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by Steve Suarez

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HIGHLIGHTS

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Canada Releases Foreign Affiliate Dumping Amendments

by Steve Suarez

Canada's Department of Finance on August 16 released proposed amendments to the foreign affiliate dumping (FAD) rules enacted in late 2012. As noted in a December 2012 article (prior coverage: *Tax Notes Int'l*, Dec. 17, 2012, p. 1145), the FAD rules are directed at perceived tax avoidance by foreign-controlled Canadian corporations that acquire or make investments in foreign subsidiaries. The FAD rules reduce the paid-up capital (PUC)[1] of the Canadian corporation's shares or deem the Canadian corporation to have paid a dividend to which nonresident dividend withholding tax may apply. Therefore, the rules treat a payment ''down'' the chain by a Canadian corporation to a foreign subsidiary as if it were a distribution ''up'' the chain by the Canadian corporation.

The August 16 proposals provide for a number of technical changes that refine the scope of the FAD rules when Canadian tax authorities are satisfied that no material abuse is likely to arise and, in other cases, make their application less punitive. Most significantly, they:

- narrow the scope of the charging provision to exclude certain transactions occurring before (but as part of the same series of transactions that includes) the acquisition of control of a Canadian corporation; and
- if the FAD rules do apply, make it easier to reach the least painful result among the permitted alternatives.

However, they could be further streamlined, in particular:

- the rules may apply even in situations in which no net value is being extracted from Canada;
- the absence of a bona fide business purpose test to limit the scope of the FAD rules to transactions that have a principal or significant tax avoidance purpose (or result) is still problematic; and
- further steps should be taken to reduce the tax cost (Canadian and foreign) of extracting from Canada the non-Canadian assets of Canadian corporations acquired by foreign purchasers, which would make the use of Canadian corporations as head office companies for foreign ventures more attractive, benefiting the Canadian economy.

The August 16 proposals are generally effective from the original date the FAD rules were announced (March 28, 2012), unless a taxpayer instead elects to have them come into force on August 14, 2012. The Department of Finance is accepting comments on the proposals until October 15.

Scope of Charging Provision

The charging provision under the FAD rules applies when a Canadian resident corporation (Canco) that is controlled by a foreign corporation (the parent) makes an investment in a nonresident corporation (Foreignco) that is a foreign affiliate of Canco.[2] Subject to limited exceptions, the FAD rules apply when:

- *Condition 1*: Canco is controlled by the parent at the time of Canco's investment, or it becomes so controlled as part of the same series of transactions that includes its investment (known as the ''relevant series''); and
- *Condition 2*: Foreignco is a foreign affiliate of Canco immediately after the investment, or it becomes one as part of the relevant series.[3]

The Canadian judicial interpretation of the term ''series of transactions'' has been broad, creating a

[1]The PUC of a class of a corporation's shares represents amounts received by it from persons subscribing for the shares on their issuance. PUC is a valuable tax attribute, because property distributed by a corporation as a return of PUC is not subject to dividend withholding tax and Canada's thin capitalization rules use PUC as part of the limit on permissible interest expense (see discussion below in section entitled ''Other Changes'').

[2]A corporation resident outside of Canada will generally be a foreign affiliate of Canco if Canco owns at least 1 percent of its shares, and Canco and all persons related to Canco collectively own at least 10 percent of its shares.

[3]*See* Section I of the December 2012 article.

fairly low threshold in order for two events to constitute part of the same series of transactions, and generating uncertainty about what is included within such a series.

