

# PRACTITIONERS' CORNER

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## Canadian Tax Planning Deadlines for 2013

by Steve Suarez and Stephanie Wong

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As the end of 2013 approaches, taxpayers should be aware of some important tax planning deadlines in the Canadian tax system. Some of these are recurring matters that arise every year, while others are specific to 2013. (Prior coverage: *Tax Notes Int'l*, Nov. 19, 2012, p. 747.) In either case, it is useful to review some of the most important of these pending deadlines to ensure that opportunities for reducing or eliminating Canadian taxes are not missed. These deadlines are discussed below with reference to a corporation that is resident in Canada for Canadian tax purposes (Canco).

### I. Deadlines Unique to 2013

#### A. Extension of Thin Capitalization Rules

The thin capitalization rules in subsection 18(4)-(8) of the Income Tax Act (Canada) (sections 18(4)-(8)) limit the amount of debt owing to related nonresidents that a Canco (or a partnership of which Canco is a member) can deduct interest expense on for tax purposes. The debt covered by these rules is debt owing by Canco to “specified nonresidents”<sup>1</sup> — nonresidents who either are 25 percent-plus shareholders (by votes or value) of Canco or do not deal at arm’s length with

such 25 percent-plus Canco shareholders. Under the current rules that came into effect in 2013, Canco cannot deduct interest on any such debt to the extent that it exceeds 1.5 times Canco’s “equity” (essentially the sum of Canco’s unconsolidated retained earnings and the paid-up capital of Canco shares held by nonresident group members).

For example, a Canco that owes \$100 million to its foreign parent (or another foreign group member) and has only \$50 million of equity will be able to deduct interest expense relating to only \$75 million of that debt. (See Figure 1.) Interest on the remaining \$25 million of debt will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend to which Canadian nonresident dividend withholding tax will apply at a 25 percent rate (subject to reduction under an applicable tax treaty), instead of as interest (which would generally be received by most U.S. recipients free of Canadian withholding tax).

As a result of changes announced in the 2013 federal budget, the thin capitalization rules will be extended to apply to Canadian-resident trusts (and to partnerships in which a Canadian resident trust is a member) for tax years beginning after 2013. The same 1.5-1 debt-to-equity limit will apply to Canadian-resident trusts. In determining the amount of debt owing to “specified nonresidents,” specified nonresidents are defined as nonresidents who either are 25 percent-plus beneficiaries (by value) of the trust or do not deal

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<sup>1</sup>August 16, 2013, draft legislative amendments released by the Department of Finance propose to exclude from the calculation of outstanding debts to specified nonresidents a debt obligation entered into as part of a series of transactions that includes the creation of a debt to Canco that is subject to the section 17.1 interest imputation regime (discussed in Section II.C of this article). The amendment, which applies to tax years that end after March 28, 2012, is intended to ensure that the thin capitalization rules do not impede the ability of Canco’s parent to finance

(Footnote continued in next column.)

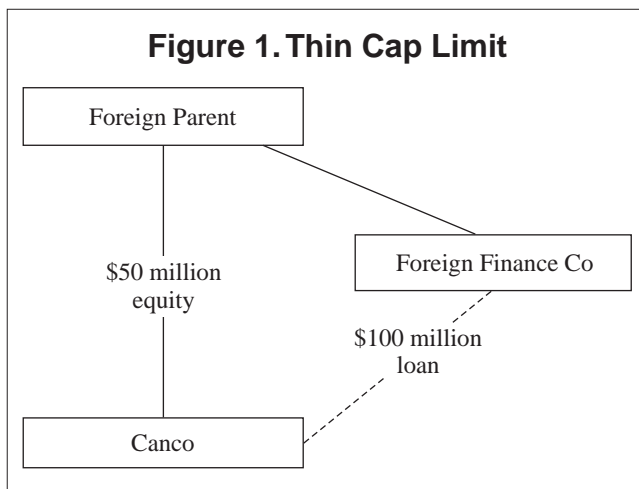
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Canco with debt where Canco in turn uses the borrowed funds to lend to its foreign affiliate and elects to have section 17.1 apply to that loan.

**Table 1. Summary of Special Tax Deadlines for 2013**

Legislative or Policy Change	Action/Deadline
Thin capitalization rules will be extended to apply to Canadian residents trusts, and to nonresident corporations and trusts carrying on business in Canada or electing to be taxed as a Canadian resident under section 216 ITA, and to partnerships of which such a corporation or trust is a member, effective for tax years beginning after 2013.	Review amounts owing by affected entities to foreign group members, and either reduce the amount of such debt or increase the affected entity's "equity amount" for thin capitalization purposes before January 1, 2014.
Mandatory reporting regime applies to tax avoidance transactions meeting two of three specific conditions (reportable transactions), if the transaction is either (1) entered into after 2010, or (2) part of a series of transactions completed after 2010.	For reportable transactions that arose in 2010, 2011, or 2012, the information return must have been filed by October 23, 2013. For reportable transactions arising in 2013, the information return must be filed by June 30, 2014.
Investment tax credit inclusion rate will be reduced for certain qualifying scientific research and experimental development (SR&ED) expenditures incurred after 2013.  Capital expenditures for property acquired after 2013 (and amounts paid or payable in respect of the use of, or the right to use, property during any period after 2013) will no longer be eligible for SR&ED deductions and ITCs.  ITC inclusion rate will be eliminated for mining sector preproduction exploration expenditures incurred after 2013.  ITC inclusion rate will be reduced for mining sector qualifying preproduction development expenditures incurred after 2013.	Consider potential for making such expenditures before January 1, 2014, in order to maximize tax benefits.
Less generous capital gains exemption under the Barbados-Canada tax treaty will take effect on January 1, 2014, if the November 2011 protocol to the treaty comes into force by the end of 2013.	Residents of Barbados holding shares that derive their value principally from Canadian real property should consider whether they could benefit by disposing of such shares before the end of 2013.
The Canada-Hong Kong tax treaty will take effect in Canada on January 1, 2014, and in Hong Kong on April 1, 2014; the Canada-Poland and Canada-Serbia tax treaties will take effect in the contracting states on January 1, 2014.	Consider delaying payments of interest, dividends, and royalties between Canadian residents and residents of Poland, Serbia, or Hong Kong until the relevant treaty takes effect in 2014, if possible to take advantage of treaty-reduced rates of nonresident withholding tax.

