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Legislation tabled October 15, 2012: Foreign affiliate dumping and shareholder loan rules

Outlines key changes to international tax measures, introduced in the October 15, 2012 Notice of Ways and Means Motion.

October 17, 2012

On October 15, 2012, the Minister of Finance tabled in the House of Commons a Notice of Ways and Means Motion (NWMM) to implement certain March 29, 2012 federal budget proposals (2012 budget or budget proposals), as well as certain other previously announced tax measures. The NWMM contains revisions to the foreign affiliate (FA) dumping rules and shareholder loan rules that were released as a consultation draft on August 14, 2012 (August proposals).[1]

During the consultation period, submissions were made to the Department of Finance (Finance) by PricewaterhouseCoopers LLP (PwC), the Tax Executives Institute, and the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, among other parties. The NWMM responds to those submissions, making important changes to the FA dumping proposals and shareholder loan rules, mostly of a relieving nature. This *Tax memo* highlights the changes in these two important areas.

Overview of foreign affiliate dumping rules and shareholder loan rules

In the past, foreign-owned corporations resident in Canada have undertaken transactions in which they acquired shares of a FA from a related foreign party, creating additional debt in Canada – referred to 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.

The 2012 budget introduced sweeping rules to curtail debt dumping transactions, although the rules are much broader and also target investments in FAs that Finance considers to be a "disguised distribution." The transactions targeted by the budget measures involve an "investment" in a FA (also referred to as the "subject corporation" in the rules) by a corporation that is:

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

1. See our *Tax memos* "August 14, 2012 legislative proposals: Important international tax changes," "August 14, 2012 legislative proposals released as consultation draft," "Canadian federal budget targets Canadian subsidiaries of foreign multinationals" and "2012 Federal budget: Continued tightening" at **www.pwc.com/ca/taxmemo**.

Generally, the thrust of the budget proposals was to deem a dividend to have been paid by the CRIC to its foreign parent to the extent of any non-share consideration (for example, debt) given by the CRIC for the investment in the FA and, when shares are issued as part of the consideration, to eliminate the paid-up capital (PUC) attributable to those shares. Any deemed dividend would be subject to withholding tax (as reduced by any applicable treaty). The 2012 budget proposals generally apply to transactions occurring after March 28, 2012.

Under the current shareholder loan rules, a loan by a Canadian corporation to a non-resident shareholder or a person "connected" with that shareholder (other than a FA of the Canadian corporation) is deemed to be a dividend paid to the non-resident shareholder if the loan is not repaid within one year after the end of the taxation year of the lender or creditor in which the loan arose. The deemed dividend is subject to non-resident withholding tax (as reduced by any applicable treaty).

Following the 2012 budget, Finance released the August proposals, which contained a number of revisions applicable to the FA dumping rules and the shareholder loan rules. More specifically, the August proposals contained the following amendments:

- an expansion of the FA dumping rules to indirect acquisitions of FA shares;
- relief from the FA dumping rules through PUC reduction and reinstatement rules as well as for investments arising in the context of certain corporate reorganizations; and
- the introduction of an exception from the shareholder loan rules, and the FA dumping rules, for debt that qualifies as a "pertinent loan or indebtedness" (PLOI).

The NWMM contains further modifications to both the FA dumping rules and the PLOI regime. The key changes in the NWMM are discussed below.

Key changes to foreign affiliate dumping rules

Investments in subject corporations

The August proposals amended the broad definition of "investment" introduced as part of the original budget proposals to:

- provide an exclusion for an investment that is a PLOI;
- expand the definition of an "investment" to include an extension of the maturity date of an existing debt obligation owing to the CRIC by a FA and the extension of the redemption, acquisition or cancellation date of existing shares of a FA owned by the CRIC; and
- expand the definition of an "investment" to include certain acquisitions of shares of a Canadian company when the acquisition meets the threshold to be considered an indirect acquisition of a FA.

