
July 12, 2013 draft legislative proposals: Implications for foreign affiliates

July 15, 2013

In brief

Canadian corporations with foreign affiliates may be affected by draft legislative proposals released by the Department of Finance on July 12, 2013.

Many of the proposals were the subject of comfort letters previously issued by the Department of Finance. Although released on July 12, 2013, the proposals have different effective dates, and in certain cases, elections are available to change the effective dates at the option of the taxpayer.

Key proposals:

- modify the imputed income rules in section 17
- ensure that various foreign affiliate rules better accommodate structures that include partnerships
- narrow the scope of certain base-erosion rules
- ensure an income inclusion for stub-period foreign accrual property income on dispositions of foreign affiliate shares
- address taxes paid by shareholders of fiscally transparent entities
- provide ownership rules for foreign non-share corporations, such as limited liability companies (LLCs)
- amend the functional currency rules, e.g., by providing an earlier election deadline

The above changes and others are summarized with additional technical detail below.

As a result of the enactment of Bill C-48 on June 26, 2013, and the release of these proposals, for the first time in over 10 years taxpayers with foreign affiliates may finally have certainty regarding the tax legislation governing transactions involving foreign affiliates.

Comments on the proposals must be submitted to the Department of Finance by September 13, 2013.

In detail

Key changes affecting Canadian corporations with foreign affiliates are outlined below. Changes that were dealt with in comfort letters are followed by an asterisk.

Section 17

Amendments to section:

- correct an ambiguity by allowing an appropriate reduction in the imputed income under

subsection 17(1) when:

- subsection 17(2) applies because of an amount owing to a controlled foreign affiliate, and

- the interest on the amount owing is foreign accrual property income (FAPI)

A similar change is made relating to the back-to-back loan rules in subsection 17(11.2).*

- clarify that subsection 17(2) applies when only a portion of an amount owing became owing because of a loan or transfer of property by a corporation resident in Canada, and provide an appropriate reduction in the imputed income under subsection 17(1)

Stub-period FAPI

Amendments to subsections 91(1.1) and (1.2) include stub period FAPI in the income of a taxpayer when the taxpayer disposes of or reduces its interest in a foreign affiliate. This new rule is not intended to apply to certain transactions within a corporate group.

Partnerships

Amendments to section 93.1 that deal with partnerships owning shares of foreign affiliates:

- extend the application of subsection 93.1(1) to new subsection 93.1(5) (described below), subsection 95(2.2)*, and section 233.4
- clarify that dividends will flow through tiered partnerships*
- add new subsection 93.1(4) to allow clause 95(2)(a)(ii)(D) to apply to recharacterize interest paid by a partnership of which all members are foreign affiliates
- add new subsections 93.1(5) and (6) to deem, for purposes of certain provisions and in particular the recharacterization rules in subparagraph 95(2)(a)(ii), a non-resident corporation to be a

foreign affiliate of a partnership and for the partnership to have a qualifying interest in the foreign affiliate. This rule is similar to the rule in paragraph 95(2)(n), but addresses partnerships.*

Non-share corporations

New subsection 93.3(2) deems a non-resident corporation without share capital, e.g. a US LLC, to have 100 issued and outstanding shares of each class. Each equity holder is deemed to own a proportionate number of shares based on the fair market of its equity interest.

Subsection 95(1) definitions

Amendments in subsection 95(1):

- amend the definition of ‘foreign accrual property income’ to accommodate situations when:
 - a partnership is the relevant taxpayer, and
 - a second partnership held by a foreign affiliate of the relevant taxpayer receives a dividend from a non-resident corporation
- amend the definition of ‘foreign accrual tax’ to allow foreign tax paid by a shareholder of a fiscally transparent entity to qualify as foreign accrual tax*

Paragraph 95(2)(a)

Amendments to the active business recharacterization rules in subparagraph 95(2)(a):

- amend subparagraph 95(2)(a)(i) to:
 - include income earned by a partnership of which a foreign affiliate is a qualifying member, and

- allow income to be recharacterized by reference to the active business activities of a partnership of which the foreign affiliate or another foreign affiliate of the taxpayer is a member*

- remove the same country requirement in clause 95(2)(a)(ii)(D) in respect of the second and third affiliate

Base erosion rules

Amendments to the base erosion rules:

- exclude the application of paragraph 95(2)(b) to income from services performed by non-residents outside of Canada*
- amend the definitions of ‘excluded income’ and ‘excluded revenue’ to:
 - allow them to work with the de minimis rule in subparagraph 95(2)(a.3)
 - include any income or revenue, respectively, that is included in computing the income or loss from an active business of a foreign affiliate because of subparagraph 95(2)(a)(ii)*
- add new subsection 93(3.2) to allow income of a foreign affiliate from the sale of property to qualify for the ‘home-country goods’ exception in certain contract manufacturing situations when the contracting affiliate is in a different country

Functional currency election

Amendments to the functional currency rules:

- require the functional currency election to be filed on or before the day that is 60 days after the

first day of the first taxation year for which the taxpayer would like the election to apply. The change from the current deadline of six months before the end of the taxation year is intended to better accommodate taxpayers with short taxation years. However, it results in an earlier election deadline for full taxation years.

- add new subsection 261(17.1) to allow an amalgamated corporation to continue to determine its Canadian tax results using the same elected functional currency of its predecessor corporations without having to file an election

Income Tax Regulations

Amendments to the Regulations relating to foreign affiliates:

- amend the definition of ‘earnings’ to compute earnings from an active business under subparagraph (a)(iii) of the definition without reference to the thin capitalization rules under subsection 18(4)*
- add new subsections 5907(1.091) and (1.092) to account for and make appropriate surplus adjustments for the tax payable by the shareholder of a fiscally transparent entity
- remove the requirement from subsection 5907(1.1) that the primary and secondary affiliate be resident in the same country and deem, for the purposes of subsection 5907(1.1), a non-resident corporation to be a foreign affiliate if the non-resident corporation is a foreign affiliate of

a related Canadian-resident corporation*

- amend certain definitions in subsection 5907(1) to accommodate changes noted in the above sections

Miscellaneous amendments

- add an anti-avoidance rule in subsection 87(8.3) to prevent the use of the foreign merger rules to circumvent subsection 85.1(4)
- add a specific rule in subsection 93.2 to allow Australian trusts to be treated as foreign affiliates and distributions from them as inter-affiliate dividends subject to general foreign affiliate rules

Let's talk

For a deeper discussion of how these proposals might affect your business, or for help formulating comments in response, please contact:

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