

Bill C-48 gets royal assent: Implications for Canadian companies with foreign affiliates

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In brief

This *Tax Insights* focuses on foreign affiliate measures in Bill C-48, *Technical Tax Amendments Act*, 2012, which received royal assent on June 26, 2013. It highlights some important dates.

Taxpayers should review current and completed transactions to determine whether any transitional elections or designations may be required, and to ensure these are filed on time.

In detail

Bill C-48 implements measures that were included in a Notice of Ways and Means Motion (NWMM), tabled by Canada's Department of Finance (Finance) on October 24, 2012.

This comprehensive package of technical income tax legislation implements a variety of outstanding technical tax amendments, including legislative proposals related to the taxation of Canadian multinational corporations with foreign affiliates.

Foreign affiliate measures

Several foreign affiliate amendments in Bill C-48 (Parts 2 and 3) are the culmination of legislative developments that started almost ten years ago. The bill consolidates and amends foreign affiliate proposals released on:

- August 27, 2010, which modified proposals released on December 18, 2009
- August 19, 2011 (referred to as the '2011 Proposals'), which modified proposals

Main Bill C-48 foreign affiliate amendments¹

- upstream loans
- foreign affiliate distributions and returns of adjusted cost base (ACB)
- hybrid surplus
- surplus anti-avoidance and calculation rules
- foreign accrual property income (FAPI) loss streaming rules
- stop-loss rules
- loss carryover rules
- foreign affiliate reorganizations, including rules dealing with absorptive mergers
- 'fill-the-hole' surplus rules
- surplus adjustments on an acquisition of control
- tax credit generators

1. These changes are considered below, except for the last three. The foreign tax credit generator rules are discussed in a previous memo; see Table 1.

released on February 27, 2004 (2004 Proposals)

See Table 1 on page 5 for PwC *Tax memos* that address these proposals and other measures in Bill C-48.

Various foreign affiliate proposals apply retroactively and certain measures contain transitional elections or designations. Table 2 (page 6) summarizes application and filing-due dates; it will help ensure that you file transitional elections and designations on time.

Upstream loans

Bill C-48 enacts new rules requiring an income inclusion in respect of loans to a 'specified debtor'² from a foreign affiliate of the taxpayer. An exception is provided for loans repaid within two years of issuance, if the repayment is not part of a series of loans and repayments.³

If an amount in respect of a loan is included in income, an offsetting deduction is available if, among other conditions, the taxpayer can demonstrate that if the amount of the loan had instead been received directly or indirectly by the taxpayer as a dividend, the taxpayer would have been entitled to a full deduction for that dividend under any of various provisions.

A deduction is also available to the extent that a loan that was included in income is repaid in a subsequent year.

The upstream loan rules in the NWMM modified the 2011 Proposals (see Table 1). The NWMM (enacted as Bill C-48) included:

- various changes designed to improve the ability to claim deductions against amounts included in income under the upstream loan rules
- a look-through rule in respect of back-to-back loans, effectively ignoring intermediate lenders
- a mechanism to set off, in certain cases, a foreign exchange gain or loss realized by a taxpayer upon settlement of an upstream loan that existed on August 19, 2011, against the related gain or loss of the foreign affiliate from the settlement, if repayment occurs before August 20, 2016

Under Bill C-48, the upstream rules apply:

- in respect of loans and indebtedness incurred after August 19, 2011
- to an amount incurred before August 20, 2011 (a 'grandfathered loan') that is still outstanding on August 19, 2014, as if it were a separate loan or indebtedness incurred on August 20, 2014

Based on the two year repayment exception noted above, grandfathered loans repaid by August 19, 2016 should avoid the application of the upstream loan rules.

Election to avoid back-to-back rule

A taxpayer can elect to avoid the application of the back-to-back rule mentioned above in respect of all loans and indebtedness incurred before October 25, 2012. The deadline for this election is the later of:

- June 26, 2014
- the filing-due date for the taxpayer's taxation year that includes June 26, 2013

Foreign affiliate distributions

General

Bill C-48 incorporates a new tax regime for distributions by foreign affiliates. There had been some uncertainty regarding the treatment of distributions that were not dividends nor returns of capital and therefore did not fit in an established category of Canadian distributions. The new rules resolve this uncertainty by deeming any pro-rata distribution on a foreign affiliate share to be a dividend, unless received on the liquidation of the affiliate, on the redemption of the share or on a qualifying return of capital (QROC).

Generally, any foreign affiliate distribution not treated as a QROC or dividend (based on the above deeming rule), and not received on the redemption of the share or on the liquidation of the affiliate, is included in income as a shareholder benefit.

