Tax memo
Canadian tax updates

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August 14, 2012 legislative proposals: Important international tax changes

Outlines key changes to international tax measures introduced in the August 14, 2012 legislative proposals.

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On August 14, 2012, the Department of Finance released for consultation draft legislative proposals implementing measures included in the March 29, 2012 federal budget. For more on the 2012 budget, see our *Tax memo* "2012 Federal budget: Continued tightening" at **www.pwc.com/ca/taxmemo**.

While the August 14, 2012 legislative proposals generally mirror the measures included in the 2012 budget, they include some significant changes to the proposed foreign affiliate debt dumping rules. The August 14, 2012 proposals also include proposed amendments to the shareholder loan rules in subsection 15(2) of the *Income Tax Act* (the Act) that were not previously announced. These changes would allow, on an elective basis, an imputation of interest on certain loans that would otherwise have given rise to a deemed dividend pursuant to the combined operation of subsections 15(2) and 214(3) of the Act.

This *Tax memo* describes the key August 14, 2012 proposals that affect Canadian subsidiaries of foreign multinationals and provides PwC's insights on the implications of these proposals.

Foreign affiliate dumping proposals

Overview of the 2012 budget proposals

In the past, foreign-owned corporations resident in Canada have often undertaken transactions in which they acquired shares of a foreign affiliate (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 foreign affiliate dumping transactions. The transactions targeted by the budget measures are those that involve an "investment" in a FA (also referred to as the "subject corporation" in the proposals) by a corporation (CRIC) that is:

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

Generally, the thrust of the 2012 budget proposals is 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 original 2012 budget proposals did not provide for relief from additional withholding tax when funds invested in a FA were actually repatriated to its foreign parent. The budget proposals generally apply to transactions occurring after March 28, 2012.

The foreign affiliate dumping proposals introduced in the 2012 federal budget extended far beyond debt-dumping transactions to potentially cover all transactions in which a CRIC acquires shares of a FA (from related parties or third parties), whether the acquisition is funded by debt, capital, or internally generated funds on hand. The only exception in the original budget proposals was for investments where a new statutory business purpose test was met.

Key changes in the August 14, 2012 draft proposals

Investments in subject corporations

The budget proposals defined "investment" broadly to include:

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

One relieving change in the August 14, 2012 proposals is to exclude an investment that is a "pertinent loan or indebtedness" (PLI). A PLI is defined to generally mean an amount owing by the subject corporation to the CRIC where the amount became owing after March 28, 2012, and the CRIC and the parent jointly elect in writing. The PLI will be subject to a new interest imputation rule, rather than the foreign affiliate dumping rules. See discussion in" Shareholder loan rule" below.

The definition of an "investment" in a subject corporation has also been expanded to include an extension of the maturity date of a debt obligation owing to the CRIC by a FA and the extension of the redemption, acquisition or cancellation date of shares of a FA owned by the CRIC. In addition, the conferral of any benefit on a subject corporation by the CRIC is treated as a contribution of capital.

One important change in the amended proposals is that the types of investments subject to the foreign affiliate dumping provisions have been expanded to include certain indirect FA acquisitions. In general, this indirect FA acquisition rule applies when a CRIC acquires the shares of a Canadian target and the total fair market value of all the FA shares owned directly or indirectly by the Canadian target exceeds more than 50% of the total fair market value of all of the properties of the Canadian target (subject to certain adjustments to exclude debts of the target corporation or any Canadian subsidiary of the target company).

The intent of the rule appears to be that, as with a direct FA investment, the CRIC will be deemed to have paid a dividend in respect of the non-share consideration attributable to the FA shares that were indirectly acquired. However, as discussed below, a new election may be available to reduce the amount of any deemed dividend by electing to reduce the PUC of the shares of the CRIC.

PwC observation – Companies will need to be cautious about the impact of the indirect FA acquisition rule in transactions in which an existing Canadian company is acquired.

Changes to the business purpose test

An investment made by a CRIC in a FA is not subject to the rules if a "business purpose" test is satisfied. As originally proposed, the "business purpose" test consisted of a 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. There was no indication of the weight to be given to the various factors or what "secondary" factors might be relevant.