Creeping Takeovers

The August 16 proposals narrow the scope of the charging provision by providing that when Canco is not controlled by the parent at the time of Canco's investment, the charging rule will apply only in certain circumstances. Condition 1 above is being amended so that in order for the FAD rules to apply, one of the three following conditions must be met:

- the parent and all persons not dealing at arm's length with the parent must collectively own 25 percent or more of Canco's shares (either by value or by voting power) at the time of investment[4];
- Canco's investment must be an acquisition of preferred shares — that is, shares that do not participate fully in the issuer's profits — of a Foreignco that is not a wholly owned subsidiary of Canco; or
- there must be an arrangement in place whereby a person other than Canco (or someone related to Canco) has a material risk of profit or loss in connection with the property regarding Canco's investment.[5]

The purpose of this amendment is to provide a safe harbor for investments made before the parent's ownership of a 25 percent interest (by votes or value) in Canco, when a subsequent acquisition of control of Canco by the parent would be part of the relevant series. Without this amendment, the charging provision could apply to a Canco that made an investment in Foreignco when the parent owned only a small shareholding in Canco but possibly intended to acquire control of Canco. (That intention could be enough to make the parent's subsequent acquisition of control of Canco part of the relevant series, causing the FAD rules to apply retroactively to Canco's earlier investment.) There is no tax policy reason to apply the FAD rules to an investment made by a Canco when the parent had no practical ability to influence Canco's investment decisions, and this amendment will sensibly prevent the FAD rules from applying in those circumstances.

These ''creeping takeovers'' are particularly common in the mining sector, in which larger companies often take smaller stakes in junior companies that own a promising early-stage project, intending a complete takeover if the project is successful.

Investments

An investment in Foreignco may take a number of forms, including the acquisition of Foreignco shares, directly or via an indirect acquisition[6]; a contribution of capital to (or conferral of a benefit on) Foreignco; or Foreignco becoming indebted to Canco (for example, through a loan from Canco). Two forms of debt owed by Foreignco are excluded from the FAD rules.[7] The August 16 proposals add a third exception: An amount owed by Foreignco to Canco as a dividend that has been declared but not yet paid will not constitute an investment under the FAD rules.

Exclusions From FAD Rules

Corporate Reorganizations Exception

The current version of the FAD rules contains two exceptions to the charging provision. The first is the corporate reorganizations exception, for situations in which there has technically been an investment that would otherwise trigger the FAD rules, but there is no new substantive movement of funds or other property out of Canada and thus no tax policy concern.[8]

The August 16 proposals amend the corporate reorganizations exception. First, they broaden provisions to ensure that on a qualifying amalgamation, a Canco that is a shareholder of the corporation resulting from the amalgamation will not be considered to have made an indirect acquisition of Foreigncos owned by that resulting corporation.

Second, under the August 16 proposals, the acquisition by Canco of shares of a Foreignco received in exchange for debt owed to Canco is one of the corporate reorganizations exceptions. Such an exchange must fall under the tax-deferred exchange rule in subsection 51(1) of Canada's Income Tax Act — that is, Canco's counterparty must be the issuer of the shares and the debtor, not another person — if the terms of the debt conferred on the holder the right to make such an exchange.

Finally, when Canco's acquisition of property is received as whole or partial repayment of a ''pertinent

[4]For this purpose, any rights that the parent and non-arm's-length persons have to acquire or control the voting of Canco shares (or to reduce the number or voting power of Canco shares held by other persons) are considered exercised and in force.

[5]This is largely an antiavoidance provision designed to prevent Canco from making an investment as an accommodation to its parent before the parent acquires control of Canco.

[6]An indirect acquisition is an acquisition of shares of another Canadian corporation for which more than 75 percent of the value of the assets consists of shares of foreign affiliates.

[7]*See* Section III of the December 2012 article.

[8]*See* Section IV of the December 2012 article.

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debt,''[9] the corporate reorganizations exception does not apply. A pertinent debt is one of the forms of debt investment in Foreignco that is excepted from the investment definition, and hence the FAD rules. Therefore, one cannot use the corporate reorganizations exception to acquire property on the repayment of a pertinent debt if acquiring that property directly would otherwise constitute an investment to which the FAD rules apply (for example, Foreignco issuing shares of itself to Canco in order to repay a pertinent debt).