The NWMM introduces two relieving amendments to the August proposals:

- the PLOI exclusion is now available when the maturity date of an existing debt obligation owing to the CRIC by a FA is extended as long as the debt obligation is a PLOI immediately after the time of the extension; and
- the threshold for when an acquisition of the shares of a Canadian company will be treated as an indirect acquisition of a FA has been increased from 50% to 75%.

Therefore, acquisitions of shares of a Canadian company will only be treated as an indirect acquisition of a FA (and subject to the FA dumping proposals) when the total fair market value of all the FA shares owned directly or indirectly by the Canadian company exceeds 75% of the total fair market value of all of the properties of the Canadian company (subject to certain adjustments to exclude debts of any corporation resident in Canada).

PwC observations – The extension of the PLOI exclusion to cases when the maturity date of an existing indebtedness is extended puts taxpayers in the same position as if they had entered into a

transaction under which a new amount became owing by the subject corporation to the CRIC (and a PLOI election was filed).

Although companies will still have to be cautious of the effect of the indirect FA acquisition rule in transactions in which an existing Canadian company is acquired, the increase to the fair market value threshold is a welcome change.

Closely connected test

A narrow exception to the application of the FA dumping rules is provided for an investment that can be demonstrated to meet a "more closely connected" test. As the exception was outlined in the 2012 budget proposals, the test was framed as a "business purpose" test, with an accompanying list of factors that were to be given primary consideration in determining whether an investment in a FA could be considered to have been primarily made for *bona fide* purposes other than to obtain a tax benefit.

The August proposals changed the rule considerably, making it much more difficult for the exception to apply, by setting out a prescriptive list of requirements, all of which must be satisfied. Generally, the approach taken is to require that specific criteria be satisfied to demonstrate that the business activities of the FA or "subject corporation" are "more closely connected" with the business activities of the CRIC making the investment in the subject corporation than the business activities of any other non-resident company in the group.

According to Finance's Explanatory Notes, the purpose of the exception is to recognize that certain FA investments made by a CRIC may have been made by the CRIC even if the CRIC had not been foreign-controlled. The exception is intended to set out criteria that would allow a determination of whether the Canadian subsidiary is making a strategic acquisition of a business that is more closely connected to its business than to that of any non-resident member of the multinational group.

The rules as tabled in the NWMM have responded to certain of the criticisms made. In particular, concern was expressed that even if the acquisition was strategically more closely connected to a business that was already carried on by an existing FA of the CRIC, the test could not be met.

In its modified form, the rule provides that the CRIC must still demonstrate that it meets all of the conditions specified, which may be summarized as follows:

- the business activities of the subject corporation (and of all other corporations in which the subject corporation has an interest – referred to as "subject subsidiary corporations") are more closely connected to the business activities carried on in Canada by the CRIC, or another non-arm's length Canadian corporation, than to the business activities of any other non-resident corporation in the group, other than the subject corporation, a subject subsidiary corporation or a company that was already a controlled foreign affiliate (CFA)[2] of the CRIC;
- officers of the CRIC were the principal decision makers in regard to the making of the investment in the subject corporation and will have the ongoing decision making authority in regard to the investment, and a majority of those officers were resident and working principally in Canada or a country in which a CFA (a "connected affiliate") of the CRIC with "closely connected" activities is resident;
- it must be reasonable to expect that at all times officers of the CRIC will have and exercise the ongoing principal decision-making authority in respect of the investment and that a majority of those officers will be persons that are residents of, and work principally in, Canada or the residence country of a connected affiliate; and
- it must be reasonable to expect that the performance evaluation and compensation of officers of the CRIC (who are resident, and work principally, in Canada or in the residence country of a connected affiliate) will be based on the results of operations of the subject corporation to a greater extent than will be the performance evaluation and compensation of officers of any non-resident corporation in the

2. The CFA must be a CFA as defined in section 17. Thus, the CRIC must directly or indirectly control the CFA.

group (other than the subject corporation, a corporation controlled by the subject corporation or a connected affiliate).

