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Could the new Canadian legislative proposals affect your company?

In brief

US companies with Canadian subsidiaries may be affected by legislative proposals included in a consultation document issued by the Canadian Department of Finance on August 14, 2012. The new proposals are intended to limit debt pushdowns and other arrangements involving 'foreign-affiliate dumping' and also limit interest expense deductions claimed by Canadian companies with non-Canadian owners. The proposals generally implement and update elements of the Canadian government's March 2012 Budget. The deadline for comments on the new proposals is September 13, 2012. If enacted, the proposals would generally apply to transactions occurring after March 28, 2012.

In More Detail

Purpose of the proposals

The debt pushdown or 'foreign affiliate-dumping' proposals target certain transactions in which corporations resident in Canada and controlled by non-Canadian residents (CRICs) acquire shares of a non-Canadian affiliate (NCA) from a related foreign party. Such transactions can create additional debt in Canada, resulting in an interest deduction with respect to the debt and the receipt of tax-free dividends from the NCA (to the extent that those dividends are deemed paid out of the NCA's exempt surplus) or could be a means of redeploying Canadian cash without triggering a Canadian withholding tax cost.

The shareholder loan proposal is an alternative to one of the original budget proposals regarding debt pushdown transactions. The current shareholder loan rule covers loans made by a Canadian corporation to a non-resident shareholder or a person 'connected' with that shareholder (other than an NCA of the Canadian corporation). The August proposals introduce a new elective exception.

The 2012 Canadian budget also proposed changes to the thin capitalization rules that limit the ability of Canadian-resident corporations to deduct interest expense. The August proposals would implement those changes.

Finally, the 2012 Canadian budget proposed changes to rules that allow a taxable Canadian corporation that has acquired control of another taxable Canadian corporation to increase the cost of certain capital assets acquired by the parent in a merger with, or liquidation of, the subsidiary. The rule changes address the applicability of that increase to a partnership interest (a 'partnership bump') owned by the subsidiary under certain circumstances. The August proposals would implement the budget provisions.

Overview of the August legislative proposals

The debt pushdown provisions

Generally, the 2012 Canadian budget proposals deem that a CRIC has paid a dividend to its foreign parent to the extent of any non-share consideration (e.g., debt or cash) given by the CRIC for the investment in the NCA. The proposals eliminate the paid-up capital (PUC) attributable to any shares issued by the CRIC as part of the consideration. Any deemed dividend would be subject to withholding tax. The budget proposals generally apply to transactions occurring after March 28, 2012.

The original proposals in the 2012 budget extended beyond debt pushdown transactions to potentially cover all transactions in which a CRIC acquires shares of an NCA. This treatment was proposed without regard to how the acquisition was funded. The only exception in the original budget proposals was for investments that met a new statutory business purpose test. The original 2012 budget proposals also did not provide relief from additional withholding tax when funds invested in an NCA were actually repatriated to its foreign parent.

The August proposals change the original budget proposals in several ways:

1) Expanded definition of an investment in a NCA

   The budget proposals defined 'investment' broadly to include, among other things, transactions where an NCA becomes indebted to the CRIC (or a related Canadian company). The August proposals exclude an investment that the CRIC and its parent jointly elect to be a 'pertinent loan or indebtedness' (PLI). A PLI is generally an amount owed by the NCA to the CRIC where the debt arises after March 28, 2012. The PLI is then subject to the new income imputation rule, rather than the deemed dividend as a result of the debt pushdown rules. (See below.)

   The August proposals also expand the definition of an "investment" in an NCA to include any extension of (i) the maturity date of any debt owing to the CRIC by an NCA and (ii) the redemption, acquisition or cancellation date of shares of an NCA owned by the CRIC. In addition, the new proposals treated as a contribution of capital the conferral of any benefit by the CRIC on an NCA.

In addition, the August proposals expand the affected types of investments to include certain indirect NCA acquisitions. In general, this rule would apply only when a CRIC acquires the shares of another CRIC where the total fair market value of all the NCA shares owned directly or indirectly by the other CRIC exceeds more than 50% of the total fair market value of all the other CRIC's properties (subject to certain adjustments).

