

Tax memo

Canadian tax updates



October 24, 2012 Notice of Ways and Means Motion: Changes to upstream loan and foreign tax credit generator rules

Discusses changes the October 24, 2012 Notice of Ways and Means Motion makes to the upstream loan rules and foreign tax credit generator proposals.

November 2, 2012

On October 24, 2012, Canada's Department of Finance (Finance) released a Notice of Ways and Means Motion (NWMM). This "comprehensive package of technical income tax legislation" implements a variety of outstanding technical tax amendments, including legislative proposals relating to the taxation of Canadian corporations with foreign affiliates.

This *Tax memo*¹ will discuss changes made by the NWMM to the:

- upstream loan rules; and
- foreign tax credit generator proposals.

Upstream loan rules

Overview of the upstream loan rules

On August 19, 2011, Finance introduced new rules to cause certain loans from a foreign affiliate of a corporation resident in Canada to a "specified debtor" to be included in the income of the Canadian taxpayer (the August 2011 Proposals). Although the Canada Revenue Agency (CRA) had expressly permitted loans from foreign affiliates to Canadian corporations in the past (even of amounts representing taxable surplus), Finance indicated that these new rules were necessary to support the integrity of the taxable surplus and the then newly introduced "hybrid surplus" regimes. However, these rules can result in an income inclusion for a taxpayer even when no such taxable or hybrid surplus exists.

The "upstream loan" rules emulate the shareholder loan rules in subsection 15(2) in several ways:

- An exception exists for an indebtedness that is repaid within two years of the date that it became outstanding provided that the repayment is not part of a series of loans and repayments.
- An exception applies to ensure debt obligations that arose in the ordinary course of the creditor's business are exempt from the rules, provided that at the time the indebtedness arose there were bona fide terms of repayment.
- The upstream loan rules can apply when a "specified debtor" receives a loan or becomes indebted to the foreign affiliate. A "specified debtor" includes the taxpayer, a person with which the taxpayer does not deal at arm's length (other than a controlled foreign

1. For an overview of the measures in the NWMM, see our *Tax memo*, "Comprehensive income tax package released: Long-awaited foreign affiliate amendments included" at www.pwc.com/ca/taxmemo.

- affiliate of the taxpayer, within the meaning assigned by section 17), as well as certain partnerships (Therefore, the rules apply to loans made to other related persons other than the shareholder, similar to subsection 15(2).)
- If an upstream loan results in an income inclusion, a corresponding deduction can be claimed when the loan is repaid (provided the repayment is not part of a series of loans and repayments).

Under the August 2011 Proposals, if an amount in respect of a loan was included in income, a deduction may have been available provided that, had the amount of the loan been received directly or indirectly by the taxpayer as one or more dividends, the taxpayer could have claimed a deduction under paragraphs 113(1)(a) to (b) (which would include deductions in respect of hybrid surplus). The amount of the deduction that could be claimed with respect to taxable surplus is equal to the grossed up underlying foreign tax relating to the taxable surplus.

When a hybrid surplus balance exists, a deduction would be available only if the hybrid underlying tax were sufficient to provide for a full deduction on the hypothetical dividend paid from hybrid surplus. Some deductions available in the context of a dividend, such as deductions for the portion of a dividend deemed paid out of pre-acquisition surplus² or previously taxed foreign accrual property income (FAPI), were not permitted in the context of an upstream loan.

Additionally, the taxpayer (or any Canadian person not dealing at arm's length with the taxpayer) could not receive a dividend from the lending affiliate or any other affiliate relevant in determining whether a deduction would be available under paragraphs 113(1)(a) to (b) at any time that the indebtedness remained outstanding. If a dividend were received

under these circumstances, the entire deduction otherwise available would not be permitted.

Under the August 2011 Proposals, the definition of "specified debtor" ensured that loans between controlled foreign affiliates (within the meaning assigned by section 17) were excepted from the rules; however, offending loans to foreign affiliates not meeting the section 17 definition of controlled foreign affiliate were fully subject to the inclusion (to the extent of the taxpayer's surplus entitlement percentage in the lending affiliate), with no regard to the taxpayer's surplus entitlement in the specified debtor, if any.

