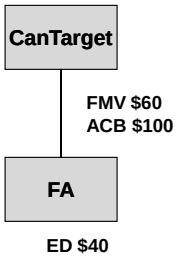
Expanded Disproportionate UFT Designation

- New opportunities for subsection 93(1) elections
  - Claim amount equal to lesser of TS and grossed-up UFT in all cases
  - For lower-tier dispositions, file protective designations on all 3rd party sales to maximize UFT available for future distributions

Expanded Disproportionate UFT Designation

- Timing
  - Claim must be made in taxpayer's return of income and no provision for late filing
  - Should designation be made in year lower tier dividend is received by upper tier FA, or only when the related TS is distributed to Canco?
  - CRA position
    - Claim to be made in tax return for year in which lower tier dividend is received by upper tier FA (see TI #August 1991-254).
    - Written statement to be attached to tax return identifying dividend and amount of claim
  - Practical issue arises as taxpayers often only compute surplus when dividends are paid to Canada, and amount of claim cannot be determined until surplus calculations completed

AOC Rules – No Deficit Re-Set



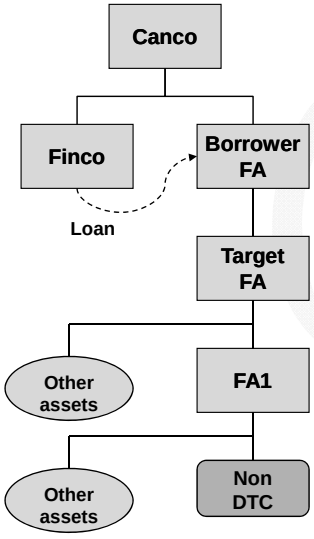
August Proposals

- Surplus written down where shares have excess tax attributes, but no equivalent rule for deficits
- On AOC of CanTarget, ACB written down to $60 but FA's ED of $40 remains
- If FA then earns $40 and is sold for $100, gain in CanTarget of $40 even though no economic gain

AOC Rules – Other Issues

- Practical issues on bump grind
  - Up-to-date surplus calculations often not available and time consuming to prepare
  - Often difficult to obtain information – hostile bids, poor record keeping by target, loss of older records
  - Tax returns for recent years may not be finalized until after required filing deadlines for 93(1) election or bump designation
  - "Reasonable efforts" and "just and equitable" tests are subjective and at CRA's discretion

Modified Excluded Property Test



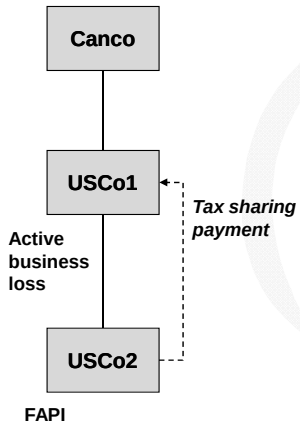
Issue

- Target FA and FA1 are resident and carry on business in same DTC
- FA1's shares make up 20% of Target FA's assets
- Assets of non-DTC branch make up 20% of FA1's assets

Result

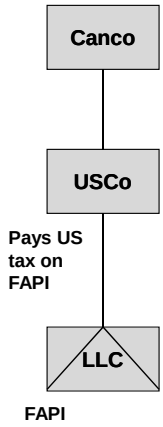
- Shares of FA1 do not meet modified EP test because substantially all of its assets are not used in an active business carried on in a DTC(FMV test practically often interpreted as a greater than 90% threshold)
- Shares of Target FA do not meet modified EP test because FA1 shares make up > say 10% of its assets
- All of Finco's interest may be taxable surplus even though on a consolidated basis only 4% (20% of 20%) of Target FA's assets are in a non-DTC

FAT Comfort Letter – Consolidated Groups



- USCo1 and USCo2 file a consolidated return such that no overall US tax arises
- USCo2 makes a tax compensatory payment to USCo1 for use of loss
- Proposed rules only allow payment to be included in FAT if it relates to use of a FAPL
- Comfort letter agrees that FAT will be allowed in a future year if USCo1's AB loss is fully utilized against AB income in group if:
  - Future year is one of 5 years following year in which FAPI arose, and
  - Canco demonstrates that no other losses of any member of group could have offset AB income
- Applies to taxation years of FA beginning after 1999

FAT Comfort Letter – FTEs



- FAT only allowed as a deduction against FAPI if tax is paid by FA earning FAPI
- Double tax could arise if a fiscally transparent entity (FTE) earns FAPI and its members pay related tax
- Comfort letter agrees that FAT will be allowed if:
  - Member of FTE is directly liable under foreign law to pay tax
  - Number of members of FTE is less than 4
- Applies to taxation years of FA ending after 2010