Closest Business Connection Exception

The other principal exception to the FAD rules is intended by the Department of Finance to allow Canco to make a ''strategic acquisition of a business that is more closely connected to its business than to that of any non-resident member of the multinational group.''[10] The preconditions to this closest business connection (CBC) exception are difficult to satisfy (or to prove satisfied), so it is unlikely to be of use to many taxpayers.[11]

The CBC exception requires that Canco officers (a majority of whom are resident and working principally in Canada or some other countries):

- exercised principal authority over Canco's decision to make the investment;
- are reasonably expected to continue to exercise principal decision-making authority over Canco's investment; and
- whose performance evaluation and compensation will be based on the operating results of Foreignco to a greater extent than those of an officer of any other non-Canadian member of the multinational group (excluding Foreignco or corporations controlled by either Foreignco or certain controlled foreign affiliates).[12]

The August 16 proposals will allow officers of a Canadian corporation that does not deal at arm's length with Canco (as well as officers of Canco) to qualify as ''good'' officers for these tests. This change is potentially useful when there are multiple Canadian members of the multinational group.

Unfortunately, the fundamental limitations of the CBC exception mean it will continue to be of little benefit to most taxpayers. What is needed is an exception for bona fide business transactions made without a primary tax motivation (as existed in the original March 2012 version of the FAD rules).

The CBC exception also includes an indirect funding rule that if a direct investment by Canco in Foreignco would have come within the CBC exception, by having Canco make an investment in another controlled foreign affiliate that in turn uses the investment under the CBC exception within 30 days to make a loan to Foreignco will not trigger the FAD rules, as long as Foreignco uses the proceeds of the loan to earn active business income.

The August 16 proposals amend the scope of this rule to allow Foreignco to use all or substantially all of the loan proceeds for some activities (such as the purchase of shares of a third-party foreign affiliate) that result in the lender's interest income being deemed active business income under the ITA.

Consequences of Rule

When the charging provision is triggered and no exception to the FAD rules applies, the result is as follows:

- If Canco, in connection with its investment, has transferred any property other than Canco shares or incurred any obligation, or received any property as a reduction of any amount owed to it, the value thereof is treated as a dividend paid by Canco to the parent. This will generally trigger Canadian dividend withholding tax at a rate of 25 percent under the ITA, reduced to as little as 5 percent if the dividend recipient is resident in a country with which Canada has a tax treaty.
- If Canco has increased the PUC of its shares for its investment, for example, by issuing shares of itself to pay for the Foreignco investment, the PUC is reduced. This PUC reduction effectively turns future Canco distributions that could otherwise have been treated as PUC returns into dividends that will trigger dividend withholding tax.

There are then three ways in which these initial results may be modified:

- *Qualifying Substitute Corporation (QSC) Election*: An election can be filed to deem a dividend that would otherwise be paid by Canco to instead be paid by a related Canadian corporation that meets specific conditions (a QSC) if that would reduce the Canadian dividend withholding tax exigible under an applicable tax treaty.
- *PUC Offset*: In some cases, a deemed dividend can be replaced with a reduction of the PUC of the shares of Canco (or a QSC), thereby deferring Canadian dividend withholding tax.

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[9]A pertinent debt is a debt on which Canco has elected to recognize a sufficiently high level of interest income (currently 5 percent) to generate taxable income in Canada. *See* Section III of the December 2012 article.

[10]*See* the explanatory notes accompanying the August 16 proposals.

[11]*See* Section V of the December 2012 article.

[12]Persons who are officers of both Canco (or under the August 16 proposals, any Canadian corporation not dealing at arm's length with Canco) and some non-Canadian members of the multinational group are deemed not to qualify as ''good'' officers.

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- *PUC Reinstatement*: The PUC reduction may be reversed to allow Canco (or a QSC) to make certain distributions of property to its shareholders, or to reduce the departure tax otherwise due upon emigration from Canada.

Dividend Time

Any dividend under the current FAD rules is deemed paid at the time of Canco's investment. The August 16 proposals amend the timing of any deemed dividend when the parent does not control Canco at the time of Canco's investment. In those cases, the ''dividend time'' is the earlier of: (1) the first time after the investment that the parent acquires control of Canco, and (2) 180 days after the investment. This delay in the timing of any deemed dividend, or PUC offset replacing a deemed dividend, may be helpful if Canco's investment is part of the relevant series but occurs before the parent acquires control of Canco. After the acquisition of control, Canco's shares may have additional PUC that could be used to replace a deemed dividend under the PUC offset rule, or the parent may be entitled to a lower dividend withholding tax rate under an applicable tax treaty.

