

Multinational Groups With Canadian Members in Hard Times

by Steve Suarez and Susan Wooles

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This article discusses some of the tax issues that may be faced by multinational groups with Canadian members that find themselves in financial difficulty, including:

- managing the use of losses within the Canadian arm of the group;
- repatriating cash from a Canadian group member;
- financing the Canadian subsidiary from within the group; and
- restructuring the debts of Canadian group members.

Unless identified and managed appropriately, these tax issues can worsen an already unfavorable situation. There may be planning opportunities available to optimize the use of tax attributes of Canadian group members, depending on the facts.

I. Repatriating Cash From Canada

A corporation having financial difficulties may seek to access a subsidiary's cash. If the parent corporation and the subsidiary corporation are not both resident in Canada, some tax issues need to be considered. Canadian tax rules generally permit a Canadian parent to access a foreign affiliate's cash without adverse tax consequences by allowing the affiliate to make an interest-free loan to its parent. When the facts are reversed, however, the same is not true. A foreign parent seeking to access cash from a Canadian subsidiary needs to be aware of important tax rules in the Income Tax Act (Canada).

There are three primary ways of repatriating cash from a Canadian subsidiary:

- the payment of a dividend by the Canadian subsidiary;
- a distribution of paid-up capital (PUC) by the Canadian subsidiary; or
- a loan by the Canadian subsidiary to the foreign parent.

(Note: When the Canadian subsidiary is borrowing the cash being repatriated rather than using funds on hand, the incremental issue of interest deductibility must also be considered.)

Dividends

A dividend paid by a Canadian subsidiary to a foreign parent will be subject to Canadian dividend withholding tax of 25 percent, subject to potential reduction under an income tax treaty. Under the Canada-U.S. income tax treaty, dividends paid by a Canadian resident corporation to a U.S. company entitled to treaty benefits will generally be subject to a 5 percent withholding tax rate if the U.S. company owns 10 percent or more of the voting stock of the Canadian subsidiary. Otherwise, the general dividend withholding rate for U.S. residents entitled to treaty benefits on Canadian-source dividends is 15 percent. Under anti-hybrid rules in the fifth protocol to the Canada-U.S. treaty, effective January 1, 2010, dividends paid by Canadian unlimited liability companies that are transparent for U.S. tax purposes appear to be subject to the full 25 percent withholding rate, despite that this result does not appear to have been intended by either country.

Distributions of PUC

PUC is essentially the tax version of the corporate law concept of stated capital or the accounting concept of share capital, subject to adjustments set out in the

ITA.¹ Under Canadian tax law, a corporation can generally choose to make distributions to shareholders as a return of share capital (to the extent of PUC) or as a distribution of profits (that is, dividends). There is no requirement to distribute profits as dividends before returning PUC, unlike the U.S. tax rule in which any corporate distribution is treated as a dividend to the extent of the corporation's earnings and profits; that is, earnings and profits are required to be distributed first in the U.S. system.

A distribution of PUC is not treated as a dividend and therefore generally can be made without incurring dividend withholding tax.² Such distributions instead reduce the shareholder's cost for tax purposes (tax cost) of the shares on which the PUC distribution is made. Accordingly, a Canadian corporation generally can distribute PUC to shareholders tax free, since such amounts are essentially a return of invested capital rather than profits.³ Of course, the tax consequences to the foreign parent in its country of residence must be examined to determine the benefit of a PUC distribution (for example, a U.S. corporation receiving a distribution from a Canadian subsidiary will be treated under U.S. tax law first as receiving a dividend to the extent of the Canadian subsidiary's E&P and taxed in the United States as such). When a PUC reduction is made by a Canadian corporation indebted to foreign group members, consideration must be given to the effect of reducing PUC on the Canadian thin capitalization rules limiting interest deductibility to the Canadian debtor, because PUC is one element determining the permissible amount of foreign intragroup debt.

Loans to Foreign Parents

There are several tax issues that must be considered if a Canadian subsidiary makes a loan to a foreign parent. Different rules apply to the loan principal and interest.

The most important rule is the shareholder loan rule in subsection 15(2) of the ITA.⁴ In general, if a Cana-

dian resident corporation makes a loan to a nonresident who is either a shareholder of the corporation or a person not dealing at arm's length with a shareholder, the amount of the loan is deemed to be a dividend subject to dividend withholding tax. There are limited exceptions to this rule, in particular when the loan is repaid within one year after the end of the tax year in which the loan was made, so long as the repayment was not part of a series of loans or other transactions and repayments. This rule prevents a foreign parent from using a loan (or a series of loans and repayments) as a substitute for a dividend from the Canadian subsidiary.

Unlike the U.S. tax system, the Canadian tax system does not include a group consolidation concept.

The ITA also contains rules designed to ensure that a reasonable interest rate is paid on a loan to a nonresident. Subsection 17(1) provides that if a nonresident owes a Canadian resident corporation an amount that is outstanding for more than one year, and the interest on that amount included in the Canadian corporation's income is less than a "reasonable rate" of interest, the difference is imputed to the Canadian resident creditor and included in its income. There are several antiavoidance rules that apply to prevent taxpayers from circumventing this rule, such as by using indirect loans. This rule does not apply if subsection 15(2) applies to the loan (that is, it has been treated as a dividend, as described above).

A separate rule may apply to a debtor who benefits from a low- or no-interest loan from a Canadian corporation. Subsection 80.4(2) provides that when a person (other than a Canadian resident corporation) is a shareholder of a corporation (or deals with a shareholder of the corporation on a non-arm's-length basis) and receives a loan from or otherwise becomes indebted to the corporation or a related corporation by virtue of that shareholding, the debtor is deemed to receive a benefit to the extent that interest computed using a prescribed interest rate exceeds the interest actually paid on the loan. If the person is a nonresident, this benefit will be deemed to be a dividend and subject to dividend withholding tax. However, subsection 80.4(2) will not apply if the loan was subject to subsection 15(2) (and therefore treated as a deemed dividend to the shareholder).

¹For a more detailed discussion of PUC, see Steve Suarez and Susan Wooles, "Ten Essential Elements of Canada's Tax System," *Tax Notes Int'l*, Sept. 8, 2008, p. 825, *Doc 2008-17137*, or 2008 WTD 177-11.

²Some PUC reductions by corporations that are "public corporations" for tax purposes are deemed to be dividends (subsection 84(4.1)).

³If the amount of the PUC distribution received by the shareholder exceeds the shareholder's tax cost of the Canadian corporation's shares, a capital gain will result. Most Canadian tax treaties exempt residents of the other jurisdiction from Canadian tax on capital gains on shares of corporations that do not derive their value primarily from Canadian real property (directly or indirectly).

⁴For a more detailed discussion of this rule and its interaction with IRS Notice 2008-91, see Michael Radolinski and Drew Morier, "Canada-U.S. Tax Planning: Borrowing From Foreign

(Footnote continued in next column.)

Subsidiaries to Ease Liquidity Concerns," *Tax Notes Int'l*, Nov. 3, 2008, p. 405, *Doc 2008-21815*, or 2008 WTD 215-13.

Table 1. Comparison of Repatriation Options

	Dividend	PUC Reduction	Loan
Withholding tax	25 percent; potentially reduced as low as 5 percent by tax treaty (note Canada-U.S. problem with ULCs).	None if sufficient PUC; reduces basis in shares of payer.	None if repaid within permitted timeframe and not part of a series of loans and repayments; otherwise treated as a dividend.
Comments	Consider whether relevant Canadian corporate law places any constraints on Canco's ability to declare and pay dividend (for example, solvency test).	No U.S.-style E&P rule; can reduce PUC if profits exist. Consider effect on thin capitalization rules to Canco.	Various rules require market interest rate to be charged by Canadian lender.

Finally, the transfer pricing rules of subsection 247(2) may apply to adjust the quantum of interest accrued by the Canadian subsidiary if the more specific provisions described above do not apply. For example, if a loan from a Canadian subsidiary to a foreign parent is outstanding for less than a year, subsection 17(1) would not be applicable to impute interest to the Canadian subsidiary. The Canada Revenue Agency appears to take the position that the transfer pricing rules could apply in circumstances when a more specific rule such as those described above do not.⁵ Under subsection 247(2), if the terms or conditions in a non-arm's-length transaction differ from those that would have been made between persons dealing at arm's length, the CRA may adjust the quantum or nature of the amounts that would otherwise be determined regarding the taxpayer to those amounts that would have been determined had the terms or conditions of the transaction been those that would have been made between persons dealing at arm's length. Penalties may also apply in some circumstances.