The August 14, 2012 proposals no longer refer to a "*bona fide* purpose" that is other than to obtain a tax benefit. Instead, for any investment in a FA or "subject corporation" to be exempt from the rule, the CRIC must demonstrate that it meets all of the conditions specified, which may be summarized as follows:

- the business activities of the FA are more closely connected to the business activities carried on in Canada by the CRIC than to the business activities of any other non-resident company in the group;
- officers of the CRIC resident in and working in Canada were the principal decision makers in regard to the making of the investment in the FA and will have the ongoing decision making authority in regard to the investment; and
- the performance evaluation and compensation of officers of the CRIC resident in and working in Canada 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 group (other than the subject corporation).

PwC observation – The revised business purpose test in the consultation draft appears to be intended to be more specific than the test as articulated in the budget papers. However, it may be very difficult in many corporate groups for a Canadian corporation that is controlled by a foreign parent to demonstrate that all of the conditions for meeting the test are satisfied. The condition relating to the performance evaluation and compensation of the Canadian resident officers of the CRIC in particular may be difficult to prove in many circumstances.

Election to reduce the PUC of the CRIC and PUC reinstatement

As noted above, the foreign affiliate dumping rules were initiated to deter foreign owned Canadian companies from borrowing to acquire FAs and leveraging their Canadian operations. To recognize that equity sourced investments in FAs do not create the same tax benefits as leveraged investments, the Department of Finance has added a provision in the August 14, 2012 proposals that would allow 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 rules are complex and differ depending on whether the CRIC has one class of shares or multiple classes of shares outstanding.

When PUC was initially reduced as a result of the election, the proposals include a rule to reinstate PUC immediately before a return of capital in certain circumstances. The proposed PUC reinstatement provision is a relieving provision that allows the CRIC to distribute an investment in a FA (or substituted property) free of Canadian withholding tax.

When the subject FA has been sold, the reinstatement rule will not apply unless the proceeds are distributed to the parent within 30 days of the sale.

PwC observation – The intended operation of the PUC reduction election and reinstatement rules is not entirely clear in circumstances when the CRIC is owned indirectly by the parent through a Canadian intermediary company.

Corporate reorganizations

The August 14, 2012 proposals introduce several exceptions to the foreign affiliate dumping rules for various corporate reorganizations and distributions that result in the acquisition of shares of a subject corporation by a CRIC. Generally, when as a result of a particular reorganization or distribution there is no new incremental investment being made by the CRIC in a FA, the exceptions ensure that the foreign affiliate dumping rules do not apply.

The exceptions apply to:

- certain acquisitions of a FA from a related CRIC;
- certain acquisitions as a result of amalgamations of related CRICs;
- acquisitions as a result of the exchange of certain convertible properties;
- acquisitions as a result of certain roll-over transactions on the transfer of shares of a FA to another FA;
- acquisitions as a result of certain foreign mergers;
- acquisitions as a result of certain liquidations of an existing FA; and
- acquisitions as a result of the redemption of shares of an existing FA or a dividend distribution from an existing FA.

Some of the exceptions are subject to a "series of transactions or events" test and some do not apply when the investment being acquired by the CRIC is not a fully participating share (i.e., a preferred share investment) or when there is an assumption of debt by the CRIC.

PwC observation – The foreign affiliate dumping proposals as originally announced in the March 2012 budget were broadly worded and could have applied to many internal reorganizations that did not result in a new investment in a FA being made by a CRIC. The introduction of exceptions for certain corporate reorganizations is a welcome change; however, the exceptions contain some restrictions that must be considered on a case by case basis.

Transitional rules

There is no change to the effective date for the foreign affiliate dumping rules, so these measures will apply to transactions after March 28, 2012, other than certain transactions that occur before 2013 between arm's length persons. Taxpayers may, however, elect to have the budget version of these proposals, with certain modifications, apply for transactions that occur before August 14, 2012.

Shareholder loan rules

Under the current rules, a loan made 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 under Part XIII of the Act. The withholding tax is recoverable when and if the loan is repaid (and the repayment is not part of a series of loans and repayments), provided that the non-resident applies for a refund of the withholding tax within a specified time.

The August 14, 2012 proposals introduce a new elective exception to the shareholder loan rules for a loan or indebtedness that qualifies as a PLI. For that purpose, PLI is defined in proposed subsection 15(2.11) as a loan received, or an indebtedness incurred, by a non-resident corporation (the "subject corporation") 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 is made or the indebtedness arises the CRIC is controlled by the subject corporation or a corporation that does not deal at arm's length with the subject corporation; and
- the CRIC and the non-resident that controls the CRIC jointly elect in writing for the exception to apply.