QSC Election

The August 16 proposals also expand the range of QSCs: Under the current rules, a QSC must be a Canadian resident corporation controlled by the parent, but under the August 16 proposals, a Canadian resident corporation that is controlled either by the parent or by another nonresident corporation dealing not at arm's length with the parent (a substitute recipient) may qualify.[13] This will give multinational groups greater flexibility to choose the least-disadvantageous dividend recipient.

In addition, the procedural elements of the QSC election are being relaxed somewhat. Instead of requiring all corporations that are QSCs of Canco to be parties to the QSC election, only the QSC that will be the deemed payer of the dividend under the QSC election need participate. Moreover, the deadline for the election is being changed to the filing due date for Canco for the taxation year that includes the time the dividend is deemed paid, rather than the earlier of that date and the QSC's corresponding filing due date. These are also positive changes.

PUC Offset

The PUC offset mechanism is usually advantageous to taxpayers because it defers the imposition of Canadian dividend withholding tax until a later event (such as a distribution of property) that relies on PUC to prevent dividend withholding tax liability. A PUC offset may help avoid the tax if the PUC reinstatement mechanism later applies. Under the existing FAD rules, the conditions for the operation of the PUC offset mechanism differ substantively, depending on whether a QSC election has been made.[14]

The August 16 proposals base the revised PUC offset mechanism on identifying each class of shares of Canco or a QSC that are owned by either the parent or another nonresident corporation not dealing at arm's length with the parent (a cross-border class of shares). If the amount of the deemed dividend called for under the FAD rules equals or exceeds the aggregate PUC of all the cross-border classes, the PUC of each is reduced to zero and the deemed dividend is reduced by a corresponding amount.

If the deemed dividend otherwise called for is less than the aggregate PUC of all the cross-border classes, then the deemed dividend is eliminated and the amount is used to reduce the PUC of one or more cross-border classes. That produces the greatest possible PUC reduction in shares of cross-border classes owned by the parent or another nonresident corporation not dealing at arm's length with the parent. However, because PUC is not unique to each shareholder, the impact of a reduction in the PUC of a cross-border class under the PUC offset mechanism will be felt by all holders of shares of that class, not just the parent and its affiliates.

That the revised PUC offset rule applies automatically to produce the greatest possible PUC reduction will largely eliminate taxpayers' ability to choose to pay dividend withholding tax immediately and retain the PUC of the cross-border classes, which could work to a taxpayer's advantage if that PUC would be used to support interest expense deductions under Canada's thin capitalization rules.

PUC Reinstatement

The PUC reinstatement rule reverses the PUC reduction to allow Canco (or the QSC) to make a distribution of property on the class of its shares that constitutes a PUC reduction rather than a dividend for Canadian tax purposes.[15] This rule currently applies to increase the PUC of those Canco (or QSC) shares if the initial Canco investment that triggered the PUC reduction was the acquisition of a Foreignco share, a contribution of capital to (or benefit conferred on) Foreignco, or an indirect acquisition. In order to qualify for PUC reinstatement, the property distributed must be:

(1) the Foreignco shares that triggered the PUC reduction;

[13]The QSC must also have some share ownership in Canco, and the QSC shares must be owned by the parent or a nonresident corporation that is not dealing at arm's length with the parent.

[14]*See* Section VI.B of the December 2012 article.

[15]*See* Section VI.C of the December 2012 article.

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(2) shares of another foreign affiliate of Canco (or the QSC) that were substituted for the Foreignco shares in (1);

(3) property received by Canco (or the QSC) as proceeds from the disposition of shares described in (1) or (2), if those proceeds are distributed within 180 days of receipt by Canco (or the QSC); or

(4) property received by Canco (or the QSC) as a dividend or qualifying return of capital in shares in (1) or (2), if that property is distributed within 180 days of receipt by Canco (or the QSC).