Note that managing these issues is particularly important when there is more than one Canadian group member or when there are different amounts owing to Canada from foreign group members and vice versa. In such circumstances, there are often ways of optimizing the tax results to, for example, minimize Canadian withholding taxes or maximize interest expense deductions for Canadian group members.

II. Interest Deductibility

Financing expenses are often a major cost for business, particularly in Canada, which is traditionally a capital-importing nation. Intragroup debt financing into Canada has some important tax issues associated with it, and to the extent that a Canadian group member incurs interest expense on such debt, it is essential to ensure the ongoing tax deductibility of that interest. A

Canadian group member never wants to be in a position in which it is incurring interest expense that is both nondeductible to it and creating a tax liability (Canadian or foreign) for the recipient.

Unpaid Non-Arm's-Length Interest

A Canadian corporation generally computes its income on an accrual basis, while nonresident interest withholding tax is exigible when amounts are paid or credited. This encourages Canadian debtors to delay as long as possible the payment of accrued interest expense owing to non-arm's-length foreign creditors' interest.⁶

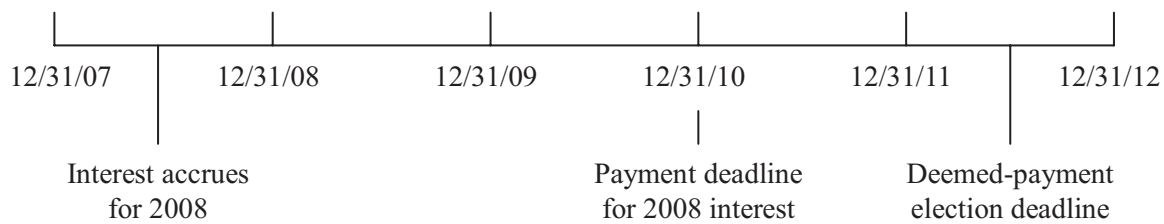
Subsection 78(1) reverses a deduction taken by a taxpayer on amounts owing to non-arm's-length creditors that are not paid within a given time frame. Specifically, when an expense owing to a non-arm's-length creditor in one tax year (for example, 2008, assuming calendar-year tax years) remains outstanding at the end of the second following tax year (2010), that amount is added back to the debtor's income at the start of the next tax year (2011). Thus, the deduction is effectively reversed if it remains unpaid long enough.

Alternatively, if the debtor and creditor file a joint election by the time the debtor's tax return for that third successive taxation year (2011) is due (typically midway through 2012), the debtor can keep the deduction and is deemed to have paid the creditor as of the first day of that tax year, and the creditor is deemed to have loaned the amount back to the debtor. This will constitute a deemed payment for interest withholding tax purposes in the case of interest owed to a non-arm's-length creditor, making the withholding tax payable. (See Figure 1.)

Canadian intragroup debtors need to keep track of how long accrued interest remains unpaid. There is one deadline for preserving the deduction by paying

⁵See CRA Document 2003-0033891E5, dated Feb. 6, 2004.

⁶An exception is compound interest, which is deductible only as paid.

Figure 1. Accrued Non-Arm's-Length Interest and Section 78(1)

the interest, and a later one for preserving the deduction by making the deemed-paid election. It is especially important to be aware of these tax-year deadlines when the Canadian debtor has one or more deemed year-ends (and thus shortened tax years) that accelerate the relevant deadlines, as might occur, for example, on an amalgamation or merger, or if an acquisition of control occurs (either directly or further up the corporate chain).

Thin Capitalization

Canada has thin capitalization rules limiting the extent to which a nonresident can debt finance its Canadian subsidiaries and have the resulting interest expense reduce their taxable income. In general, a Canadian corporation cannot deduct interest expense on debt owing to specified nonresidents⁷ that exceeds two times the sum of the corporation's retained earnings and the PUC of any shares of the corporation held by such nonresidents. In effect, these rules require that a Canadian subsidiary of a nonresident corporation have \$1 of equity for every \$2 of foreign intragroup debt.⁸

The thin capitalization rules limit the amount of cross-border intragroup debt creating interest expense that reduces the Canadian corporation's corporate income tax and that is subject only to interest withholding tax in Canada (to prevent erosion of the Canadian tax base). One dollar of interest expense for a Canadian corporation will generally save it about \$0.30 of taxes and typically generates only about \$0.10 of Canadian interest withholding tax if the nonresident shareholder is entitled to a treaty-reduced rate of with-

holding tax. Most importantly, the recently enacted fifth protocol to the Canada-U.S. tax treaty eliminates virtually *all* withholding tax on related-party interest between Canada and the United States. This development puts greater pressure on the role of the thin capitalization rules in protecting the Canadian tax base, and the CRA can be expected to look closely at compliance with these rules.

The mechanics of the thin capitalization rules are more complex than the summary above, and they contain a number of subtleties and potential traps. The components of equity may be affected by the economic downturn. For example, if a corporation's retained earnings decrease, its equity is smaller; therefore, the ability to deduct interest on debt owing to specified nonresidents will likewise decrease.⁹ Similarly, if a Canadian corporation returns capital to a nonresident shareholder by way of a PUC reduction in order to repatriate cash (as discussed above), the Canadian corporation's equity will decrease and the amount by which the Canadian subsidiary can be debt financed (with fully deductible interest expense) will decrease. Legislative developments should also be watched closely. In December 2008 the Advisory Panel on Canada's System of International Taxation released its final report detailing recommendations for updating Canada's international tax regime. Included among its recommendations was a suggestion to reduce the maximum debt-to-equity ratio under the thin capitalization rules from 2 to 1 to 1.5 to 1.¹⁰

Foreign groups with Canadian corporate members should be mindful of these rules to ensure that the interest expense on loans from foreign group members is

⁷Essentially, a nonresident person that either:

- owns (alone or together with non-arm's-length persons) 25 percent or more of the corporation's shares (by votes or value); or
- does not deal at arm's length with a person who is such a 25 percent shareholder.

⁸There is no thin capitalization limit on debt owing to Canadian lenders or arm's-length nonresidents.

⁹The corporation's retained earnings at the start of the year is the relevant amount in computing its "equity" for the year.

¹⁰The Department of Finance has not indicated whether it intends to act on this recommendation. For further discussion, see Nathan Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 2," *Tax Notes Int'l*, Jan. 26, 2009, p. 345, *Doc 2009-84*, or *2009 WTD 15-11*.

not denied. Moreover, when a Canadian group member in financial difficulty is not in a position to use interest expense deductions in the immediate future, the group as a whole must consider whether alternative financing arrangements might yield a better overall result.

III. Optimizing Losses and Deductions

Making the best use of its available tax attributes is important in managing a Canadian subsidiary's tax position. A Canadian subsidiary that seeks to optimize its own tax position should examine the extent to which it has tax attributes of potential value and then undertake transactions to utilize them. The following are some simple, typical self-help strategies. (Transactions involving other Canadian group members are described in Section IV below.)

Realize Latent Losses

When a Canadian corporation is in a taxpaying position and has latent losses on its balance sheet, consideration should be given to whether it is impossible to reduce tax payable by crystallizing accrued but unrealized losses that can be used against other taxable income or gains. The ITA contains a variety of rules (so-called stop-loss rules) designed to prevent losses from being recognized when they are not perceived as constituting true economic losses. In broad terms, these rules deny or suspend the recognition of losses on sales to members within the affiliated group, and they prevent a loss being recognized on property sold outside the group if the property (or an identical property) is acquired by the seller or an affiliated person within 30 days before or after the sale.¹¹ Careful planning may be necessary to trigger losses in a way that will be recognized for tax purposes to achieve the desired effect. This planning may be particularly useful when the Canadian corporation has latent capital losses that if recognized could be offset against realized capital gains, since using operating losses to shelter capital gains is generally suboptimal (operating losses are more versatile and hence more valuable).

Carry Back Losses to Prior Years

The Canadian tax system allows losses from a particular year (either net capital losses or noncapital losses) to be carried back up to three tax years and used in those earlier years (capital losses against capital gains only; noncapital losses against all income). If one or more of the corporation's three most recent tax years have positive taxable income, it will generally make sense to carry back current losses and apply them to those earlier years.

¹¹The stop-loss rules are described in more detail in Steve Suarez, "Tax Planning With Losses in Canada," *Tax Notes Int'l*, Aug. 1, 2005, p. 451, *Doc 2005-11065*, or *2005 WTD 148-12*.