QROC elections

Bill C-48 amended the *Income Tax Act* to permit QROC elections. A taxpayer can elect to treat as a QROC any pro-rata distribution from a foreign affiliate on a reduction of the affiliate's paid-up capital (PUC). A QROC is taxed as a PUC reduction, rather than a dividend – i.e. the amount of the QROC is not included in income, but is deducted from the ACB of the share.

The provision permitting QROC elections applies after August 19, 2011. Returns of capital on or before that date are treated in accordance with their legal form, i.e. not as deemed dividends. A separate QROC election

2. 'Specified debtor' includes the taxpayer, a person with which the taxpayer does not deal at arm's length (other than a controlled foreign affiliate of the taxpayer, within the meaning assigned by section 17), as well as certain partnerships.

3. This exception is similar to the exception in subsection 15(2).

must be made for each distribution, and (for non-partnerships) is due on or before the taxpayer's filing-due date for the year that includes the last day of the foreign affiliate's taxation year in which the distribution is made. (A partnership's deadline for QROC elections is based in part on the filing-due dates of its members.) In some cases, a joint election is required, potentially with a different deadline.

Any election that would otherwise be due before October 24, 2013, can be filed before June 27, 2014.

Pre-acquisition surplus elections

Bill C-48 alters the tax treatment of foreign affiliate dividends, which generally depends on which surplus accounts the dividends are paid from.

By default, once an affiliate's exempt, (given Bill C-48) hybrid and taxable surplus balances have been exhausted, the remaining portion of a dividend paid by the affiliate is from its pre-acquisition surplus (PAS). This amount, when paid to a Canadian corporate taxpayer, is deductible in computing taxable income, but reduces the ACB of the affiliate shares.

Bill C-48 modifies the surplus ordering rules by generally allowing a corporation to elect for the whole amount of a foreign affiliate dividend to be paid from PAS, even if other surplus balances are available.

The PAS election is available for dividends paid after August 19, 2011. A corporation must file the election on or before its filing due-date for the year in which the relevant dividend is paid. An election that would otherwise be due before October 24, 2013, can be filed before June 27, 2014.

In some cases, a joint election is required, potentially with a different deadline.

Taxpayers can file a transitional election, which allows them to make PAS elections for dividends paid after December 20, 2002, and before August 20, 2011. This separate election is due by the later of:

- June 26, 2014
- the filing-due date for the taxpayer's taxation year that includes June 26, 2013

In some cases, a joint election is required, potentially with a different deadline.

Once this election for retroactivity is made, a separate PAS election must be made for each intended dividend. This retroactivity election forces the retroactive application of other provisions in Bill C-48, including the new deeming rule for foreign affiliate distributions.

Surplus rules

Hybrid surplus

New hybrid surplus and consequential rules in Bill C-48 replace a gain suspension regime (never enacted but introduced as part of the 2004 Proposals) to deal with the internal transfers of certain shares of foreign affiliates and partnership interests.

Under the new rules, the full amount of any gains realized by a foreign affiliate from the disposition of shares or partnership interests (if gains are not otherwise included in FAPI) will be added to the foreign affiliate's hybrid surplus in respect of the taxpayer. Upon repatriation of hybrid surplus to a Canadian corporation:

- half of the hybrid surplus amount will be deductible from taxable income (similar to an amount paid out of exempt surplus)

- the other half will be eligible for a deduction based on grossed-up underlying foreign tax (similar to the deduction against an amount paid out of taxable surplus)

With the introduction of hybrid surplus, the default deemed ordering of surplus distributions in Regulation 5901 is amended. A foreign affiliate's surplus pools will now be distributed in the following order:

1. exempt surplus
2. hybrid surplus
3. taxable surplus
4. pre-acquisition surplus

However, a new election will allow corporate taxpayers to access taxable surplus before hybrid surplus.

For internal dispositions (to a 'designated person or partnership'), the new hybrid surplus regime applies after August 19, 2011. However, for dispositions to other persons or partnerships, the rules apply after 2012.

The election to access taxable surplus before hybrid surplus is available in respect of dividends paid after August 19, 2011, and must be filed by the corporation on or before the corporation's filing-due date for its taxation year that includes the day the dividend is paid.

Because the gain suspension rules previously proposed have been abandoned, half of any gains realized on the disposition of foreign affiliate shares or partnership interests before August 20, 2011, will be included in each of the selling affiliate's exempt and taxable surplus pools pursuant to the former rules.