The August 16 proposals clarify that the PUC reinstatement rule encompasses distributions of property made by Canco (or the QSC) on a redemption of its own shares.[16]

They also allow the PUC reinstatement rule to potentially apply when the original investment that triggered the PUC reduction was a debt of Foreignco,[17] rather than an equity investment. The property distributed must be received by Canco (or the QSC) as interest on, a repayment of, or proceeds of a disposition from the original Foreignco debt, and the distribution must occur within 180 days of Canco (or the QSC) receiving that property.

However, the August 16 proposals also state that in such a case, or if the distribution is like that in point (3) or (4) above, the property received by Canco (or the QSC) must not have been acquired as part of an investment in a Canco foreign affiliate to which the FAD rules did not apply. The government's policy is that those investments ''would not be expected to enhance the income-earning capacity of [Canco's] Canadian operations,'' in order to warrant PUC reinstatement, although it is not obvious that this will necessarily be the case. This new requirement is effective for transactions after August 15, 2013.

Other Changes

Thin Capitalization

Canada's thin capitalization rules restrict the amount of interest-deductible debt owed by a Canco to ''specified nonresidents'' — nonresidents of Canada who either are 25 (plus) percent shareholders of Canco (by votes or value) or do not deal at arm's length with them. Currently, these rules prevent Canco from deducting interest expense on debt owed to specified nonresidents that exceeds 150 percent of the sum of (1) Canco's unconsolidated retained earnings at the start of the taxation year, and (2) the PUC attributable to Canco shares owned by, and the contributed surplus received from, a nonresident 25 (plus) percent shareholder of Canco. These rules limit the ability of multinational groups to strip profits out of Canadian group members as deductible interest that reduces the Canadian debtor's corporate income tax. There is no comparable limitation on debt owed to Canadian or arm's-length creditors.

A pertinent debt owed by a Foreignco to a Canco generates no less than a prescribed amount of interest income for Canco. Therefore, if Canco has borrowed money from a nonresident creditor in the multinational group and used that money to make an investment in Foreignco that is a pertinent debt, Canco could be denied an interest deduction on its borrowings under the thin capitalization rules yet be including interest income on the related pertinent debt owed to it by Foreignco. The August 16 proposals exclude from the thin capitalization rules a Canco debt whose proceeds can reasonably be considered to have funded a pertinent debt owed to Canco. Therefore, debt incurred to fund a pertinent debt is not eroding the Canadian tax base.

Antiavoidance Rules

An important question of the charging provision is whether the parent controls Canco. The August 16 proposals include a new deemed control rule, for when no one nonresident corporation has de jure control of Canco, but two or more related nonresident corporations control or are ''in a position to control'' Canco. In those cases, Canco will be deemed controlled by the member of the related nonresident group with the greatest shareholding in Canco. This new rule applies after August 15, 2013.

The FAD rules prevent Canco from avoiding the FAD rules by making an investment in a ''good'' foreign affiliate that meets the CBC exception, if as part of the relevant series it uses the property it receives on the investment to do something that would have triggered the FAD rules if Canco had done it. The August 16 proposals extend the scope of this rule to investments that are excepted under not only the CBC exception, but also the favorable indirect funding rule for the CBC exception.

Corporate Emigration

Canco may choose to emigrate from Canada rather than distribute property to shareholders, particularly if doing so achieves the desired tax result of removing property from the Canadian tax system while not triggering a disposition under foreign tax laws. The August 16 proposals amend the corporate emigration rules to incorporate the changes to the PUC reinstatement rule. ◆

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[16]On a redemption of the shares of a Canadian corporation, the Canadian corporation is generally deemed to have paid a dividend in the amount by which the redemption proceeds exceed the PUC of the redeemed shares.

[17]That is, when Foreignco becomes indebted to Canco, or Canco acquires or extends the maturity date on a Foreignco debt.

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