Discretionary Deductions

Various deductions from taxable income are voluntary on the part of the taxpayer, such as claiming reserves and capital cost allowance (CCA, the tax version of depreciation). In some cases it will make sense for these to be claimed as fully as possible — for example, if seeking to maximize a current-year loss for the purpose of carrying it back to an earlier profitable year and recover taxes paid, as described above. Because Canadian corporate tax rates have generally been decreasing over the past several years, there is typically a permanent benefit to claiming as many deductions as possible in earlier years rather than in later years, apart from the time value of money benefit in deferring the payment of taxes to later years whenever possible.

Conversely, there can be situations in which it makes sense not to claim deductions as quickly as possible. While the carryforward limitation period for non-capital losses is now quite generous (20 years), this is a relatively recent development; until a few years ago, the limitation period was only 7 years. In some cases, having the loss in latent form (for example, as the undepreciated capital cost of depreciable property) rather than as a realized loss may offer more flexibility in terms of how and when to use it. It is also possible to reverse claims for CCA and similar discretionary deductions taken in prior years so long as the earlier years are still within the time period permitted for reassessment and no change in tax payable for those years results.

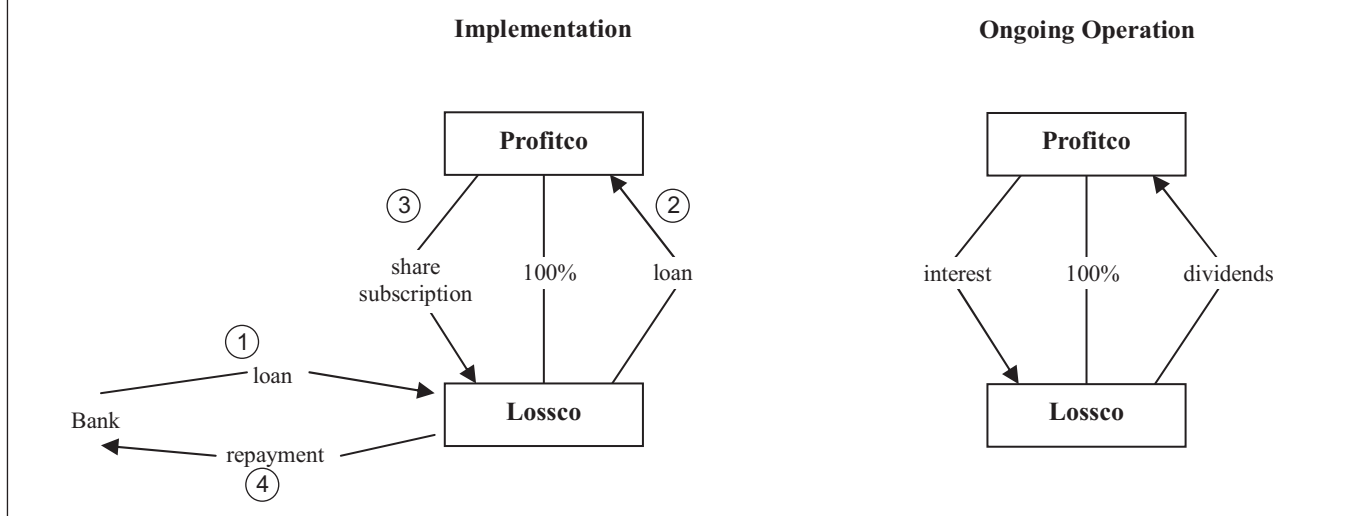
What will work best in any given situation will depend on the specific facts at hand, but the foregoing illustrates the general principle of making optimal use of whatever tax attributes are available within the Canadian corporation.

IV. Intragroup Loss Utilization

Unlike the U.S. tax system, the Canadian tax system does not include a group consolidation concept whereby an affiliated group of corporations can apply losses of one group member against income and gains of another simply by filing a consolidated tax return.¹² Under Canadian rules, each entity computes its own income and deductions and is responsible for its own tax payable. This notwithstanding, it is often possible with careful planning to achieve results similar to those that would occur under a group taxation system. Although the general scheme of the ITA prevents a taxpayer's losses and deductions from being used by or transferred to *unaffiliated* persons, Canadian tax authorities normally accept planning designed to allow

¹²The U.S. consolidated return regulations contain some limitations on the ability to apply losses of one group member against income and gains of another, for example, the separate return limitation year rules.

Figure 2. Basic Loss Consolidation



Canadian members of an *affiliated* group to match income and losses realized within the group. If a Canadian corporation has accrued losses or latent deductions (for example, excess future depreciation expense) and an affiliated Canadian corporation is profitable, it may be possible to effect a loss utilization transaction between the two entities. Indeed, loss/deduction utilization within an affiliated group of Canadian taxpayers is fertile ground for effective tax planning to make the best use of the group's tax attributes.

It is common for taxpayers to seek to transfer losses and deductions within an affiliated corporate group to achieve a de facto consolidation, and the CRA has issued many favorable private rulings to this effect. The general CRA policy permitting this between affiliated entities is subject to some important caveats. In particular:

- the transactions must be legally effective under relevant corporate/commercial law;
- transactions designed to import into Canada foreign losses from outside the Canadian tax system may be challenged;
- planning that results in a circumvention of the ordinary time limits for using accumulated losses (loss refreshing) is viewed as offensive;
- the loss transaction should not be seeking to access losses or similar tax attributes that arose before the relevant entity became part of the affiliated group; and
- provincial revenue authorities are becoming increasingly concerned with transactions that they perceive may reduce the amount of tax owing to one province or another because the relevant tax-

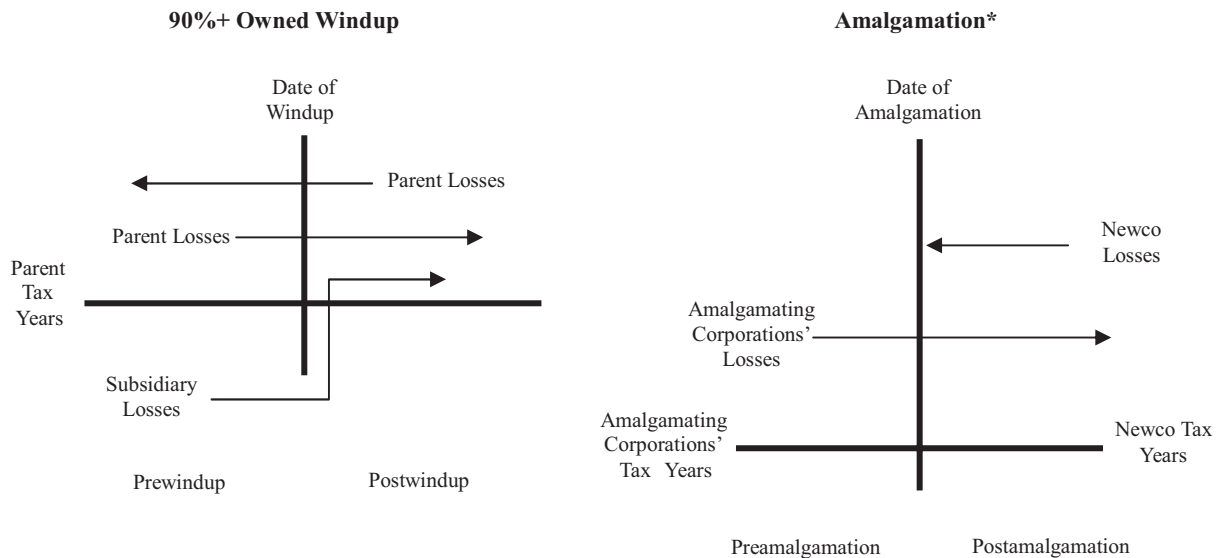
payers do not have the same interprovincial income allocation, and the risk of a challenge by provincial tax authorities must also be considered.

There are various ways in which one Canadian group member can use the tax attributes of another. Perhaps the most common form of loss utilization transaction when one member of a corporate group has accumulated noncapital (that is, operating) losses involves a transaction between the loss corporation (Lossco) and a profitable corporation (Profitco) that creates a deduction in Profitco and a corresponding income inclusion in Lossco that will be offset by Lossco's losses. (See Figure 2.) Briefly, a simple form of the transaction would comprise the following steps:

- Step 1: Lossco obtains a daylight loan from a financial institution.
- Step 2: Lossco uses the proceeds to make an interest-bearing loan to Profitco.
- Step 3: Profitco uses the borrowed funds to subscribe for shares of Lossco.
- Step 4: Lossco uses the share subscription proceeds to repay its daylight loan.¹³

The result of this transaction is that Profitco incurs deductible interest expense on the funds borrowed from Lossco (reducing Profitco's taxable income), and Lossco's interest income on the loan should be absorbed by its losses. Lossco will pay dividends to Profitco, which (as a general rule) Profitco should receive tax free as a

¹³There are many variations on this simple structure, but the basic version illustrates the essential concepts.