Many also believed there were insufficient "grandfathering" provisions in respect of existing loans that were now subject to these rules. Pre-existing loans were deemed to have been repaid and re-loaned on the announcement date and therefore would have been subject to the upstream loan rules if not repaid by August 19, 2013. For many taxpayers who had relied on CRA administrative policy or rulings and entered into upstream loans (including those to related entities not under the control of the taxpayer), the two-year period seemed insufficient to unwind their existing structures.

The restrictions on claiming deductions in respect of upstream loans, the lack of sufficient "grandfathering" provisions and several other items were the subject of many submissions Finance received in respect of the August 2011 Proposals.³ The revised upstream loan proposals released as part of the NWMM are generally more robust and address several (but not all) of the concerns with the original draft.

2. The lack of relief when a dividend could have been paid free of tax as a result of a paragraph 113(1)(d) deduction was especially perplexing given that the August 2011 Proposals also included an election to "side-step" the normal dividend ordering rules in Regulation 5901(1) with respect to actual dividend distributions and allow dividends to be deemed paid out of pre-acquisition surplus prior to other surplus accounts.

3. See PwC's October 19, 2011, Submission to Finance on Amendments Regarding the Taxation of Foreign Affiliates at www.pwc.com/ca/en/canadian-national-tax-service/government-submissions/2011-09-foreign-affiliate-amendments.jhtml.

Key changes to the upstream loan rules

Ability to claim deductions improved

The ability of a taxpayer to claim a deduction in respect of an amount included in income relating to an upstream loan has improved under the NWMM.

a) Deductions for pre-acquisition surplus and previously taxed FAPI

The changes included in the NWMM may allow taxpayers to claim a larger deduction in respect of amounts included in income relating to upstream loans in certain situations. Subject to the restrictions noted below, taxpayers can now also claim relief for amounts that would have given rise to deductions under paragraph 113(1)(d) (pre-acquisition surplus amounts) and subsection 91(5) (previously taxed FAPI amounts) had an amount equal to the upstream loan been received directly or indirectly by the taxpayer as one or more dividends.

Deductions available in respect of pre-acquisition surplus amounts are limited to the adjusted cost base to the taxpayer of the shares of the foreign affiliate at the “lending time.” In addition, a deduction in respect of pre-acquisition surplus is not available if the specified debtor is a non-resident person with which the taxpayer does not deal at arm’s length or a partnership with a non-resident member that does not deal at arm’s length with the taxpayer.

b) Access to downstream surplus clarified

The NWMM clarifies the ambiguity in the August 2011 Proposals regarding the ability to access “downstream surplus” (surplus of foreign affiliates below the lending affiliate) when calculating the amount of any deduction available in respect of an upstream loan. Proposed subsection 90(11) deems the amounts of exempt, taxable and hybrid surplus (or the corresponding deficits) relevant to the calculation of the deduction to be the amounts that would be determined, at the lending time, under subparagraph 5902(1)(a)(i) of the Regulations. Thus, the NWMM clarifies that downstream surplus is to be taken into account when determining any deduction available in respect of an upstream loan.

c) Prohibition on Dividend Payments removed

The restriction in the August 2011 Proposals prohibiting deductions if a dividend was paid during the time that an upstream loan was outstanding has been removed. Although dividends will be allowed under the NWMM, new “anti-double-counting rules” are introduced. Under these rules, taxpayers cannot use the same amount of exempt surplus, hybrid surplus, taxable surplus or adjusted cost base (if applicable) during the period in which an upstream loan is outstanding to provide a deduction for any other loan or indebtedness or in respect of any deduction claimed under subsection 91(5) or paragraphs 113(1)(a) to (b) in respect of an actual (or deemed) dividend. Also, the adjusted cost base cannot be relevant in determining the taxability of any other distribution during the time that the specified amount remains owing.

PwC observations – *The relief provided in the NWMM relating to the ability to claim deductions in respect of amounts included in income under the upstream loan rules represent a welcome change for taxpayers. However, taxpayers that hope to take advantage of this deduction will need to maintain up to date information relating to the tax attributes of foreign affiliates.*

Surplus entitlement in specified debtor

The NWMM has addressed the concern that the August 2011 Proposals gave no regard to the taxpayer’s surplus entitlement in a specified debtor. The NWMM version of the upstream loan rules now provides that the amount of income inclusion to a taxpayer is determined by multiplying the amount of the upstream loan by the difference between the taxpayer’s surplus entitlement percentage in the creditor affiliate and the taxpayer’s surplus entitlement in the specified debtor, if any.