For purposes of applying the above tests, officers of the CRIC working and resident in a connected affiliate's residence country cannot be counted in the majority if they are also officers in a non-arm's length non-resident corporation that is not a connected affiliate (i.e., an "upstream" entity from the CRIC).

The Explanatory Notes have also been expanded to elaborate on the intended interpretation of the tests, and to provide examples.

PwC observations – The rules as modified still do not provide much relief for strategic investments that from a common-sense business point of view are appropriately held under a Canadian corporation within a foreign-controlled group.

In some industries (for example, the mining industry), it is a common for a Canadian publicly-listed corporation that is only a holding company to hold a number of foreign investments. If this company is controlled by a non-resident (for example, an investor with 51% of the shares), it will be subject to the FA dumping regime. To avoid the application of these rules, the corporation will need to avail itself of the PUC reduction and reinstatement rules discussed below. The relief provided by the "more closely connected" exception is only available when it can be established that there is a Canadian business to which the FA's business activities are connected. Thus, the FA dumping measures may create a significant disincentive to certain industry participants using Canada as a listing jurisdiction to access capital markets.

Further, the requirements relating to performance evaluation and compensation seem to require that the evaluation and compensation of officers of the CRIC must, to some degree, depend on the results of the operations of the subject corporation, which may not be in line with the group's global executive compensation model.

PUC reduction and reinstatement rules

As noted above, the FA dumping rules were initiated partly to deter foreign-owned Canadian companies from borrowing to acquire FAs and leveraging their existing Canadian operations. To recognize that equity funded investments in FAs do not create the same tax benefits as leveraged investments, Finance added a provision in the August proposals that allowed a CRIC to elect, in certain circumstances, to reduce the deemed dividend that would otherwise arise under the rules by the existing PUC of the shares of the CRIC. The August proposals were complex and differed depending on whether the CRIC had one class of shares or multiple classes of shares outstanding.

The August proposals also included a PUC reinstatement rule which permitted a CRIC to reinstate PUC prior to a distribution of an investment in a FA so that the distribution could be effected free of Canadian withholding tax. Generally, the PUC reinstatement rule applied when the CRIC reduced PUC after the initial investment and the following three conditions were satisfied:

- the investment by the CRIC was an acquisition of shares of a FA;
- the CRIC had previously made an election to reduce PUC; and
- the CRIC subsequently distributed the FA shares (or substituted property), or proceeds of disposition of the FA shares (or substituted property) within 30 days of the disposition.

The NWMM introduces a number of relieving measures that expand the circumstances in which the PUC reduction and reinstatement rules will apply.

Notably, under the NWMM, the PUC reduction rule is effectively expanded so that cross-border PUC in a Canadian chain of companies, and not merely the cross-border PUC of the CRIC, may be accessed to reduce any deemed dividend that otherwise arises under the rules. This is accomplished through the addition of a new dividend substitution election and an amendment to the PUC reduction rule.

Under the dividend substitution rule, relevant members of the CRIC group may elect to have all or a portion of any dividend that is deemed to be paid by the CRIC to its foreign parent to instead be paid by one or more other Canadian-resident corporations in the group (referred to as "qualifying substitute corporations") to either the foreign parent or another non-resident corporation that is controlled by the foreign parent.

To be a qualifying substitute corporation, a Canadian-resident corporation must be controlled by the foreign parent, shares of the Canadian-resident corporation must be owned by the foreign parent or another non-resident corporation in the group and the Canadian-resident corporation must own, directly or indirectly, shares of the CRIC. The election requires that the full amount of the deemed dividend otherwise arising under the rules be allocated among shares of any of the CRIC and one or more qualifying substitute corporations on a class-by-class basis.

Where an election under the dividend substitution rule has been made, the new PUC reduction rule will apply to reduce any dividends deemed to be paid by the CRIC and any qualifying substitute corporation by the PUC of the shares on which the dividend is deemed to be paid. This rule will apply automatically if a non-resident in the CRIC group owns shares of every class of the CRIC or a qualifying substitute corporation on which a dividend is deemed to be paid and the election under the dividend substitution rule results in the greatest possible PUC reductions.