Foreign Accrual Property Losses

- Carry-over period extended
  - Current 5 year carry-forward only
  - Proposed 3 year carry-back, 20 year carry-forward (transitional 7 and 10 years)
- Group claim rule – Reg. 5903(2)(c)
  - FAPL is ground by the greatest amount claimed by any non-arm's length person (regardless of actual claim by taxpayer)
  - Prevents duplication of FAPLs where FAs transferred amongst related persons
  - Effectively requires all related persons to make consistent FAPL claims
  - Retroactive to 1999
- Restriction on tax sharing payments – Reg. 5907(1.4)
  - December changes only applied if payment was for use of a FAPL
  - August changes clarify that rule is only relevant if tax sharing payment is made for use of losses

SEP Adjustments

- Current rules
  - Regulation 5905(1) applies where Canco or an FA acquires shares of another FA and Canco's SEP in the other FA increases
    - Surplus balances adjusted by ratio of SEP before/SEP after
  - Potential trap if FA transferred on a on a rollover basis to another FA under subsection 85.1(3) or paragraph 95(2)(c) and SEP in transferred FA is diluted
    - Canco's SEP in transferred FA is diluted
- Draft Regulation 5905(1)
  - Combines SEP adjustment aspects of old Reg. 5905(1), (2), and (9)
  - Applies any time there is an acquisition or disposition of shares of an FA and taxpayer's SEP in FA or any other FA in which the particular FA has an equity % changes
  - New rule applies to both SEP increases and decreases

93(1) Elections – Transitional Rules

- Election to use February 27, 2004 proposals (consolidated net surplus approach)
  - Applicable to dispositions between Dec 20, 2002 and Dec 19, 2009
  - Election must be made for all FA's of the particular Canadian corporation
  - Deadline: later of filing due date for year of royal assent & 1 year after assent
  - Imports consolidated surplus computation and deficit reallocation rules
- Election to use December 20, 2002 proposals
  - Applicable if make Feb. 2004 election and make this additional election, to dispositions occurring between Dec. 20, 2002 and Feb. 27, 2004
  - Essentially restricts surplus available for election to stand-alone surplus of transferred FA without any increase for surplus or decrease for deficits of lower tier FAs

93(1) Elections – Transitional Rules

- Election to amend previous 93(1) elections
  - If do not file the election to use the Feb 27, 2004 rules, but actually filed 93(1) elections on the basis of the previous proposals
  - Must be made before December 31, 2012
  - Only if CRA considers it "just and equitable" to allow the amendment
  - Technical Notes suggest this standard is met where the original election was filed based on the consolidated net surplus rules and the taxpayer simply amends the election to reflect their non-application
  - No late filing penalty if amendment is accepted (unlike general extension beyond 3 years)

FTC Generator Proposals Update

- The FTC Generator Proposals[1] – A year in the Life
  - March 2010 Budget
  - Comments by Finance at 2010 IFA Seminar
  - August 27, 2010 proposals
  - Submissions received by Finance until September 27, 2010
  - March 2011 Budget – nothing

[1]FTCG Proposals – 91(4.1) to (4.5), 126(4.11) to (4.13) and Regulations 5907 (1.03) to (1.06)

FTC Generator Proposals Update

- Application of August FTC Generator proposals:
  - Proposals will apply if the "hybrid condition" is met:
    - A partner's direct or indirect share of partnership income is less for foreign tax purposes than it is for Canadian tax purposes
    - A pertinent person or partnership ("PPOP") is considered to own fewer shares in a corporation or have a lesser direct or indirect share of partnership income (the corporation or partnership also being a PPOP) for foreign tax purposes than for Canadian tax purposes.
  - Result is denial of FTC, FAT and UFT for foreign taxes paid
  - Generally effective for taxation years ending after March 4, 2010 with transitional rules for taxation years ending after March 4, 2010 and on or before the August 27, 2010 announcement date

FTC Generator Proposals Update

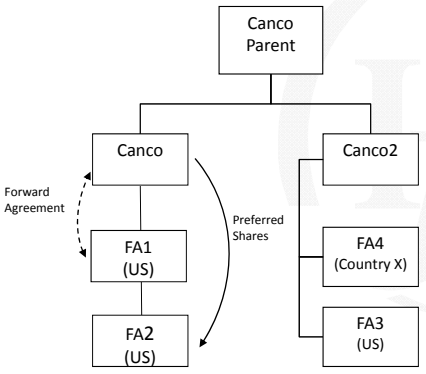
- The good news - Carve Out Rules Added for:
  - Hybrid entities (i.e., entities that are not treated as corporations under the relevant foreign tax law)
  - Hybrid partnerships (i.e., partnerships that are treated as corporations under the relevant foreign tax law).
  - Situations where a partner's share of partnership income is considered to be less for foreign tax purposes than it is for Canadian tax purposes because:
    - There are differences in the income computation between Cdn tax rules and the foreign tax law
    - There are differences in the income allocation because of the manner in which the admission or withdrawal of a member is treated between Cdn tax rules and the foreign tax law, or
    - Because a member is not treated as a corporation under foreign tax law

