

Tax memo

Canadian tax updates



August 14, 2012 legislative proposals released as consultation draft

*Highlights
international tax
measures
included in the
August 14, 2012
legislative
proposals.*

August 15, 2012

On August 14, 2012, the Department of Finance released for consultation draft legislative proposals that implement measures included in the March 29, 2012 federal budget. Comments on the proposals are due by September 13, 2012.

This *Tax memo* highlights international tax measures included in the August 14, 2012 legislative proposals. A more detailed *Tax memo* on these measures will follow shortly. In addition, we will release a *Developments* that addresses the Scientific Research and Experimental Development (SR&ED) proposals.

Thin capitalization rules

The international tax measures include the changes to the thin capitalization rules that, among other things:

- reduce the debt-to-equity ratio from 2-to-1 to 1.5-to-1, for taxation years beginning after 2012;
- extend the rules to debts of partnerships of which a Canadian resident corporation is a member, for taxation years beginning after March 28, 2012; and
- treat disallowed interest as dividends for Part XIII withholding tax purposes, for taxation years ending after March 28, 2012.

In general, the draft legislation to implement the changes to the thin capitalization rules contains few surprises.

Shareholder loan rules

One unexpected measure that was not included in the 2012 federal budget responds to submissions made relating to the shareholder loan rules. A Canadian corporation will now be permitted to make loans to foreign parent companies or related non-resident companies without incurring the deemed dividend withholding tax, on an elective basis. To avail itself of this elective relief from withholding tax, the Canadian corporation will be required to include in income interest at the prescribed rate plus 4% (thus, 5% for the third quarter of 2012).

Foreign affiliate dumping

The consultation draft also includes draft legislation to implement the “anti-foreign affiliate dumping” measures included in the 2012 budget. These rules curtail a variety of

transactions, generally occurring after March 28, 2012, involving an investment in a foreign affiliate by a Canadian subsidiary of a foreign parent corporation, unless a “business purpose” test for the investment can be met. In general, the rules cause a deemed dividend to be paid to the foreign parent corporation when the Canadian subsidiary acquires or makes a further investment in a foreign affiliate.

The Department of Finance had conducted consultations on the proposed rules as originally released and the revised draft legislation contains some changes that respond to the submissions made. However, in many respects the draft legislation released yesterday makes the holding of foreign affiliates by a Canadian subsidiary of a foreign parent corporation more difficult.

Some modest relief was provided for reorganizations involving foreign affiliates and for loans made to a foreign affiliate (similar to the elective relief from dividend withholding tax referred to above, there will be an interest inclusion

in respect of these loans at the prescribed rate plus 4%).

Other modifications to the rules (including a restated version of the “business purpose” test that seems to both clarify the conditions and make them more restrictive) are less beneficial. The rules have been expanded to apply to indirect acquisitions of foreign affiliates through the acquisition of a Canadian corporation holding significant foreign affiliates, a measure that can have important implications for arm’s length acquisitions of Canadian target companies.

For more help

For more details on the revised measures and PwC’s observations on what they mean for your company, watch for PwC’s upcoming *Tax memo* and contact your PwC adviser or any of the following individuals.

International Tax Services			
Vancouver	William Holms	604 806 7052	<i>william.holms@ca.pwc.com</i>
	Ronnie De Zen	604 806 7065	<i>ronnie.de.zen@ca.pwc.com</i>
Calgary	Jason Durkin	403 509 7598	<i>jason.d.durkin@ca.pwc.com</i>
	Johnson Tai	403 509 7544	<i>johnson.tai@ca.pwc.com</i>
Toronto	Ken Battenham	416 869 2600	<i>ken.battenham@ca.pwc.com</i>
	Mike Maikawa	416 365 2719	<i>mike.maikawa@ca.pwc.com</i>
	Jamie Mitchell	416 814 5755	<i>jaimie.c.mitchell@ca.pwc.com</i>
Montreal	Pierre Bourgeois	514 205 5139	<i>pierre.bourgeois@ca.pwc.com</i>
Mergers and Acquisitions	Doug Frost	416 365 8852	<i>doug.l.frost@ca.pwc.com</i>
Wilson and Partners LLP			
A law firm affiliated with PwC Canada			
	Elizabeth J. Johnson ¹	416 869 2414	<i>elizabeth.j.johnson@ca.pwc.com</i>
	David Glicksman ¹	416 947 8988	<i>david.glicksman@ca.pwc.com</i>

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