The Explanatory Notes indicate that this latter requirement contemplates that under the dividend substitution rule, dividends will be allocated first to the class of shares of the CRIC or a qualifying substitute corporation of which the parent or non-resident corporation owns the greatest proportion of shares, then to the class of which the parent or non-resident corporation owns the second greatest proportion of shares, and so on.

The PUC reduction rule in the August proposals (described above) has largely been maintained in the NWMM, although it now applies automatically and no election is required. This rule applies when no dividend substitution election has been filed.

The NWMM also contains several amendments to the PUC reinstatement rule:

- the rule applies when the FA dumping rules give rise to a deemed dividend (either directly or under the dividend substitution rule) as well as when these rules operate to cause a reduction of PUC of the shares of CRIC;
- the rule is no longer limited to circumstances when the investment is an acquisition of FA shares, but also applies when the investment is a capital contribution to a FA or an indirect acquisition of FA shares;
- the timeline for distributing the proceeds of disposition from the FA shares (or substituted shares) has been extended from 30 days to 180 days, however, proceeds arising in the context of corporate reorganizations subject to a corporate reorganization exception no longer qualify; and
- the rule also applies when the property to be distributed on the PUC reduction is received as a dividend or reduction of PUC on the shares of the subject corporation (or substituted shares) within 180 days of the distribution.

PwC observations – The revised PUC reduction rule provides greater relief in that cross-border PUC of a direct or indirect Canadian-corporate shareholder of the CRIC may be used to reduce any deemed dividends under the rules resulting from an investment made directly by a lower-tier CRIC. Under the August proposals, there was some uncertainty relating to the operation of the PUC reduction and reinstatement rule when the CRIC was owned indirectly by the foreign parent through a Canadian intermediary company. The Finance Explanatory Notes indicate that the revised PUC reduction and reinstatement rules in the NWMM, and in particular, the dividend substitution rule, are intended to "accommodate" these types of holding structures.

The automatic nature of the PUC reduction mechanism in certain cases will mean taxpayers will have to carefully consider the effect of FA

investment transactions when PUC is being relied on for thin capitalization purposes.

Corporation reorganization exceptions

The August proposals introduced several exceptions to the FA dumping rules for various corporate reorganization and distribution transactions that result in the acquisition of shares of a FA by a CRIC.

The NWMM expands the exceptions to include exceptions for internal reorganizations that involve an indirect acquisition of FA shares by a CRIC resulting from a direct acquisition by the CRIC of shares of another corporation resident in Canada. The exceptions are analogous to the exceptions available for direct acquisitions of FA shares with a few important differences.

One main difference is that all acquisitions by a CRIC of shares of another corporation resident in Canada which meet the fair market value threshold described above to be considered an indirect acquisition of a FA are excepted from the FA dumping rules if the shares are acquired from a corporation to which the CRIC is related.

The analogous exception relating to the direct acquisition by a CRIC of FA shares requires that the FA shares be acquired from a related corporation resident in Canada. The fact that there is no requirement that the shares be acquired from a Canadian resident company in the case of an indirect FA acquisition ensures that indirect FA transfers from related foreign corporations continue to be governed by section 212.1 and the FA dumping rules do not apply to these transactions.

There is also an exception added to prevent the FA dumping rules from applying more than once, in certain circumstances when funds are transferred through tiers of related Canadian corporations and invested in a FA.

The NWMM adds a new anti-avoidance rule that deems persons to be unrelated for the purposes of the corporate reorganization exceptions if it can reasonably be considered that one of the main purposes of one or more transactions or events was to cause those persons to be related so that one of those exceptions would apply.