Figure 3. Permitted Use of Losses on Windups and Amalgamations

*Other than when one amalgamating corporation owns all shares of the other.

result of a 100 percent dividends received deduction for Canadian-source intercorporate dividends.¹⁴ Note that the interest rate must be commercially reasonable, and the amounts borrowed and invested must be within the parties' arm's-length borrowing capacity.

Corporate reorganizations involving Canadian group members may also achieve some degree of consolidation. Combining an income-generating activity in one entity with the tax shelter of another entity (for example, loss carryforwards, future depreciation deductions, or accrued but unrealized losses) often makes sense if completed within the limitations of the statute. For example, if one Canadian corporation owns 90 percent or more of each class of the shares of another,¹⁵ a windup of the subsidiary into the parent can occur on a tax-deferred basis and leave the parent able to use the loss carryforwards of the subsidiary in future years.¹⁶ Amalgamating two Canadian corporations within an affiliated group similarly leaves the newly created corporation able to carry forward the losses and other tax attributes of its predecessors and use

them against income generated in the postamalgamation period.¹⁷ (See Figure 3.)

More elaborate planning strategies may produce a better result than that occurring from a simple amalgamation or windup. Other strategies for optimizing the use of losses and deductions among Canadian group members include:

- transferring a profitable business to a loss corporation or a corporation with the ability to generate surplus deductions in the future (for example, by claiming more CCA) so that future income earned is sheltered by its losses and deductions;
- selling assets (for example, shares of a subsidiary) to a profitable group member in exchange for interest-bearing debt, the interest from which will reduce the profitable corporation's income and be absorbed by the seller's losses; and
- moving assets or personnel within the group to create deductible charges (for example, lease expenses or management fees) that will reduce the income of a profitable group member.

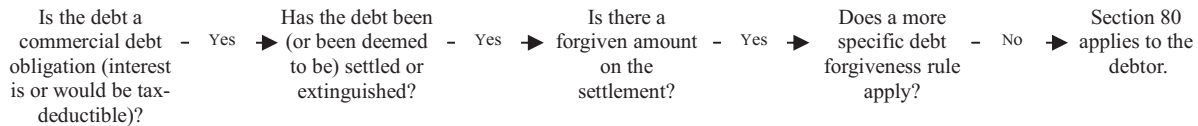
¹⁴For a more detailed discussion of these transactions, see Suarez, *supra* note 11.

¹⁵Any remaining shares must be held by arm's-length persons.

¹⁶Subsection 88(1). Note that the subsidiary's losses cannot be carried back to *prewindup* parent tax years. The parent can carry its own losses back and forth between the *prewindup* and *postwindup* period.

¹⁷Section 87. The corporation resulting from the amalgamation cannot carry postamalgamation losses back against the preamalgamation income of its predecessors, unless one predecessor owned all the shares of the other at the time of the amalgamation (in which case the rule is similar to that for 90 percent+ owned windups).

Figure 4. Application of Section 80 Summarized



There are other potential ways for Canadian group members to optimize the use of their tax attributes, depending on the circumstances. The important point is that this is unlikely to occur in the absence of planning to achieve this result. In all cases, the provincial tax aspects of shifting income and deductions from one entity to another should always be considered.

V. Debt Forgiveness

In more serious cases of financial difficulty, a corporation may need some degree of debt relief from its creditors (either external or within the group). The ITA contains many complex rules dealing with what happens to the debtor when a debt, including interest, is repaid at less than 100 cents on the dollar (a debt forgiveness). The debt forgiveness rules apply in a variety of circumstances, such as on a debt restructuring or even on some purchases and sales of debt. Determining when and how these complex rules apply often requires considerable analysis, and the implications for debtors can be significant. These rules can have surprising results; for example, in some circumstances, they deem a debt to have been settled for tax purposes even though it remains legally outstanding. As such, these provisions must be considered whenever debt is paid, transferred, amended, or restructured.

General Policy on Debt Forgiveness

When a debtor is able to avoid repaying the full amount of a loan, the tax system treats the debtor as having received a benefit that could result in more income for tax purposes or a reduction in favorable tax attributes (such as tax losses or the cost of property for tax purposes). Thus, the settlement of a debt by less than full payment typically has negative income tax consequences for the debtor. The impact of these tax consequences depends on the debtor's particular facts — for example, which statutory provisions apply to it or what its tax attributes are.

The ITA has various rules that apply to debt forgiveness in different cases. Relatively narrow specific rules apply in particular circumstances, such as:

- non-arm's-length debts that go unpaid for a specified length of time (see Section II above);
- debt owing by an employee to her employer;
- debt owing to a corporation by a shareholder;

- trade payables; and
- debt in which the creditor has foreclosed on the debtor's property (that is, the debtor has surrendered property to the creditor as a result of the debtor's failure to pay).

If none of these special rules applies, a debt forgiveness is typically governed by the residual rule in section 80 (although anomalous results can occur if different rules apply in different years). There are three basic preconditions to the application of section 80:

- *Commercial debt obligations.* Section 80 applies only to debts the interest on which is (or would be, if interest were charged) tax deductible. This limits the scope of the rule to debts incurred as part of a business or investment, not debts of a personal nature (compound interest is also excluded, as it is deductible only when paid, not when accruing).
- *Settlement.* The debt must be (or must be deemed to be) settled or extinguished.
- *Forgiven amount.* There must be a forgiven amount regarding the debt (that is, payment of less than the full amount owing under the debt).

For this purpose, interest on a debt is treated as a distinct debt separate from the underlying principal of the debt, meaning section 80 has to be applied separately to the principal and the interest. (See Figure 4.)

'Settled or Extinguished'

Section 80 applies only when the debt has been "settled or extinguished." Generally, a debt is settled when the debtor is no longer liable to pay it. If the creditor accepts new debt or shares of the debtor in satisfaction of the old debt, the old debt will be considered to have been settled (although the rules described below as to what the forgiven amount is will apply). Also, if a debt owing to an unrelated creditor ceases to be enforceable by the creditor because of the passage of time and a statutory limitation period for collecting it, the ITA deems it to have been settled.

A debt may also be settled if it is modified or restructured to the point that the changes are so extensive that they cause the existing debt to be considered to have been settled and a new debt created in its place for tax purposes. The Federal Court of Appeal held in

*General Electric Capital Equipment Finance v. The Queen*¹⁸ that if substantial changes were made to the fundamental terms of an obligation that materially alter the terms, a new obligation would be created.¹⁹ The court found that the fundamental terms of the debt obligations before it were:

- the identity of the debtor;
- the principal amount of the note;
- the amount of interest due under the note; and
- the maturity date of the note.

Since three of these four fundamental terms had been changed on the facts of the case (only the identity of the debtor had not changed), the court held that a new obligation had been created. The court further concluded that a debt could be modified so significantly as to constitute the creation of a new debt without a novation of the debt occurring under the relevant commercial law.²⁰ In that case, the original obligation will be viewed as having been disposed of for tax purposes and a new obligation created. The law regarding modifications of debt instruments is much less developed in Canada than in the United States, where detailed regulations describe significant modifications of debt instruments that will result in a deemed exchange of the old debt instrument for a new debt instrument.²¹

Finally, in some circumstances a debt may be deemed to have been settled under the “debt parking” rules described below, even though the debt remains legally outstanding. While the debt parking rules are complex, essentially they may apply when a person who doesn’t deal at arm’s length with the debtor acquires the debt from an arm’s-length creditor at a significant discount from the debt’s principal amount. This could occur if a group member acquires the Canadian subsidiary’s external debt from its lenders, or if an arm’s-length party acquires both the shares and intragroup debt of the Canadian subsidiary.

Forgiven Amount

Finally, there must be a forgiven amount (that is, extinguished principal or interest in excess of the

amount paid by the debtor) for section 80 to apply. The forgiven amount is the principal amount of the debt less any amounts paid or deemed to have been paid on its settlement. The forgiven amount is reduced by any amounts paid by the debtor to another person to assume the debt. A taxpayer that is bankrupt under the Bankruptcy and Insolvency Act is deemed to have no forgiven amount.