PwC observations – *The relief provided in the NWMM relating to the income inclusion taking into account the taxpayer’s surplus entitlement in a specified debtor is a welcome change for taxpayers. As a result, many loans within a foreign affiliate group when the taxpayer holds a consistent surplus*

entitlement in members of the group should not result in an inclusion for the taxpayer.

Indirect loans

The NWMM includes a look-through rule in respect of back-to-back loans. This provision applies anytime an “intermediate lender” makes a loan to an “intended borrower” because it received a loan from an “initial lender.” In these circumstances, the loan made by the intermediate lender to the intended borrower is deemed to have been made by the initial lender to the intended borrower.

The deemed loan will be for an amount equal to the lesser of the loan between the initial lender and the intermediate lender and the loan from the intermediate lender to the intended borrower. The actual loans between the initial lender and the intermediate lender and the intermediate lender and the intended borrower are deemed not to have been made to the extent of the deemed loan from the initial lender to the intended borrower. The initial and intermediate lenders and the intended borrower can be either a person or a partnership.

A corporation may elect out of the application of this back to back rule for loans made after August 19, 2011 and on or before October 24, 2012.

PwC observations – *This look-through rule may mitigate some of the concerns regarding the application of the upstream loan rules when there are multiple loans within a multinational group, especially when the ultimate parent is not a Canadian corporation. In particular, cash sweeping or pooling arrangements may be affected by this rule. Care should be exercised to ensure that unexpected consequences do not arise when there are multiple borrowing and lending arrangements between the entities in large multinational groups.*

Application date extended for existing loans

The NWMM version of the upstream loan rules become effective as of August 19, 2011, but only in respect of loans or indebtedness incurred after that date. For amounts outstanding as of August 19, 2011, the upstream loan rules will become applicable if those amounts remain outstanding on

August 19, 2014, as if they were a separate loan or indebtedness incurred as of August 20, 2014, and therefore could avoid application of the upstream loan rules if repaid by August 19, 2016. As a result, all loans or indebtedness existing on August 19, 2011, will effectively be entitled to a five-year repayment window prior to the upstream loan rules applying whereas all post August 19, 2011, loans or indebtedness will be entitled to only a two-year repayment window prior to the rules applying.

In addition, the NWMM provides a mechanism to set off any foreign exchange gain or loss realized by the taxpayer on settling an upstream loan that exists on August 19, 2011 with the related loss or gain of the foreign affiliate from the repayment, provided such repayment occurs before August 19, 2016 and the amount of the foreign exchange gain and loss in the taxpayer and foreign affiliate are equal.

PwC observations – *The extension of the grandfathering period for debts outstanding on August 19, 2011, is a welcome change for corporations that relied on previous CRA rulings or administrative positions. Notwithstanding this extension, companies with pre-existing upstream loans may want to consider the impact of these loans on their financial statements before August 2016.*

Foreign tax credit generator proposals

Background

First introduced in the March 4, 2010, federal budget (the March 2010 Proposals), the foreign tax credit generator rules targeted hybrid investments in foreign entities that were used to artificially create credits and deductions for foreign taxes when the taxpayer did not bear the economic cost of the tax.

Specifically, foreign tax credits for taxes paid on foreign-source income, and deductions for foreign accrual tax on FAPI of controlled foreign affiliates and underlying foreign tax on dividends received from foreign affiliates, were created using hybrid

instruments in order to reduce the taxpayer's Canadian tax on related investment income and enhance its return.

The foreign tax credit generator rules were introduced to address this concern. When these rules apply to an investment, the foreign tax associated with this investment is excluded in computing the foreign tax credits and deductions described above.

The first draft of the rules was released in the March 2010 Proposals. These rules generally applied to the following hybrid investments:

- an investment in a particular foreign affiliate, when the investor was considered under the relevant foreign tax law to own less than all of the shares of the particular affiliate that it owned under Canadian tax law; and
- an investment in a partnership, when the investor was considered to have a lesser direct or indirect share of the partnership income under the relevant foreign tax law than it had under Canadian tax law.

When the rules applied to a hybrid investment in a foreign affiliate, the foreign tax of other affiliates in the same ownership chain was also denied.