PwC observations – The exception to the FA dumping proposals for transactions subject to section 212.1 is a welcome change that was included in PwC's submission to Finance in respect of the August proposals.[3]

Indirect funding exception

The NWMM introduces an exception to the FA dumping rules for investments made by a CRIC in a FA when the following conditions are met:

- all of the properties transferred by the CRIC to the FA as a result of the investment were used (within 30 days of the investment time and at all times after the investment time) by the FA to make a loan to a particular corporation that was a CFA of the CRIC for the purposes of section 17;
- the particular corporation receiving the loan from the FA would meet the "more closely connected" exception had an investment been made directly by the CRIC to the particular corporation; and
- the particular corporation uses, throughout the period during which the loan is outstanding, the proceeds from the loan in its active business carried on by it in the country in which it is resident.

The indirect funding exception essentially provides for a "look through rule" when financing "more closely connected" FA operations via indirect loans.

PwC observations – This welcome addition was also included in PwC's submission to Finance and tries to put foreign controlled CRICs that meet the "more closely connected" exception on a level playing field with Canadian multi-national corporations (MNCs) with respect to the ability to finance foreign operations tax-efficiently.

3. See "PwC's submission on August 14, 2012 Proposals Regarding Foreign Affiliate Dumping and Pertinent Loan or Indebtedness Regimes" at: **www.pwc.com/ca/en/canadian-national-tax-service/government-submissions/index.jhtml**

However, it is important to note that this rule introduces additional restrictions regarding the funding of the financing and the use of the loan proceeds that are not present for a Canadian MNC.

Acquisitions of control

The NWMM contains a new provision that states that when a non-resident corporation acquires control of a CRIC and the CRIC was not previously controlled by a non-resident corporation, relief is provided from the interest imputation rules on any PLOIs for a 180 day period.

PwC observations – This provision seems to permit a CRIC that becomes subject to non-resident control for the first time to follow through on commitments it may have made to provide funding to a FA in the form of loans for a transitional period (180 days following the acquisition of control) without interest being imputed at the PLOI regime rate.

Key changes to shareholder loan rules

The August proposals introduced a new elective exception to the shareholder loan rules for a loan or indebtedness that qualifies as a PLOI. A PLOI was defined as a loan received, or an indebtedness incurred, by a non-resident corporation (referred to as a "non-resident corporate debtor") to which the shareholder loan rules would apply, that is an amount owing to a CRIC, if:

- the amount became owing after March 28, 2012;
- at the time the loan was made or the indebtedness arose the CRIC was controlled by the non-resident corporate debtor or a non-resident corporation that does not deal at arm's length with that corporation; and
- the CRIC and the non-resident corporation that controls the CRIC jointly elected in writing for the amount owing to be a PLOI.

Under the August proposals, the PLOI election was a one-time election that, once made, applied to all loans and indebtedness incurred by a particular non-resident corporate debtor to the CRIC.

The filing of a PLOI election (either under the shareholder loan rules or under the proposed FA dumping rules) would trigger the application of a new income imputation regime that requires the CRIC to include in income the greater of:

- interest computed at the "prescribed rate" established for the purposes of the rules; and
- the amount of any interest payable on any debt incurred by the CRIC or any non arm's length Canadian resident person (or partnership of which the CRIC or such a person is a member) that can reasonably be considered to have directly or indirectly funded the PLOI.

Any interest actually charged by the CRIC on the PLOI reduces the amount of imputed income. Under the August proposals, the prescribed rate was the rate set by Regulation 4301(a), which is based on the 3-month Government of Canada treasury bill rate (rounded to the next higher whole percentage) plus 4%.

Following consultations with interested taxpayers, Finance introduced some significant changes to the PLOI regime, most of which are relieving in nature.

First, the prescribed rate for purposes of the interest imputation has been fine-tuned. The rate will be established as the prescribed rate in new Regulation 4301(b.1), which will provide for interest at 4 percentage points over the Government of Canada 3-month treasury bill rate, but will not use the "rounding-up" convention of Regulation 4301(a) (under which the minimum rate is 1%). Instead, the applicable interest rate will be rounded only to two decimal points.