When the debtor issues a new debt in payment of existing debt, the principal amount of the new debt is deemed to have been paid in satisfaction of the principal amount of the new debt. Differences in the *value* of the new debt and the old debt are irrelevant in and of themselves. It is therefore possible to accomplish a debt-for-debt exchange without producing a forgiven amount simply by maintaining the same principal amount. This result should be contrasted with section 108(e)(10) of the U.S. Internal Revenue Code of 1986 as amended, which in a debt-for-debt exchange treats a debtor as having satisfied the old obligation with an amount of money equal to the issue price of the new debt obligation. This rule could result in a debtor realizing cancellation of indebtedness income even if the old debt obligation and the new debt obligation have the same stated redemption price at maturity.

When the debtor issues shares of itself in payment of existing debt, it is considered to have paid an amount on the debt equal to the fair market value of the shares issued.²² The debt forgiveness rules may therefore apply when the value of shares received by a creditor to settle the debt is less than the debt’s principal amount. Moreover, if a creditor is also a shareholder of the debtor and the value of its existing shares of the debtor increases as a result of the debt settlement, that increase in value is treated as a payment toward the debt and reduction of the forgiven amount.

An obvious alternative to issuing shares in direct repayment of intragroup debt is to have a group member inject cash into the Canadian subsidiary as a share subscription or capital contribution, which the Canadian subsidiary then uses to repay the debt in full. When a foreign parent holding debt of a Canadian subsidiary subscribes for Canco shares with cash that is used to repay the debt, the CRA has expressed the view that this transaction could be challenged as an abuse or misuse under the general antiavoidance rule in the ITA.²³ While the soundness of this administrative position is open to

¹⁸2002 DTC 6734 (FCA) (hereinafter *GE Capital*).

¹⁹The issue in the case was whether a new obligation had been created for purposes of determining whether the obligation was exempt from withholding tax under former subparagraph 212(1)(b)(vii).

²⁰The CRA’s administrative position is largely similar, holding that a debt instrument will be considered to have been rescinded when the parties have effected such an alteration of its terms as to substitute a new obligation in its place that is entirely inconsistent with the original debt or, if not entirely inconsistent with it, is inconsistent to such an extent that goes to the very root of it. See *Income Tax Technical News*, No. 14, Dec. 9, 1998. The CRA has stated that *GE Capital* is consistent with this view (*Income Tax Technical News*, No. 30, May 21, 2004).

²¹Treas. reg. section 1.1001-3.

²²This rule, which does not apply if the shares being issued are distress preferred shares (see Section VI below), is similar to IRC section 108(e)(8), which provides that if a debt obligation is satisfied by the issuance of stock, the debtor corporation will be treated as having satisfied the debt with an amount of money equal to the fair market value of the stock.

²³E.g., see CRA document 2003-0022357, dated Sept. 25, 2003.

debate, foreign parents holding debt of their Canadian subsidiaries should be aware of it.

Consequences of Section 80

When section 80 applies, it takes the forgiven amount of the debt and applies it to reduce various favorable tax attributes of the debtor, such as accumulated and unused losses from earlier years (loss carryforwards) and the cost of property for tax purposes (tax cost). This will typically result in higher taxable income in later years due to, for example, prior years' loss carryforwards being unavailable to shelter future income. For property whose tax cost has been reduced under section 80, there will be smaller future depreciation deductions each year for depreciable property (since tax depreciation is computed as a percentage of a property's cost) and higher gains realized when the property is sold.

The order in which the debtor's attributes will be ground down by a forgiven amount generally is as follows (the debtor has some ability to choose certain grind-downs):

- i) noncapital (that is, operating) loss carryforwards;
- ii) capital loss carryforwards (losses usable only against capital gains);
- iii) the tax cost of depreciable properties;
- iv) the tax cost of properties (generally intangible assets) known as eligible capital properties;
- v) accumulated expenditures on some natural-resource-sector properties;
- vi) the tax cost of capital properties other than depreciable property and the properties in vii) and viii) below;
- vii) the tax cost of shares and debt of corporations in which the debtor is a specified shareholder²⁴ (other than those in viii) below);
- viii) the tax cost of shares and debt of corporations that are related to the debtor and interests in partnerships that are related to the debtor²⁵; and
- ix) current-year capital losses.

To the extent that the forgiven amount exceeds these reductions in the debtor's tax attributes, 50 percent of the excess (100 percent for partnerships) is added to the debtor's income for tax purposes, potentially increasing its taxes payable. For example, assume that a debtor

settles a \$10,000 debt for \$7,000 (that is, a \$3,000 forgiven amount), and that the debtor has a \$1,500 loss carryforward from a previous year and a property with a cost for tax purposes of \$1,000. Section 80 could apply the \$3,000 forgiven amount to eliminate the loss carryforward (\$1,500) and reduce the tax cost of the debtor's property down to zero (\$1,000). Fifty percent of the remaining unapplied \$500 of the debt forgiveness would be added to the debtor's income for the year of the debt settlement, which (depending on the debtor's circumstances) could result in taxes owing. While the actual section 80 rules are much more complex, this simplified example nonetheless illustrates the essence of the provisions.

The example above is only a general description of the sequence in which a forgiven amount is applied. For example, some tax attributes are reduced only if the taxpayer so chooses, and others can be used to absorb the forgiven amount only if other tax attributes have been reduced to the full extent possible. These rules are intended to prevent a taxpayer from largely negating the effect of section 80 by reducing less favorable tax attributes first, although with careful planning, there is considerable scope for managing how section 80 applies. This general summary nonetheless provides a good basic sense of how section 80 operates.

Planning Within a Canadian Group

When more than one Canadian group member exists, there may be additional opportunities for managing the application of the debt forgiveness rules. For intragroup debt, for example, corporate reorganizations are often useful for making the best of an unfavorable situation.

Amalgamations and windups involving Canadian group members can often be very useful for dealing with debt forgiveness issues, either in terms of making the best use of available tax attributes within the Canadian group to manage section 80 or eliminating debt of one Canadian group member held by another. For example, when a debtor and creditor that are both Canadian corporations amalgamate, or when one is wound up into the other on a tax-deferred basis, deeming rules basically provide that no debt forgiveness will arise as long as the creditor's tax cost of the debt is not less than the principal amount.

Moreover, section 80 includes a mechanism that in some circumstances allows any residual forgiven amount to be transferred to a related member of the Canadian group. This can offer some degree of choice as to which tax attributes get ground down by the forgiven amount. Applied with suitable creativity, this mechanism can be very useful, especially when there are reasons for maintaining the separate existence of different Canadian group members (for example, legal liability) that make a windup or amalgamation undesirable. In principle this mechanism requires the debtor to

²⁴In general, a specified shareholder is a shareholder who, together with non-arm's-length persons, owns at least 10 percent of any class of shares of the corporation.

²⁵A debtor corporation may be able to elect under section 80.04 to transfer a portion of the remaining forgiven amount to certain eligible transferees, including related taxable Canadian corporations, instead of reducing the adjusted cost bases of shares and debt of related corporations.

make the maximum possible reductions in its most advantageous tax attributes before transferring any residual forgiven amount to eligible transferees, although again there are a number of planning opportunities for optimizing the results.

Debt ‘Parking’

A planning strategy for dealing with some debt forgiveness situations under older versions of section 80 was to have the debt purchased by a related entity that simply let it remain outstanding indefinitely without ever enforcing repayment. Absent a formal extinguishment of the debt, section 80 would not apply. Such debt parking is directly targeted by specific rules in the current version of section 80 that deem a debt to have been settled in some circumstances. Since these rules catch situations beyond the simple strategy described above, it is always important on a debt restructuring or acquisition of debt to ensure that the debt has not been deemed to have been settled by the debt parking rules.

The debt parking rules are fairly complex; however, in general terms, when the following conditions apply, these rules deem a debt to have been settled for tax purposes even though it remains legally outstanding:

- the debt was previously either:
 - owned by a creditor who dealt at arm’s length with the debtor and did not have a significant interest in the debtor²⁶; or
 - acquired by the holder from a person unrelated to it²⁷; and
- the current holder does not deal at arm’s length with the debtor or has a significant interest in the debtor, and its cost of the debt is less than 80 percent of its principal amount.