FTC Generator Proposals Update

- The bad news – definition of PPOP
  - The August 27th proposals can extend the application of the rules far beyond the chain with the offending hybrid instrument due to the definition of "pertinent person or partnership"
  - A "pertinent person or partnership" in respect of a taxpayer is:
    - The taxpayer
    - A Canadian resident person dealing NAL with the taxpayer
    - A partnership if a member is a PPOP in respect of the taxpayer
    - A foreign affiliate of: i) the taxpayer, ii) a person that is a PPOP in respect of the taxpayer, or (iii) a partnership that is a PPOP in respect of the taxpayer

FTC Generator Proposals Update

Example – Related Canadian Groups



Analysis

- Hybrid condition is met in relation to Canco's hybrid financing of US group
- Proposed ss. 91(4.1) and 5907(1.03) deny FAT and UFT in respect of any FAPI or taxable earnings of FA1 and FA2
- Due to PPOP definition rules also apply to FA3 and perhaps FA4 (if hybrid condition is met pursuant to Country X tax law)

Results

- Result is application of FTC generator rules to FA3 and FA4 (potentially) even though not party to hybrid financing
- Result is no relief for actual foreign taxes borne indirectly by Canco and Canco2
- Is review of the application of all foreign tax laws to all financing instruments in related party structure necessary?

FTC Generator Proposals Update

- Review of concerns not addressed in August proposals
  - Application of rules based solely on the “hybrid condition” ignores the other features of the FTC generator “schemes” targeted by Finance
  - Denial of UFT and/or FAT in relation to transactions that may have nothing to do with the existence of a hybrid instrument (i.e., capital gains and FAPI) results in double tax

TIEA Update

- TIEA activity over past year
- The Residency double standard revisited
- The Timing of DTC status double standard revisited

TIEA Update - Current status of TIEAs

	Jurisdiction	Date
In force	Bonaire (1&3)	January 1, 2011
	Curacao (1&3)	January 1, 2011
	Saba(1&3)	January 1, 2011
	Sint Eustatius (1&2)	January 1, 2011
	Sint Maarten (1&3)	January 1, 2011
Signed	Anguilla (2)	October 28, 2010
	Bahamas (2)	June 17, 2010
	Bermuda (3)	June 14, 2010
	Cayman Islands (3)	June 24, 2010
	Dominica (2)	June 29, 2010
	Guernsey (3)	January 19, 2011
	Isle of Man (3)	January 17, 2011
	Jersey (3)	January 12, 2011
	Saint Lucia (2)	June 18, 2010
	San Marino (2)	October 27,2010
	St. Kitts and Nevis (2)	June 14, 2010
	St. Vincent and the Grenadines (2)	June 22, 2010
	Turks and Caicos (2)	June 22, 2010

	Jurisdiction	Date
Negotiations	Aruba	May 25, 2009
commenced	Bahrain	June 29, 2009
	Belize	June 26, 2010
	British Virgin Islands	December 6, 2005
	Brunei	May 13, 2010
	Cook Islands	August 19, 2010
	Costa Rica	June 22, 2010
	Gibraltar	May 14, 2009
	Liberia	February 23, 2010
	Liechtenstein	July 6, 2010
	Vanuala	July 21, 2010

Note:(1) Bonaire, Curacao, Saba, Sint Eustatius and Sint Maarten were formerly the Netherlands Antillies, which ceased to exist on October 10, 2010. However, the TIEA between Canada and the Kingdom of the Netherlands in respect of the Netherlands Antilles, will continue to apply to all five jurisdictions.

(2) Taxes covered by these agreements – Taxes on income, capital, and on goods and services imposed or administered by the Government of Canada.

(3) Taxes covered by these agreements – Taxes on income or on capital imposed or administered by the Government of Canada.

TIEA Update – Not all Exempt Surplus is Created Equal

- Access to Exempt Surplus – DTC Residency Test
  - Treaty-Based DTC:
    - Central management and control (“CM&C”) common law test; and
    - Regulation 5907(11.2) deeming rule (FA must be resident of the DTC for the purposes of the specific tax treaty, which generally implies that the FA must be “liable to tax” in the foreign jurisdiction by reason of its domicile, place of management, or other criterion stated in the treaty)
  - TIEA-Based DTC:
    - CM&C common law test only