Once the election is made, it applies to all loans and indebtedness incurred by a particular subject corporation to the CRIC that become owing after March 28, 2012.

When a PLI election is filed (either under the shareholder loan rules or under the proposed foreign affiliate dumping rules) new section 17.1 applies to require the CRIC to include in income interest at a specified rate, which is the "prescribed rate" (currently at 1%) plus 4%. Any interest that is actually charged by the CRIC on the loan or

indebtedness will be credited against the income inclusion.

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

PwC observation – The PLI exception is a significant new development and appears to have been included by the Department of Finance as a relieving provision in response to submissions from the tax and business communities. The extent of the relief provided by this rule will depend on each taxpayer's situation. While the PLI election may allow Canadian subsidiaries of foreign multinationals to redeploy cash within the related group without triggering non-resident withholding tax in Canada, whether or not interest should actually be charged will depend on the circumstances.

Although it appears that the Department of 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 will need to be considered. The ability of a Canadian lender to take advantage of the PLI election where existing loans are repaid and new loans are made is also unclear.

Thin capitalization rules

The 2012 federal budget proposed changes to the thin capitalization rules that limit the deductibility of interest expense of a Canadian-resident corporation that will:

- for years beginning after 2012, reduce the debt-to-equity ratio from 2-to-1 to 1.5-to-1;
- for years that begin after March 28, 2012, extend the thin capitalization rules to apply to debts of a partnership in which a Canadian-resident corporation is a member;
- for years that end after March 28, 2012, treat disallowed interest as dividends for Part XIII withholding tax purposes; and
- prevent double taxation in circumstances when a controlled foreign affiliate of a Canadian-resident corporation lends funds to the corporation and the interest is included in the foreign accrual property income of the affiliate.

For the purpose of applying the thin capitalization rules to partnerships, debts of the partnership are allocated to partners based upon their proportionate interest in the partnership. The partnership will not itself be denied an interest deduction when the corporate partner exceeds the permitted debt-to-equity ratio. Instead, the corporation will have an income inclusion equal to a portion of the deductible interest of the partnership.

Disallowed interest will be treated as dividends paid at the time the interest is paid, or the end of the corporation's taxation year if unpaid at that time, subject to an election to allocate disallowed interest to the latest interest payments made in a year. Withholding tax will be due based on these deemed payment dates.

The August 14, 2012 legislative proposals relating to changes to the thin capitalization rules are not materially different from the 2012 budget proposals.

Partnership bumps

Section 88 contains rules that allow a taxable Canadian corporation (the parent) that has acquired control of another taxable Canadian corporation (the subsidiary) to increase the cost of certain capital assets acquired by the parent on a vertical amalgamation with, or winding-up of, the subsidiary (the section 88 "bump").

The March 2012 budget contained proposals that would generally deny a bump in respect of a partnership interest owned by the subsidiary to the extent that the accrued gain in respect of the partnership interest is reasonably attributable to the amount by which the fair market value of "income assets" (assets that would not themselves be eligible

for the bump) exceed their cost amount, when the income assets are held directly by the partnership or indirectly through one or more other partnerships. This measure is applicable to amalgamations that occur, and windings-up that begin, after March 28, 2012. An exception is available for a taxable Canadian corporation amalgamating with its subsidiary before 2013, or beginning to wind up its subsidiary before 2013, if before March 29, 2012, certain other conditions were met. Generally, these conditions require a pre-March 29, 2012 acquisition of control (or a binding obligation to acquire control) and an established intention to effect the amalgamation or winding-up.

The August 14, 2012 draft proposals contain two supporting anti-avoidance rules to ensure that the bump denial rule proposed in the budget is effective. The first anti-avoidance rule is aimed at tax-deferred transfers of property to a partnership, or transfers of certain partnership interests to the subsidiary, before the time the parent acquires control of the subsidiary, when these transfers occur as part of the series of transactions that includes the acquisition of control. The second anti-avoidance rule is similar, but is aimed at transfers of certain property to a partnership that occur after the parent acquires control of the subsidiary. The first anti-avoidance rule is generally applicable on or after August 14, 2012 and the second anti-avoidance rule is generally applicable after March 28, 2012.

Next steps

Interested parties who wish to provide comments on the legislative proposals are invited to do so by September 13, 2012.

The August 14, 2012 proposals are complex and may have far reaching implications for Canadian subsidiaries of foreign multinationals. If you wish to discuss what these proposals mean for you or your business, please contact your PwC adviser or any of the following individuals.

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