These rules might apply when a subsidiary or parent of the debtor purchases the debt from a bank or other arm’s-length creditor at a substantial discount. It can also apply when an arm’s-length acquirer purchases both the shares of the debtor and its debt owing to the shareholders. For example, when the value of the debtor’s assets is less than its outstanding debt, an acquirer will typically purchase the debtor’s shares at a nominal amount and the debtor’s debts at an amount less than the principal amount. If the discount at

which the debt is acquired is big enough (that is, the amount the acquirer pays for the debt is less than 80 percent of its principal amount), the debt parking rules will deem the debt to have been settled immediately after the shares and debt are acquired since at that point the acquirer and debtor will not deal at arm’s length. There are structuring strategies that can prevent this from occurring if the problem is spotted in time. However, it is common for the debt parking issues in these situations to be overlooked, because the rules are complex and the rationale for deeming debt forgiveness to have occurred in these situations is not always straightforward. Hence, the debt parking rules constitute a trap for the unwary.

Amalgamations and windups involving Canadian group members can often be very useful for dealing with debt forgiveness issues.

When a debt is deemed to have been settled under the debt parking rules, the debtor is deemed to have paid an amount equal to the current holder’s cost of the debt in satisfaction of the principal. Because the creditor must have a cost of the debt that is less than 80 percent of the principal amount for this rule to apply, a forgiven amount will result, causing a reduction in the favorable tax attributes of the debtor and/or extra taxable income for the debtor. These rules are conceptually similar to IRC section 108(e)(4), which treats an acquisition of a taxpayer’s debt by a related person as an acquisition by the debtor. Unlike the Canadian rules, however, the U.S. rules apply in any circumstance when debt is purchased by a related party and not only when the debt is purchased at a significant discount.

Comparison With Analogous U.S. Rule

The debt forgiveness rules under section 80 generally are more favorable to taxpayers than those found in the IRC, in which the general rule is that cancellation of indebtedness income is included in gross income.²⁸ There is an exclusion to the general rule if a taxpayer is bankrupt or insolvent, in which case instead of including any cancellation of indebtedness in gross income, a taxpayer is required to reduce, or grind, certain

²⁶For the purposes of the debt parking rules, a shareholder of the debtor who holds 25 percent or more of the votes or value of the debtor’s shares (including shares held by non-arm’s-length persons) is deemed not to deal at arm’s length with the debtor. A person has a “significant interest” in the debtor if that person or someone not dealing arm’s length with that person owns 25 percent or more (by votes or value) of the debtor’s shares.

²⁷Generally, two parties will be related when one has legal control of the other or when both are under common legal control. Some elective bad debt write-downs can also trigger the debt parking rules.

²⁸Section 61(a)(12). The recently enacted American Recovery and Reinvestment Act of 2009 provides for an elective deferral of COD income regarding debt repurchases that occur in 2009 or 2010.

tax attributes.²⁹ Thus, whereas in Canada taxpayers generally will grind tax attributes before an income inclusion is required and bankrupts will not be subject to the debt forgiveness rules, in the United States taxpayers generally must recognize an income inclusion (excluding bankrupt and insolvent taxpayers who must instead grind their tax attributes).

VI. Distress Preferred Shares

As a general rule, in the Canadian tax system, interest is deductible to the payer and fully taxable to the recipient. Dividends are nondeductible to the payer, and in the case of dividends paid by one Canadian corporation to another are generally received tax free by virtue of a 100 percent dividends received deduction for intercorporate dividends. This means that dividend payments have a higher after-tax cost to corporate payers, and interest income produces a lower after-tax return for corporate recipients. In this way, a 6 percent interest rate might be economically equivalent to, say, a 4 percent dividend for the parties on an after-tax basis.

A DPS is a share that has many debt-like features designed to provide the holder with a more secure investment than regular equity.

Not surprisingly, attempts have been made to create equity investments that have the security of debt but that generate dividend income that a corporate investor can receive on a tax-free basis. These are especially likely to be attractive when the payer is not in a position to use or is otherwise willing to forgo the deduction that interest expense would generate for it, and so is relatively indifferent between paying interest or dividends. The ITA contains a variety of complex rules (often called the preferred share rules) designed to prevent this from happening by denying the recipient the dividends received deduction (that is, making the dividend taxable) and by imposing special taxes on the dividend payer and the recipient.

A distress preferred share (DPS) is a share that has many debt-like features designed to provide the holder with a more secure investment than regular equity — for example, it allows the holder to exchange the DPS for higher-ranking debt of the issuer in various circum-

stances. However, by virtue of a specific exception in the preferred share rules, dividends on DPS will still be eligible for the 100 percent dividends received deduction. This means that the investor can accept a lower pre-tax rate of return on its investment than would otherwise be the case if the dividends were taxable to it. Using the previous example, for an investor who wants debt-like security, a DPS with a 5 percent dividend rate is a better after-tax return than a 6 percent interest rate on “regular” debt, while the same 5 percent dividend rate is less onerous for an issuer than a 6 percent interest rate on “regular” debt if the issuer can’t use the interest expense deduction because it is not in a tax-paying position. Both parties are better off.

A DPS generally is a share issued by a corporation resident in Canada:

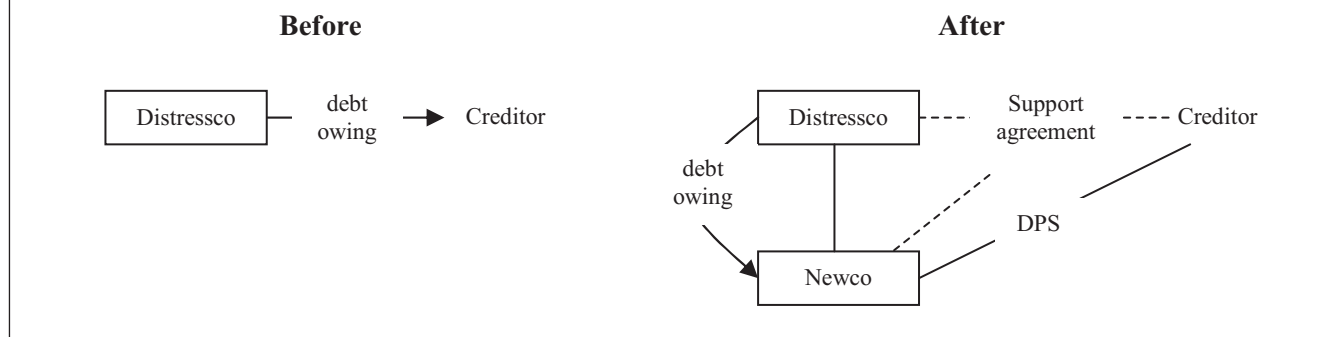
- as part of a proposal or arrangement with its creditors that had been approved by a court under the Bankruptcy and Insolvency Act;
- when all or substantially all of its assets were under the control of a receiver or trustee in bankruptcy; or
- when, by reason of financial difficulty, the issuing corporation or a non-arm’s-length Canadian corporation was in default, or could reasonably be expected to default, on a debt obligation held by an arm’s-length creditor, and the share was issued either wholly or in substantial part and either directly or indirectly in exchange or substitution for all or a part of that obligation.

A typical DPS transaction is illustrated in Figure 5 and could be summarized as follows:

1. The financially distressed corporation (Distressco) creates a new single-purpose subsidiary (Newco).
2. Newco receives a demand loan from the creditor equal to the face amount of the Distressco loan owing to the creditor and uses it to purchase the loan from the creditor.
3. The creditor then subscribes for DPS of Newco, which uses the funds to repay the demand loan owing to the creditor. The terms of the DPS generally provide that the holder can retract them (that is, force a redemption) at any time if an event of default occurs, and that the holder is entitled to an annual cumulative preferred share dividend. The DPS is often redeemable after five years, or earlier if Distressco generates excess cash flow. The DPS therefore contains many of the features of a debt.
4. Various agreements are entered into among Distressco, Newco, and the creditor providing that Newco will not receive any interest on the Distressco debt, Distressco will make capital contributions to Newco sufficient to fund its DPS obligations, and the creditor can put its DPS to

²⁹Section 108(a) and (b).

Figure 5. Distress Preferred Shares



Distressco and reacquire the Distressco debt (that is, revert to its original position as a Distressco creditor).

Essentially, the DPS structure puts the creditor in the position of being a preferred shareholder in form, so as to be able to receive returns that are tax-advantaged dividends. At the same time, however, the creditor is able to switch back into holding a debt security if necessary, and so effectively maintains its priority against other claimants. The CRA has issued numerous DPS rulings to confirm the favorable tax treatment of these structures, and creditors may insist on an advance tax ruling. DPS financing is likely to be most useful when the creditor does not have other tax shelters available to it to absorb taxable interest income and is (or can be made to be) a Canadian resident corporation so as to take advantage of the dividends received deduction. When subsequently settled, DPS is treated as if it were debt, so it can potentially come within the debt forgiveness rules in section 80.