Surplus reclassification rule

A new specific anti-avoidance rule reclassifies exempt earnings arising on a disposition of property (other than money) to a 'designated person or partnership' as taxable earnings, if the disposition is an 'avoidance transaction.'⁴ According to the Explanatory Notes released with the 2011 Proposals, Finance believes this rule is necessary to replace the abandoned gain suspension regime in respect of certain internal transfers of property (other than foreign affiliate shares).

This new rule applies to transactions entered into after August 19, 2011.

Other changes affecting surplus

Bill C-48 modifies several stop-loss rules⁵ to ensure they do not apply to losses realized by a foreign affiliate on a disposition of excluded property. The amendments, which generally apply to dispositions that occur after August 19, 2011, ensure that those losses are realized and reduce surplus.

Another new rule requires a foreign affiliate's active business earnings or loss (when based on Canadian tax rules) to be computed as if:

- the maximum amounts of all discretionary deductions have been claimed, and
- all necessary elections have been made in order to maximize deductions

This rule applies to foreign affiliate taxation years that end after August 19, 2011.

Losses

FAPI loss streaming

Bill C-48 contains new rules that prevent capital losses realized by a foreign affiliate from the disposition of non-excluded property from being deducted against ordinary FAPI. This is done by limiting the deduction for allowable capital losses in the FAPI definition to the taxable portion of current year capital gains that are included in FAPI.

In addition, consistent with the new loss streaming approach, foreign accrual capital losses (FACLs) are now tracked separately from foreign accrual property losses (FAPLs) and their application is limited to taxable capital gains included in FAPI (after deducting current year capital losses). This change is made to align the FAPI system with domestic rules by providing that capital losses can be deducted only against capital gains.

These rules generally apply to foreign affiliate taxation years that end after August 19, 2011.

Dividend stop-loss rules

The dividend stop-loss rules that apply to dispositions of foreign affiliate shares on which exempt dividends were previously received are amended to allow the loss (without regard to the quantum of exempt dividends paid on the shares) to the extent that the taxpayer realizes a foreign exchange gain on a related financing instrument and certain other conditions are met. Similar amendments are also made to deal with foreign affiliate share dispositions by partnerships and the disposition of certain partnership interests when the partnership holds foreign affiliate shares.

These changes generally apply to dispositions of shares and partnership

interests that occur after February 27, 2004. However, taxpayers can elect to have them apply to dispositions occurring after 1994, triggering transitional rules. The deadline for this transitional election is the later of:

- June 26, 2014
- the filing-due date for the taxpayer's taxation year that includes June 26, 2013

Reorganizations

Share-for-share rollovers of shares of foreign affiliates from a Canadian corporation to another foreign affiliate, or between two foreign affiliates, will no longer apply if the fair market value of the transferred shares is less than their ACB to the transferor. The resulting loss will be suspended and released only upon one of the triggering events set out in the stop-loss rules.

These rules apply to dispositions that occur after August 19, 2011.

Assessments

Some amendments in Bill C-48 can be effective as of earlier dates, for example, in relation to taxation years of foreign affiliates beginning after November 1999, or to dispositions occurring after February 27, 2004.

In many cases, years that would otherwise be statute-barred are automatically kept open to allow the amendments to have retroactive effect. However, an election must be filed by December 26, 2013, to have most sections in Part 2 of Bill C-48 override the normal statute-barring rules.

Other measures in Bill C-48

Bill C-48 contains numerous other technical tax amendments. As with the foreign affiliate proposals,

4. 'Avoidance transaction' is defined in section 245.
5. Subsections 13(21.2), 40(3.6) and 93(4), as well as paragraphs 14(12)(a), 18(13)(a), 40(2)(e.1), (e.2) and (g), and 40(3.3)(a).

taxpayers should review current and completed transactions to determine whether any transitional elections or designations may be required or beneficial.

Accounting implications

For accounting purposes, Bill C-48 is considered:

- ‘substantively enacted’ for Canadian GAAP purposes on November 21, 2012
- ‘enacted’ for U.S. GAAP purposes on June 26, 2013

However, the date of substantive

enactment for Canadian GAAP purposes may be earlier for certain measures in Bill C-48, as follows:

- measures that were previously in Bill C-10 (2007) continue to be substantively enacted for Canadian GAAP purposes as of June 15, 2007, the date that Bill C-10 (2007) is considered to be substantively enacted
- the date of substantive enactment for measures in Bill C-10 (2007) that are modified by Bill C-48 must be evaluated to determine if the date of substantive enactment remains June 15, 2007