The NWMM extends the PLOI regime to amounts owing by a partnership to a CRIC of which a non-resident corporate debtor is a member, and to amounts owing to a "qualifying Canadian partnership" in respect of a CRIC, when all the members of the qualifying Canadian partnership and a non-resident corporation that controls the CRIC file the joint election. For this purpose, a "qualifying Canadian partnership" is defined in respect of a CRIC as a partnership each member of which is the CRIC or a Canadian-resident

corporation related to the CRIC. Tiered partnerships can also be qualifying Canadian partnerships.

Another significant departure from the August proposals is the fact that the PLOI regime now applies on a loan-by-loan basis, instead of to all loans and indebtedness incurred by a particular borrower. The election in respect of each PLOI must be filed before the CRIC's filing-due date for the taxation year in which the indebtedness arises, or, in the case of a qualifying Canadian partnership, before the CRIC's filing-due date for its taxation year in which the partnership's fiscal period ends (which fiscal period includes the time the amount owing arises).

Absent from the August proposals was the possibility of late-filing a PLOI election. The NWMM allows taxpayers to file a PLOI election within three years from the normal filing-due date provided that the CRIC pays a late-filing penalty when the election is made equal to $100 for each month, or part thereof, that the filing is late. A PLOI election that would otherwise be required to be filed on or before the day that is 120 days after the day on which the implementing legislation receives royal assent is deemed to have been filed on time if it is filed on or before the day that is 365 days after the days on which the implementing legislation receives royal assent.

The NWMM contains a restriction on the availability of the PLOI regime which did not form part of the August proposals. Under this rule, a loan or indebtedness that would otherwise be a PLOI will be deemed not to qualify as such when, as a result of the application of a provision of one of Canada's tax treaties, the amount included in computing the income of the CRIC (or a qualifying partnership in respect of a CRIC) for any taxation year (or fiscal period) in respect of the loan or indebtedness is less than it would be absent the application of the tax treaty.

This provision is apparently intended to address situations where, by virtue of the competent authority procedures contained in a tax treaty, Canada may be obliged to agree to an interest amount in respect of the PLOI calculated at a lower rate than the PLOI prescribed rate if the other jurisdiction denies part of the interest under transfer pricing principles. This provision will presumably deter Canadian taxpayers from applying for any treaty-based adjustment with regard to the interest income on a loan or indebtedness if the taxpayer wishes to rely on the PLOI regime with regard to the debt.

Notwithstanding that the PLOI election provisions did not form part of the original 2012 budget proposals, the amendments related to the PLOI election apply to loans received and indebtedness incurred after March 28, 2012.

PwC observations – The PLOI regime was a surprising but welcome new development in the August proposals. The NWMM appears to provide additional relief by extending the PLOI regime to loans made by or to certain partnerships and by allowing late-filing of the PLOI election.

The change from a one-time election to an election available on a loan-by-loan basis may provide taxpayers with more flexibility, although it may also increase compliance burdens for certain taxpayers, depending on the facts. The extent of the relief provided by the PLOI regime will ultimately depend on each taxpayer's situation. The PLOI election may allow Canadian subsidiaries of foreign multinationals to redeploy cash within the related group without triggering non-resident withholding tax in Canada; however, whether or not interest should actually be charged (as opposed to imputed) will depend on the circumstances.

Although it appears that Finance intended to set the imputed interest rate at a rate that was more comparable to an arm's length interest rate, whether or not the rate specified in the rule (if actually charged on the loan or indebtedness) is an arm's length rate will depend on the circumstances. The transfer pricing rules in the jurisdiction in which the non-resident borrower is resident must be considered, particularly in light of the new restriction in the NWMM. The application of the current shareholder loan rule to existing loans

remains unclear when the loan is repaid and a new loan is made in respect of which a PLOI election is made.

Next steps

The NWMM is complex and may have far reaching implications for existing Canadian subsidiaries of foreign multinationals and for transactions in which a foreign acquirer buys a Canadian target that holds FAs. To discuss what these measures mean for you or your business, please contact your PwC adviser or any of the individuals below.

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