VII. Foreign Exchange Issues

A Canadian corporation that repays or restructures debt that is not denominated in Canadian dollars must consider whether a foreign exchange gain or loss could be recognized, because of a difference in the value (expressed in Canadian dollars) of the amount borrowed and the amount subsequently repaid.³⁰ In general, the characterization of a foreign exchange gain or loss on either income account or capital account is determined

by reference to the character of the underlying transaction, asset, or liability to which the foreign exchange gain or loss relates.³¹ Characterizing foreign exchange gains and losses on debt depends on the characterization of the underlying debt, which in turn generally depends on the use of borrowed funds.

Debt-related foreign exchange gains and losses on capital account are generally recognized when the underlying debt is settled. This may occur on the repayment of the debt, including on a debt-for-debt or debt-for-equity exchange, or (as noted above) if the terms of the debt are modified to the point that the old debt is considered to have been disposed of and replaced by a new debt. The recognition of a foreign exchange gain or loss typically does not depend on whether the debtor actually converts an amount of Canadian dollars into the foreign currency to repay the debt. A foreign exchange gain or loss on the settlement of debt is generally computed as the difference between:

- the amount paid on the settlement, multiplied by the exchange rate in effect on the date of settlement; and
- the original amount of the debt, multiplied by the exchange rate in effect on the date the liability arose.

Under the section 80 rules, currency fluctuations are generally ignored for purposes of determining whether a debtor has realized a forgiven amount on the settlement of debt. In other words, a forgiven amount should not arise under the debt forgiveness rules of section 80 solely by virtue of fluctuations in the value

³⁰The general rule is that a taxpayer's Canadian tax results must be reported in Canadian dollars. However, some corporations resident in Canada may elect to report their tax results in a currency other than the Canadian dollar if that other currency is the primary currency in which the taxpayer keeps its books and records for financial reporting purposes. For more on this topic, see section 261 of the ITA; see also Steve Suarez, "Deadline Extended for Electing Foreign Currency Reporting," *Tax Notes Int'l*, Nov. 10, 2008, p. 459, *Doc 2008-23127*, or *2008 WTD 212-1*.

³¹For example, an F/X gain or loss on money borrowed and used to purchase a capital asset will generally be a capital gain or loss. For a detailed discussion of this issue, see Steve Suarez and Byron Beswick, "Canadian Taxation of Foreign Exchange Gains and Losses," *Tax Notes Int'l*, Jan. 12, 2009, p. 157, *Doc 2008-26103*, or *2009 WTD 9-17*.

of the currency in which the debt was denominated, even if the debtor realizes a foreign exchange gain or loss on an exchange of debt. In practice, however, there are circumstances in which foreign exchange issues can arise under section 80 on the restructuring of foreign-denominated debt, and it is important to carefully work through all the elements of these complex rules before acting.

VIII. Transfer Pricing

Transfer pricing (the economic terms of transactions between members of a related group in different countries) is a topic unto itself and one that cannot be discussed properly only in passing.³² In particular, however, the application of transfer pricing rules to the current business environment is in a state of considerable uncertainty. The OECD released a discussion draft on different aspects of internal business reorganizations on September 19, 2008.³³ It attempts to offer guidance on the application of the OECD 1995 transfer pricing guidelines to various forms of business restructurings. Public commentary on the discussion draft has been extensive.³⁴ A general theme arising from the business community is that the “commercial rationality” standard proposed in the discussion draft represents a significant lowering of the threshold for fiscal authorities to ignore the taxpayers’ legal contracts and recharacterize what actually occurred — an alarming development to say the least.³⁵

Canada has one of the most aggressive transfer pricing enforcement authorities in the OECD. The CRA continues to expand the resources devoted to enforcing

the transfer pricing rules in the ITA, and many multinational groups with Canadian members find transfer pricing disputes involving Canada to be among the most challenging to resolve. One would expect things to get more challenging in the current business environment as tax revenues shrink, and the principles set out in the OECD discussion draft on business restructurings do not fit particularly well with Canada’s domestic transfer pricing rules.³⁶ Accordingly, multinational groups will have to pay particular attention to transfer pricing issues should Canadian group members be involved in any form of business restructuring.

IX. Sale of Canadian Subsidiary

In the extreme, a multinational group in financial distress may have to consider an actual arm’s-length sale of group members to raise funds. Should a Canadian subsidiary be sold, various Canadian tax considerations may become relevant.

Should the Canadian subsidiary have loss carry-forwards or accrued but unrealized losses, a foreign parent should understand that it may be difficult to obtain value for them in a sale to a third party. The scheme of the Canadian tax system generally operates to prevent losses from being used by or transferred to unaffiliated persons, meaning that when an acquisition of control of a corporation occurs (directly or indirectly),³⁷ a number of tax implications arise:

- 1) a deemed year-end for the corporation;
- 2) the deemed realization of any accrued but unrealized losses on its property immediately before such year-end³⁸; and
- 3) the application of loss restriction rules that prohibit or restrict the corporation’s ability to use preacquisition of control losses (including those from 2), above) in the postacquisition period and vice versa.

³⁶For further discussion, see Richard Tremblay and Steve Suarez, “The OECD Discussion Draft on Business Restructurings — Canadian Considerations,” *Tax Mgmt Int’l J.*, Vol. 38, No. 2, Feb. 13, 2009, p. 98.

³⁷That is, a change in the shareholdings of the corporation (or of another entity that directly or indirectly controls the corporation) such that a different person or group of persons has the ability to elect the majority of the corporation’s board of directors. In general, no acquisition of control occurs if the new controller is related to the previous controller (if any) or was already related to the target corporation (that is, intragroup transfers generally should not matter).

³⁸This generally prevents accrued losses from being carried over to the post-acquisition-of-control period, and instead realizes them before the deemed tax year-end to be either used in the tax year ending on the acquisition of control or made subject to the rules described below governing the carryover of losses on acquisitions of control.

³²For a detailed comparison of the Canadian and U.S. views on this topic, see William Morgan, “Perspectives on U.S. and Canadian Transfer Pricing Analyses,” *Tax Notes Int’l*, Sept. 1, 2008, p. 765, *Doc 2008-17047*, or *2008 WTD 171-10*.

³³“Transfer Pricing Aspects of Business Restructurings,” available at <http://www.oecd.org/dataoecd/59/40/41346644.pdf>.

³⁴See Public Comments on the Transfer Pricing Aspects of Business Restructurings, available at http://www.oecd.org/document/25/0,3343,en_2649_37989760_42155737_1_1_1_37427,00.html.

³⁵See, e.g., David D. Stewart, “OECD ‘Commercially Rational’ Standard Sparks Concern,” *Tax Notes Int’l*, Mar. 23, 2009, p. 1039, *Doc 2009-5815*, or *2009 WTD 49-2*, quoting the Confédération Fiscale Européenne:

The proposed watering down of this principle not only subverts the arm’s length principle but undermines certainty and threatens the rule of law as it heightens the risk of taxation by administrative discretion and arbitrary application. . . . This new approach appears to attempt to give tax administrations an opportunity to hypothesize what they think the behavior ought to be.

See also Andreas Bullen, Andreas Gerten, and Birgit Stürzlinger, “A Report on the OECD Discussion Draft on Business Restructurings,” *Tax Notes Int’l*, Mar. 16, 2009, p. 997, *Doc 2009-3572*, or *2009 WTD 50-9*.

Essentially, noncapital losses from an *investment* (as opposed to a business) and net capital losses from the preacquisition of control period cannot be carried forward and used in tax years postacquisition of control (and vice versa); they effectively become worthless if they cannot be used in the preacquisition period.³⁹ Noncapital losses from a *business* may be carried forward and used against postacquisition income if the following conditions are met:

- the corporation must carry on the loss business with a reasonable expectation of profit throughout the later year in which it seeks to use the loss; and
- the income against which the loss is used must arise from carrying on either the business that generated the loss (the loss business) or a business of selling similar properties or rendering similar services that were sold or rendered in the loss business.