Observation: In particular, companies should consider how the indirect NCA acquisition rule could impact transactions involving acquisitions of existing Canadian companies.

2) Three-part test to meet the business purpose exception

A CRIC's investment in an NCA is not subject to the debt pushdown rules if the transaction satisfies a 'business purpose' test. The 'business purpose' test in the March budget listed factors for evaluating whether an investment in an NCA was made primarily for a 'bona fide purpose' other than to obtain a tax benefit. The budget gave no indication of the weighting for the various factors. The August proposals no longer refer to a 'bona fide purpose' or tax benefit. Instead, for any investment in a NCA to escape the debt pushdown rules, the CRIC must meet all of the following conditions:

- The NCA's business activities are more closely connected to those carried on by the CRIC in Canada than to those of any other non-Canadian company in the group.
- Officers of the CRIC resident, and working, in Canada were the principal decision-makers regarding the investment in the NCA and will have the ongoing decision-making authority regarding that investment.
- The performance evaluation and compensation of the CRIC's officers resident, and working, in Canada will be based on the NCA's operating results to a greater extent than will be the performance evaluation and compensation of officers of any non-Canadian corporation in the group (other than the NCA).

Observation: The revised business purpose test may be more specific than the test as originally proposed in the budget. A Canadian corporation that is controlled by a foreign parent may have difficulty demonstrating that it satisfied all of the conditions. In particular, the condition relating to the performance evaluation and compensation of the CRIC's Canadian resident officers may be difficult to prove in many circumstances.

3) Election to reduce the CRIC's PUC (and PUC Reinstatement)

The debt pushdown rules in the March 2012 budget seek to deter Canadian companies owned by non-Canadians from borrowing to acquire NCAs and leveraging their Canadian operations or using Canadian cash to make the investment to avoid incurring Canadian withholding taxes. The Canadian Department of Finance has recognized that equity-funded investments in NCAs do not create the same tax benefits as leveraged investments. Accordingly, the August proposals include an elective provision allowing a CRIC to reduce the deemed dividend (as discussed above) by the existing PUC of the CRIC's shares. The rules relating to this elective relief are complex.

The August proposals also include a provision that would reinstate electively-reduced PUC immediately before a return of capital, in certain circumstances. This provision would allow the CRIC to distribute an investment in an NCA (or substituted property) free of Canadian withholding tax. The reinstatement rule would not apply unless the proceeds of the subject NCA's sale were distributed to the parent within 30 days of the sale.

Observation: This relief provision may help in some circumstances, but the rules' intended operation is not clear in circumstances where the parent owns the CRIC indirectly through a Canadian intermediary company.

4) New exceptions announced for certain corporate reorganizations

The August proposals introduce several exceptions to the debt pushdown rules for various corporate reorganizations and distributions resulting in a CRIC's acquisition of an NCA's shares. The general principle is that the rules would not apply if there is no new incremental investment being made by the CRIC in an NCA. More specifically, the exceptions apply to:

- certain acquisitions of an NCA from a related CRIC.
- certain acquisitions as a result of related CRIC amalgamations;
- acquisitions resulting from the exchange of certain convertible properties;
- acquisitions resulting from certain roll-over transactions on the transfer of shares of an NCA to another NCA.
- acquisitions resulting from certain foreign mergers.
- acquisitions resulting from certain liquidations of an existing NCA.
- acquisitions resulting from an existing NCA's share redemptions or dividend distributions.

Note that some of the exceptions are subject to a 'series of transactions or events' test. In addition, some do not apply when the investment being acquired by the CRIC is not a fully-participating share or when the CRIC assumes debt.

Observation: The debt pushdown proposals as originally announced in the March 2012 budget were broadly worded. They could have applied to many internal reorganizations that did not result in a new investment by a CRIC in an NCA. The introduction of exceptions for certain corporate reorganizations is a welcome change.

