Tax memo
Canadian tax updates
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Canadian federal budget targets Canadian subsidiaries of foreign multinationals

Highlights significant changes associated with new "foreign affiliate dumping" and thin capitalization proposals in the 2012 Canadian budget.

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Although the 2012 Canadian federal budget, released on March 29, 2012, did not change corporate tax rates, it included unexpected policy changes that will affect Canadian subsidiaries of foreign multinationals.

New "foreign affiliate dumping" proposals

The budget introduced sweeping rules to curtail a variety of transactions it describes as "foreign affiliate dumping" transactions. These transactions involve an investment in a foreign affiliate (FA) by a corporation that is:

- resident in Canada; and
- controlled by a non-resident of Canada.

Those corporations are referred to in this *Tax memo* as CRICs.

When certain conditions are met, a dividend will be deemed to have been paid by the CRIC to its foreign parent to the extent of any non-share consideration given by the CRIC for the "investment" in the FA. The proposals define "investment" broadly to include:

- an acquisition of shares or contribution of capital;
- transactions where the FA becomes indebted to the CRIC (or a related Canadian company); and
- an acquisition of certain options in shares or debt of the FA.

Any deemed dividend will be subject to Canadian withholding tax (as reduced by the applicable treaty). As currently worded, the proposals do not provide for relief from additional withholding tax when funds invested in a FA are actually repatriated to its foreign parent. In addition, the paid-up capital of any shares of the CRIC that are given as consideration is disregarded (including for purposes of the thin capitalization rules). These proposals extend an existing cross-border surplus stripping rule to cover transactions involving FAs. The proposals generally apply to transactions occurring after March 28, 2012.

"Business purpose" test

Transactions that meet a "business purpose" test will not be subject to these rules. A business purpose will exist if it is reasonable to conclude that the investment in, and ownership of, the FA belongs in the Canadian subsidiary more than in any other entity in the foreign parent's

group. The proposals set out factors to be considered in determining whether the business purpose test will apply. These will prove difficult for most CRICs to meet. The federal government has invited stakeholders to submit comments concerning the details of the proposed business purpose test before June 1, 2012.

Perceived abuse

In the past, companies have undertaken transactions to leverage CRICs to fund the acquisition of shares of a FA from foreign related parties – referred by some as "debt-dumping" or "debt pushdown" transactions. Generally, the result of these transactions is an interest deduction in respect of the debt and the receipt of tax-free dividends from the FA (dividends deemed paid out of the exempt surplus of the FA).

Debt-dumping transactions have long been questioned by the government from a policy perspective; however, previous measures introduced to curtail these transactions have been unsuccessful. The foreign affiliate dumping proposals introduced in the 2012 federal budget extend far beyond debt-dumping transactions to potentially cover all transactions whereby a CRIC acquires shares of a FA (from related parties or third parties), whether the acquisition is funded by debt, capital, or even internally generated funds on hand.

Transactions potentially subject to withholding tax

Under the new, broadly worded foreign affiliate dumping proposals, **many transactions involving a CRIC and a FA could result in a deemed dividend that is subject to withholding tax**. Transactions that may give rise to a deemed dividend include:

- an acquisition by a CRIC of shares of the capital stock of an entity that is or becomes a FA, irrespective of whether the acquisition is from a third party or related party and whether the acquisition is funded via debt, capital or cash resources;
- a contribution of capital to a FA by a CRIC;
- a loan of funds to a FA by a CRIC;
- an acquisition of debt of a FA by a CRIC;
- transfers of shares of FAs between CRICs, if the transferee CRIC pays non-share consideration; and
- transfers of FA shares directly held by a CRIC to another FA of the CRIC.

The above list is not exhaustive. As a result, the impact of the proposals should be considered when reviewing **any** transactions involving a CRIC and a FA.

Changes to thin capitalization rules

The 2012 federal budget modifies the Canadian thin capitalization rules as follows:

- Interest deductibility of a Canadian-resident corporation is limited if the amount of debt owing to certain non-residents exceeds a 1.5-to-1 debt-to-equity ratio (the previously allowed debt-to-equity ratio was 2-to-1). This amendment applies to corporate taxation years beginning after 2012.

- The thin capitalization rules are extended to cover debts owed by partnerships of which a Canadian-resident corporation is a member. The Canadian-resident corporation is deemed to owe its specified proportion of the debts owing by the partnership. When the corporation determines that an amount of debt of the partnership deemed owed by it for the purposes of the thin capitalization rules is "excess debt" as determined for thin capitalization purposes, the corporation is required to include in its taxable income interest calculated on the excess debt portion. This amendment applies in respect of debts of a partnership that are outstanding during corporate taxation years beginning after March 28, 2012.

- The interest expense of a Canadian-resident corporation that is not deductible by reason of the application of the thin capitalization rules is characterized as a dividend for Canadian withholding tax purposes (previously treated as

interest for Canadian withholding tax purposes). This amendment generally applies to taxation years ending after March 28, 2012.

- Under the thin capitalization rules, a Canadian-resident corporation may be prevented from deducting its interest expense on a loan made to it by one of its controlled foreign affiliates (CFAs). Nevertheless, the Canadian-resident corporation would be taxed in Canada on an accrual basis on the interest income the CFA earned on that loan (referred to as "foreign accrual property income"). The amendments correct this element of double taxation for taxation years of a Canadian-resident corporation ending after March 28, 2012.

For more help

For more information on how these rules apply to your company, please contact any of the individuals listed below:

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