Thus, business losses are streamed to be usable only against income from the same or similar business, and only if the loss business itself continues to be carried on. This means that a foreign parent should consider the impact that closing a Canadian subsidiary's unprofitable business will have on its accumulated losses. A further result is that when the subsidiary's business is in a sector with several profitable competitors, its losses are much more likely to have value to a third party than a situation in which the industry as a whole is suffering. When the vendor and purchaser are willing to cooperate, there are possible planning opportunities for optimizing the use of the acquired corporation's losses and deductions, and a vendor of a Canadian subsidiary seeking to maximize the sale price would be well advised to ensure that any available tax attributes of the subsidiary are used to the fullest extent possible on the sale.

When one Canadian corporation acquires another and then winds it up or amalgamates with it on a tax-deferred basis, Canadian tax law provides for a potential step-up in the tax cost of the acquired company's property that the buyer acquires on the windup or amalgamation. This effectively allows the buyer to push its tax cost of the acquired corporation's shares onto the nondepreciable capital property of the acquired corporation. In many cases, the benefit of this step-up is considerably enhanced if the vendor agrees to cause its Canadian subsidiary being sold to restruc-

ture its assets before the closing of the sale. For this reason, a foreign parent selling a Canadian subsidiary should expect a well-informed purchaser (either Canadian or foreign, since foreign purchasers typically create a Canadian acquisition company to make Canadian purchases) to cooperate in presale tax planning, which creates value that can in turn allow the vendor to maximize its sale price.⁴⁰

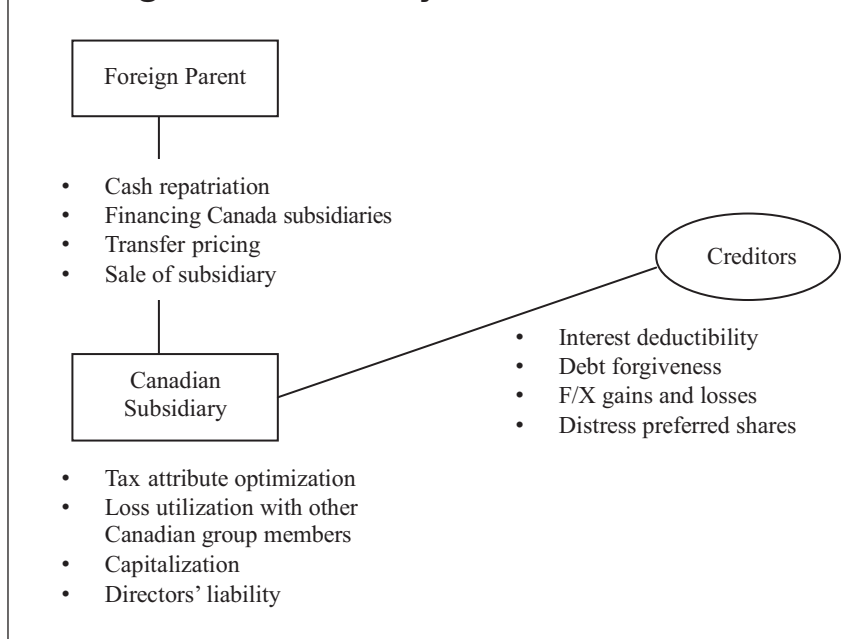
Another situation in which preclosing cooperation can produce an improved result is when the debt forgiveness rules (see Section V above) could potentially apply, such as when the Canadian subsidiary is repaying its debt as part of or as a prelude to the share sale or when both the debt and the shares of the Canadian subsidiary are being purchased. The interaction of the acquisition of control rules and the debt forgiveness rules is a trap for the unwary, so taking steps to avoid an undue result will benefit both parties.

Gains and losses on the sale of the debt of a Canadian subsidiary by a foreign parent are generally not subject to Canadian capital gains tax. To the extent that the nonresident has a gain on the disposition of the shares of a Canadian subsidiary, this will generally be subject to Canadian capital gains tax, subject to relief under any applicable tax treaty. Only 50 percent of capital gains are included in income, so they are advantageously taxed. Most (but not all) Canadian tax treaties exempt foreign treaty residents entitled to treaty benefits from Canadian taxation of gains on the sale of a Canadian subsidiary, so long as the shares of the subsidiary do not derive their value primarily from Canadian real property (directly or indirectly). Canada's domestic legislation also taxes nonresidents on the disposition of privately held shares of *foreign* corporations that derive (or have recently derived) more than half their value from Canadian real property (directly or indirectly); therefore, in some cases, a sale of a foreign holding company will also create Canadian tax issues (at least for vendors not resident in a treaty jurisdiction).

Finally, the sale of a closely owned Canadian subsidiary by a nonresident vendor will require compliance with the notification and withholding regime set out in section 116. That regime creates a potential notification and tax return filing obligation for the foreign vendor, as well as an obligation on the part of the purchaser to remit 25 percent of the purchase price to the CRA as a prepayment on account of any Canadian tax liability of the vendor, unless an exception applies. That the purchaser otherwise withholds 25 percent of the purchase price makes compliance with these rules

³⁹The potentially harsh effects of this rule are somewhat alleviated by a one-time election the corporation can make to effectively use any otherwise unusable pre-acquisition-of-control capital losses against any accrued but unrealized capital gains on its property that exist immediately before the acquisition of control. Doing so increases the tax cost of (and reduces the accrued gain on) the gain property.

⁴⁰This step-up in tax cost is reviewed in depth in Steve Suarez, "Canada's Tax Cost Step-up: What Foreign Purchasers Should Know," *Tax Notes Int'l*, Dec. 4, 2006, p. 779, *Doc 2006-21865*, or *2006 WTD 237-7*.

Figure 6. Summary of Potential Issues

effectively the vendor's responsibility. These obligations exist regardless of whether any gain exists on the shares and whether any tax is in fact owed from the disposition, although relief may be available in some circumstances when a gain on the shares would be treaty exempt.⁴¹

X. Directors' Liability

Directors of a corporation experiencing financial difficulty should be aware that in some instances, they may become personally liable for some of the corporation's tax liabilities. More specifically, directors may be personally liable when the corporation has failed to deduct, withhold, or remit to the CRA certain amounts, including:

- salary, wages, certain employment benefits, and distributions out of various plans paid by the corporation;
- amounts paid or credited by the corporation to nonresidents and subject to withholding tax; and
- the federal goods and services tax and any harmonized provincial sales tax collected by the corporation.

⁴¹For a detailed discussion of this issue, see Steve Suarez and David Gaskell, "Canada's Revised Section 116 Regime for Non-resident Vendors," *Tax Notes Int'l*, Jan. 26, 2009, p. 321, *Doc 2008-27299*, or 2009 *WTD 16-10*.

The amount for which directors may be liable is the amount that the corporation failed to deduct, withhold, or remit, as well as any interest or penalties. Generally, a director will become personally liable only if:

- the CRA has first pursued the corporation for amounts owing (that is, the CRA must seek to impose liability on directors only as a last resort);
- the CRA reassesses a director within two years after the director last ceased to be a director of the corporation; and
- the director failed to exercise the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances (the due diligence defense).

The ITA also provides that every person who is a legal representative that administers, winds up, controls,

or otherwise deals with the property or business of a corporation is required to apply to the CRA for a clearance certificate before distributing any of the corporation's property. The clearance certificate generally certifies that the corporation has paid certain taxes or posted security for such amounts. Failure to obtain a clearance certificate will render the representative personally liable for the payment of the corporation's taxes owing, up to the value of the property distributed. Although this provision most commonly arises in the case of executors, it may also apply to directors (for example, on the windup of a corporation). Finally, separate from the tax issues, Canadian corporate law typically provides that if the directors of a corporation declare dividends when a corporation is unable to pay its liabilities (including taxes) or such a payment would result in the corporation becoming unable to pay its liabilities, the directors may become liable to the corporation for the amount of the improper payment.⁴²

Directors of a financially troubled Canadian subsidiary should demonstrate the appropriate diligence in making sure that the corporation is meeting its tax obligations. For example, regular inquiries should be made of management to the effect that the corporation is deducting and remitting to the CRA all tax and payroll-related amounts (including Employment Insurance and Canada Pension Plan premiums) that it is

⁴²See, e.g., section 130(2) of the Ontario Business Corporations Act.

legally required to deduct and remit, and there should be suitable procedures in place to ensure that all required deductions and remittances occur. A director concerned about potential liability can avail herself of the due diligence defense by acting accordingly (suitable directors' insurance should also be in place).

XI. Conclusion

Difficult tax issues are the last thing businesses need during challenging economic times. Unfortunately, they are a fact of life in today's environment. If these issues are identified early enough and addressed appropriately, there are often several alternatives for managing them and achieving effective results. ◆