5) Are there any changes to the effective date or transition rules?

There is no change to the effective date for the debt pushdown rules. Accordingly, these measures would generally apply to transactions after March 28, 2012 (with some exceptions). Taxpayers could also elect to have the original March 2012 budget version of these proposals (with certain modifications) apply for transactions that occur before August 14, 2012.

The shareholder loan rules

The current shareholder loan rules focus on loans made by a Canadian corporation to a non-resident shareholder or a person 'connected' with that shareholder (other than an NCA of the Canadian corporation). Such a loan may be deemed a dividend paid to the non-resident shareholder if the loan is not repaid within a year after the end of the lender or creditor's tax year. The deemed dividend is subject to non-resident withholding tax. That tax may be recoverable under certain circumstances. The

August proposals introduce a new elective exception to the shareholder loan rules for a loan or indebtedness that qualifies as a PLI (as defined above).

Where the election is filed, a PLI is not subject to the deemed dividend rules but instead is subject to an income imputation rule. The exception requires the electing CRIC to include in income interest at a specified rate, which is the 'prescribed rate' (currently at one percent) plus four percent. Any interest the CRIC actually charges on the debt would be credited against the income inclusion.

The exception would apply to loans received and debt incurred after March 28, 2012.

Observation: The PLI exception is a significant new development providing meaningful taxpayer relief in certain circumstances. 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 a CRIC should actually charge interest will depend on the circumstances. The Department of Finance may have intended to set an arm's-length imputed interest rate. Whether the rate specified in the rule is actually an arm's-length rate will depend on the circumstances, including the transfer pricing rules in the non-resident borrower's country. It is unclear whether a Canadian lender can take advantage of the PLI election if it repays existing loans and makes new loans.

The thin capitalization rules

The August legislative proposals relating to changes in the thin capitalization rules are not materially different from the 2012 budget proposals. Those proposed changes would generally limit further the deductibility of a Canadian-resident corporation's interest expense under certain circumstances. The budget provisions would (i) reduce the debt-to-equity ratio from 2-to-1 to 1.5-to-1, (ii) extend the rules to apply to partnership debts where a Canadian-resident corporation is a partner, (iii) treat disallowed interest as dividends for certain withholding tax purposes, and (iv) prevent double taxation where a controlled non-Canadian affiliate of a Canadian corporation lends funds to the corporation and the interest is included in the affiliate's foreign accrual property income.

New anti-avoidance rules proposed related to the partnership bump

Existing rules allow a taxable Canadian corporation that has acquired control of another taxable Canadian corporation to increase the cost of certain capital assets acquired by the parent in a merger with, or liquidation of, the subsidiary. The March 2012 budget would generally deny applicability of that increase to a partnership interest (a 'partnership bump') owned by the subsidiary under certain circumstances. Specifically, those proposals would apply to the extent that any accrued gain in the partnership interest is reasonably attributable to the amount by which the value of 'income assets' (which would not themselves be eligible for the bump) exceed their cost amount. This condition would apply whether the income assets are held directly by the partnership or indirectly through other partnerships. This measure generally would apply to amalgamations that occur, and liquidations that begin, after March 28, 2012. Very limited exceptions exist.

The August proposals contain two supporting anti-avoidance rules for the partnership bump denial provision:

- The first new proposed rule addresses certain tax-deferred transfers of property to a partnership, or transfers of certain partnership interests to the subsidiary. The rule would apply only when a) the transfers occur before the time the parent acquires control of the subsidiary, and b) these transfers occur as part of the series of transactions that includes the acquisition of control. This rule would generally apply on or after August 14, 2012.

- The second new proposed rule is similar but addresses transfers of certain property to a partnership that occur after the parent acquires control of the subsidiary. This rule would generally apply after March 28, 2012.

Actions to consider

The August proposals are complex and may have far-reaching implications for a foreign multinational's Canadian subsidiaries. You may wish to discuss the proposals with knowledgeable advisers. Note that these proposals may still change in response to comments. The deadline for comments is September 13, 2012.

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