TIEA Update – Not all Exempt Surplus is Created Equal

- CRA's Historical Position on Barbados EICs
  - Barbados Exempt Insurance Companies (EICs):
    - Business of insuring risks located outside Barbados with premiums originating outside Barbados
    - Subject to Barbadian tax or license fee up to a maximum of BD$5,000/year for first 30 years
  - CRA's historical position:
    - Barbadian EICs with CM&C in Barbados not "liable to tax" in Barbados within Article IV of the treaty (i.e., no exempt surplus treatment since deemed not be resident of a DTC under 5907(11.2))

TIEA Update – Not all Exempt Surplus is Created Equal

- CRA's New Position on Barbados EICs
  - ITTN no. 35 (Feb. 26, 2007)
    - Where a person's worldwide income is subject to a contracting state's full taxing jurisdiction but domestic law does not levy tax on the income or taxes it at low rates CRA generally accepts that the person is a resident of the other contracting state unless the arrangement is viewed as abusive
  - CRA Document 2009-0316631C6 (dated June 5, 2009)
    - "Our current position is that a Barbados EIC is not liable to taxation in Barbados within the meaning of Article IV… Our position, however, is under review and we will release the conclusions reached in the course of our review when it is completed"

TIEA Update – Not all Exempt Surplus is Created Equal

- CRA's New Position on Barbados EICs (con't)
  - CRA Document 2007-0261551I7 (dated Oct. 19, 2010)
    - Barbadian EICs with CM&C in Barbados no longer considered deemed not to be resident of a DTC under 5907(11.2); Exempt surplus treatment now accepted by CRA
    - Taxable surplus dividend received from an EIC before Feb. 26, 2007:
      - Relief will be granted if valid objection or appeal outstanding
    - Taxable surplus dividend received from an EIC after Feb. 25, 2007:
      - Relief will be granted if amended returns filed within assessment / reassessment period

TIEA Update – Not all Exempt Surplus is Created Equal

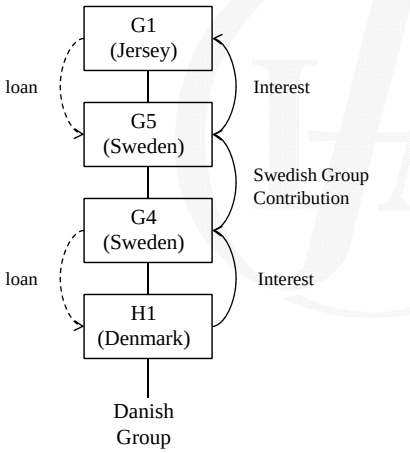
- Access to Exempt Surplus – Timing of DTC Status
  - For the purposes of the DTC definition:
    - A tax treaty is deemed to have entered into force on the 1st day of the FA's taxation year that includes the day on which the treaty was signed
    - A TIEA is deemed to have entered into force on the 1st day of the FA's taxation year that includes the particular day on which the TIEA entered into force
  - Ratification of several TIEA's may be delayed due to amendments to the Excise Tax Act announced as part of the pre-election 2011 budget (and presumably to be included in the upcoming budget). TIEAs affected are those that apply to all taxes imposed by the government of Canada (income, capital and excise taxes) and were otherwise ready to be ratified

Beneficial Ownership Developments

- OECD Discussion Draft – Meaning of "Beneficial Owner" in the OECD Model Tax Convention (April 29, 2011)
  - Significant rise in controversy globally around what is meant by "beneficial ownership"
  - Lack of a clear or common understanding of what constitutes beneficial ownership is causing significant differences amongst countries

Beneficial Ownership Developments

Danish Tax Tribunal Decision – SKM2011.57LSR



- Loan from G1 to G5 and loan from G4 to H1 had identical terms and timing
- G4 and G5 had no employees or offices (two managers from a NAL management company - salaries paid by G1)

Findings

- G4 could not be regarded as the "beneficial owner" either in relation to the Nordic Tax Treaty or in relation to the EU Interest Directive
- As group contribution transactions did not result in any taxation in Sweden, G4 and G5 should be regarded as conduit companies. Nature of payments as group contributions and not interest not relevant
- Establishment of Swedish companies together with structuring was undertaken to evade taxation of interest payments by H1

Recent CRA Rulings / Interpretations

- Conversion from a BV to a Dutch Cooperative (2010-0373801R3, Jan. 19, 2011)
  - Holders of the membership interest in the Dutch Co-op will be considered to own shares [Comments in IT-392 apply]
  - On conversion into the Co-op:
    - No disposition of inside assets
    - Cancellation of BV shares in exchange for membership interest in Co-op on conversion is tax deferred [s.86(1)]
  - Provisions of 85.1(3) apply to share transfers to Co-op

Recent CRA Rulings / Interpretations

- Amounts owed by Non-residents under section 17 (2003-001723, Mar. 9, 2011)
  - CRA is of the view the meaning of the term “amount owing” is sufficiently broad to include amounts accrued for accounting purposes by a corporation resident in Canada but not yet legally owing