The foreign tax credit generator rules were substantially revised by the draft legislation released on August 27, 2010 (the August 2010 Proposals). These proposals significantly broadened the scope of the rules for foreign affiliates, by introducing the "pertinent person or partnership" concept. The August 2010 Proposals generally applied to any investment by a taxpayer in a foreign affiliate when:

- a pertinent person or partnership in respect of the taxpayer had a hybrid investment in an entity; and
- this entity was also a pertinent person or partnership in respect of the taxpayer.

Pertinent persons or partnerships generally included:

- the taxpayer;
- a person resident in Canada who did not deal at arm's length with the taxpayer;

- a partnership, any member of which was a pertinent person or partnership of the taxpayer; and
- a foreign affiliate of any of the above persons or partnerships.

When a taxpayer had a hybrid investment in a foreign affiliate, the March 2010 Proposals only denied the foreign tax of affiliates in the same ownership chain. In contrast, the August 2010 Proposals generally denied the foreign tax of all foreign affiliates of the taxpayer (and all foreign affiliates of non-arm's length persons) that were subject to tax under the relevant foreign tax law.

The August 2010 Proposals made two other changes to the foreign tax credit generator rules:

- They provided exceptions from the rules when the different tax treatment of the hybrid investment arose solely because of the presence of a hybrid entity, or because of differences in the tax laws governing the computation of partnership income.
- They introduced look-through rules for tiered partnerships. For example, when a partnership was a member of another partnership, a member of the first partnership was deemed to also be a member of the second partnership.

October 24, 2012, Notice of Ways and Means – Key changes

Overview

The scope of the August 2010 Proposals was very broad. When a taxpayer had a hybrid investment in a foreign affiliate, the rules could apply to every member of the taxpayer's corporate group and could deny the foreign tax of all foreign affiliates in the group that were subject to tax under the relevant foreign law, even if these affiliates had no connection to the hybrid investment.

At the 2012 International Fiscal Association (IFA) Conference, Finance⁴ stated that the foreign tax credit generator rules were intended to apply across foreign affiliate chains, in order to catch loans

4. Foreign Affiliate Proposals," a presentation made to the IFA Conference on May 17, 2012.

between affiliates. Finance acknowledged that the August 2010 Proposals were too broad, and stated that the cross-chain application of the rules would be restricted to situations where there was a clear link between affiliate chains, such as a funding arrangement.

The changes in the NWMM are generally consistent with these comments. The changes narrow the scope of the rules by revising the “pertinent person or partnership” definition and introducing the “specified owner” definition. These changes have the effect of restricting the rules to foreign affiliates in the same ownership chain as the hybrid investment. However, the NWMM also introduces two new proposals that can broaden the scope of the rules:

- an indirect funding rule, which can draw in other foreign affiliate chains when entities in these chains receive funding from the chain that includes the hybrid investment; and
- a deemed ownership rule, which deems an investor to have a hybrid investment in a foreign affiliate when dividends on the affiliate shares are treated as interest or other deductible payments under the relevant foreign tax law.

These changes are discussed in more detail below.

PwC observations – *Broadly, these changes address a key issue with the foreign tax credit generator rules, by generally limiting the denial of foreign taxes to affiliates in the same chain as the hybrid investment. However, several other issues that were raised have not been addressed.⁵ Finance had suggested that it was particularly concerned with certain third-party hybrid financing arrangements.*

As a result, there had been some optimism that exceptions would be made for other types of hybrid investments, including:

- *internal financing arrangements within a corporate group; and*

- *shares that are considered debts under the relevant foreign tax law solely because of their terms (e.g., certain preferred shares).*

It now appears based on the NWMM that no such exemptions will be provided. This means that taxpayers must pay close attention to the foreign tax treatment of their equity investments.

While the rules are now more focused, they still do not require a causal connection between the hybrid investment and the denied foreign tax. As a result, the rules can apply to genuine foreign tax that has no connection to the hybrid nature of an investment, such as taxes incurred by a foreign affiliate on the sale of another affiliate.

New definitions

The August 2010 Proposals applied if two “pertinent person or partnership” tests were satisfied: one for the owner of the hybrid investment, another for the entity that received the hybrid investment. The rules in the NWMM apply to a particular foreign affiliate of a taxpayer if:

- a “specified owner” in respect of the taxpayer has a hybrid investment in an entity; and
- this entity is a “pertinent person or partnership” in respect of the particular affiliate.

Essentially, the investor-level “pertinent person or partnership” test is replaced with a “specified owner” test, and the scope of the investee-level “pertinent person or partnership” test is modified.