Table 1: Evolution of Bill C-48 – Key proposals

Last public draft	Highlights	PwC Tax memos at www.pwc.com/ca/taxmemo
July 16, 2010 technical amendments	<ul style="list-style-type: none"> • Restrictive covenants • Limitation on the deductibility of expenses where shares or options issued • Securities lending arrangements 	None
August 27, 2010 budget proposals and other measures	<ul style="list-style-type: none"> • Non-resident trusts 	October 24, 2012 Notice of Ways and Means Motion: “Final” version of non-resident trust rules (dated November 23, 2012)
	<ul style="list-style-type: none"> • Offshore investment funds 	October 24, 2012 Notice of Ways and Means Motion: Offshore investment fund rules revised (dated December 4, 2012)
	<ul style="list-style-type: none"> • Specified investment flow-through trust and partnership conversions and loss trading • Specified leasing property • Employee stock options • Registered charities 	August 27, 2010 Draft Legislation Implements 2010 Budget Proposals and Other Previously Announced Measures (September 22, 2010)
	<ul style="list-style-type: none"> • Foreign tax credit generators 	October 24, 2012 Notice of Ways and Means Motion: Changes to upstream loan and foreign tax credit generator rules (dated November 2, 2012)
	<ul style="list-style-type: none"> • Reporting regime for aggressive tax planning transactions 	New Federal Reporting Regime for Aggressive Tax Planning: Draft Legislation Released (September 21, 2010)
December 16, 2010 technical amendments	<ul style="list-style-type: none"> • Real estate investment trusts 	Proposed Changes to Real Estate Investment Trust (REIT) Tax Rules (December 20, 2010)
March 16, 2011 technical amendments	<ul style="list-style-type: none"> • Limitation on the deductibility of contingent amounts 	Finance Proposes Legislative Measures to Counter FCA Decisions (March 17, 2011)
	<ul style="list-style-type: none"> • Part XIII withholding tax on certain interest paid to a non-resident 	
	<ul style="list-style-type: none"> • Segregated fund policy reserves of a life insurance corporation 	
August 19, 2011 technical amendments	<ul style="list-style-type: none"> • Foreign affiliate amendments 	Long-awaited foreign affiliate amendments released (August 22, 2011)
October 24, 2012 technical amendments		October 24, 2012 Notice of ways and means motion: Changes to upstream loan and foreign tax credit generator rules (November 2, 2012)

Table 2: Important dates

Rules	Application	Regular or transitional election
Upstream loans	Loans and indebtedness incurred after August 19, 2011 Amounts incurred before August 20, 2011, if still outstanding on August 19, 2014	Transitional election: Back to back rule does not apply to loans and indebtedness incurred before October 25, 2012, with an election filed by the later of: <ul style="list-style-type: none"> June 26, 2014 the filing-due date for the taxation year that includes June 26, 2013
Qualified returns of capital (QROCs)	Elections available for returns of capital after August 19, 2011	Filing-due date for the year that includes the last day of the foreign affiliate's taxation year in which the distribution is made. (Partnership and joint elections could have other deadlines.) Any election that would otherwise be due before October 24, 2013 can be filed before June 27, 2014.
Surplus reordering – priority to PAS	Dividends paid after August 19, 2011	Filing due-date for the year in which the relevant dividend is paid. (Joint elections could have other deadlines.) Any election that would otherwise be due before October 24, 2013, can be filed before June 27, 2014
PAS-priority (transitional)	Dividends paid after December 20, 2002, and before August 20, 2011	Transitional election due on the later of: <ul style="list-style-type: none"> June 26, 2014 filing-due date for taxation year that includes June 26, 2013 Joint election could have a different deadline.
Hybrid surplus	For internal dispositions after August 19, 2011. Otherwise, after 2012	Election to access taxable surplus before hybrid surplus is available for dividends paid after August 19, 2011, and is due by the filing-due date for taxation year that includes the day the dividend is paid
Surplus reclassification (anti-avoidance)	Transactions entered into after August 19, 2011	N/A
Stop-loss rules not applying to excluded property losses	Dispositions after August 19, 2011	
Forced maximizing of deductions in computing active business earnings	Foreign affiliate tax years ending after August 19, 2011	
FAPI loss streaming		
Dividend stop-loss rules allowing certain foreign exchange losses	Dispositions of shares and partnership interests after February 27, 2004	Transitional election: Amendments can apply (generally) to dispositions occurring after 1994 with the filing of an election due on the later of: <ul style="list-style-type: none"> June 26, 2014 the filing due date for the taxpayer's taxation year that includes June 26, 2013
Assessments in respect of Part 2 amendments for statute-barred years	Election required	December 26, 2013
Reorganizations	August 19, 2011	N/A
Substantively enacted (Canadian GAAP)	November 21, 2012 (generally)	
Enacted (US GAAP)	June 26, 2013	
Royal assent		

Let's talk

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