Specified owners generally include:

- the taxpayer;
- a foreign affiliate of the taxpayer;
- a partnership of which either the taxpayer or a foreign affiliate is a member; and
- certain other persons and partnerships, when there is an indirect funding arrangement.

The key difference from the August 2010 Proposals is that the specified owner concept does not include other Canadian residents who do not deal at arm’s length with the taxpayer. As a result, a taxpayer’s hybrid investment in a foreign affiliate should not

5. See for example Paul L. Barnicke and Melanie Huynh, “Foreign Tax Credit Generators: Redraft” (2010) 18:10 Canadian Tax Highlights, 7 - 8.

taint foreign affiliates of other Canadian companies in the same corporate group.

Pertinent persons or partnerships generally include:

- the particular foreign affiliate;
- other foreign affiliates in the same ownership chain;
- partnerships of which any of the above foreign affiliates are members; and
- certain other persons and partnerships, when there is an indirect funding arrangement.

Unlike the equivalent rule in the August 2010 Proposals, this definition does not include foreign affiliates in different ownership chains. Therefore a hybrid investment in a foreign affiliate should not taint foreign affiliates in other chains.

PwC observations – *These changes generally restrict the scope of the foreign tax credit generator rules to the affiliate chain which includes the hybrid investment. This should allow taxpayers to make hybrid investments without affecting the foreign tax of their existing affiliates, provided that these investments are structured carefully. Taxpayers should isolate their hybrid investments in separate ownership chains, and should closely monitor any transfers of funds between these chains.*

Indirect funding

The indirect funding rule expands the scope of the foreign tax credit generator rules if the foreign affiliate chain that includes the hybrid investment provides funding to another affiliate chain in the same corporate group. When this rule applies, the “specified owner” and “pertinent person or partnership” definitions are broadened to include the ownership chain that provides the funding.

This rule applies to a particular foreign affiliate when funding is directly or indirectly provided to the particular affiliate (or to a partnership of which the particular affiliate is a member) by a “funding affiliate” or a “funding partnership,” as part of a series of transactions that includes the earning of the relevant FAPI. A “funding affiliate” is another foreign affiliate of the taxpayer, or of a person resident in Canada who is related to the taxpayer. A

“funding partnership” is a partnership of which a funding affiliate is a member.

Generally speaking, when the indirect funding rule applies:

- the “specified owner” definition is expanded to include the related person, each foreign affiliate of the related person and any partnership of which any of these entities is a member, and
- the “pertinent person or partnership” definition is expanded to include the funding affiliate or partnership, any non-resident corporation in the same ownership chain as the funding affiliate and any partnership of which any of these entities is a member.

This rule does not apply when funding is provided by way of:

- acquisitions of corporate shares; or
- loans or other indebtedness with arm’s length terms and conditions.

PwC observations – *This rule could present a challenge for structures that seek to isolate hybrid investments from other foreign affiliates, particularly when taxpayers use intra-group financing. Taxpayers may need to conduct additional due diligence, to confirm that the terms and conditions of the debt used in their financing structures reflect arm’s length terms and conditions.*

Deemed ownership test

As discussed above, a hybrid investment in a foreign affiliate is determined based on an ownership test, i.e., whether an investor is considered under the relevant foreign tax law to own less than all of the shares of the affiliate that it owns under Canadian tax law. The NWMM expands the scope of this test by introducing a deemed ownership rule. This rule deems the ownership test to be satisfied when a specified owner owns shares of a foreign affiliate and the dividends on these shares are treated as interest or other deductible payments under the relevant foreign tax law.

PwC observations – *This rule could significantly expand the scope of the rules to capture*

investments that might not be considered hybrid investments in the conventional sense. For example, dividends paid on shares in certain countries are considered dividends under local corporate law but are deductible by the payer. As a result, such instruments that are equity but have deductible payments could be considered hybrid investments under the new rules. Taxpayers will need to closely examine the foreign tax treatment of distributions on their investments.

Application

The foreign tax credit generator rules in the NWMM apply to taxation years ending after October 24, 2012.

For taxation years ending between March 4, 2010 and October 24, 2012, a transitional version of the rules applies. These transitional rules are essentially the same as the March 2010 Proposals, with the addition of the hybrid entity exemptions from the August 2010 Proposals.

For more help

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