**Figure 1. Thin Cap Limit**



at arm's length with such 25 percent-plus beneficiaries. Also, a trust's "equity amount" for a tax year<sup>2</sup> is calculated as the trust's tax-paid earnings for the year, plus the average amount of all equity contributions made to the trust by specified nonresidents before the beginning

of each month in the year, minus the average amount of certain capital distributions made by the trust to specified nonresidents before the beginning of each month in the year.<sup>3</sup>

A trust to which these rules apply can designate the nondeductible interest as a payment of income of the trust to the nonresident recipient of the interest. In

<sup>2</sup>An elective transitional rule allows a trust to compute its equity as at March 21, 2013 (the date the changes to the thin capitalization rules were originally announced), based on the net fair market value of the trust's assets on that date computed in accordance with specified rules. While the election is available to all Canadian resident trusts, it is intended to assist trusts that have insufficient historical information available to determine their equity amounts on March 21, 2013.

<sup>3</sup>Excluded from the capital distribution calculation are distributions that are:

- included in the specified nonresident's income under subsection 104(13) ITA;
- subject to nonresident trust income withholding tax; or
- paid or payable to a person other than a specified nonresident beneficiary of the trust.

such a case, the trust will be able to deduct the payment in computing its income, but the payment will be subject to Canadian nonresident withholding tax at a 25 percent rate (subject to reduction under an applicable tax treaty) and potentially to tax under Part XII.2 of the ITA, depending on the character of the income earned by the trust.

Also effective for tax years beginning after 2013, the thin capitalization rules will apply to nonresident corporations and trusts that either carry on business in Canada or elect to be taxed as a Canadian resident under section 216 ITA (and to partnerships of which such a nonresident corporation or trust is a member). The same 1.5-1 debt-to-equity limit will apply to these corporations and trusts. However, since a Canadian branch is not a separate legal person from the nonresident entity and therefore does not have its own equity for purposes of the thin capitalization rules, a 3-5 debt-to-assets ratio is used to determine a notional amount of equity for the branch.<sup>4</sup> In addition, loans from a nonresident who does not deal at arm's length with the nonresident corporation or trust are included in "outstanding debts to specified nonresidents." For a nonresident corporation, the application of the thin capitalization rules could increase its liability for branch tax under Part XIV of the ITA.

Entities affected by the upcoming changes to the thin capitalization rules should review amounts owing to relevant foreign creditors and, if necessary, reduce the amount of such debt (for example, by replacing it with debt owing to a Canadian or arm's-length lender) or increase the entity's "equity amount" for thin capitalization purposes by the end of 2013, to ensure compliance with applicable debt/equity limitations starting on January 1, 2014.

## B. Tax Avoidance Transaction Reporting

The mandatory tax avoidance transaction reporting regime in section 237.3 ITA applies to certain tax avoidance transactions ("reportable transactions") if the transaction is either:

- entered into after 2010; or
- part of a series of transactions completed after 2010.

<sup>4</sup>Based on this 3-5 debt-to-assets ratio, the equity amount for a nonresident corporation or trust is generally computed as 40 percent of the amount by which the cost (determined on an averaged monthly basis) of all property (other than partnership interests) that is (a) used or held by the corporation or trust in the year in the course of carrying on business in Canada or (b) an interest in real property or timber resource properties and timber limits in Canada in respect of which the corporation or trust files an income tax return under section 216 ITA exceeds all outstanding debts (determined on an averaged monthly basis) of the corporation or trust relating to its Canadian business or to a property interest described in (b) above that are not included in its outstanding debts to specified nonresidents.

Legislation implementing the mandatory reporting regime, which was first proposed in 2010, was enacted on June 26, 2013.

For a transaction to be a reportable transaction, it must be an avoidance transaction for purposes of the general antiavoidance rule in the ITA — that is, a transaction that would result, or is part of a series of transactions that would result, in a tax benefit (a reduction, avoidance, or deferral of tax), unless the transaction has been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. Moreover, the avoidance transaction must also satisfy at least two of the following three conditions:

- *Fee condition:* An adviser or a promoter (or a person who does not deal at arm's length with an adviser or promoter) is entitled at any time (either absolutely or contingently) to a fee that is *to any extent* either:
  - based on the amount of a tax benefit from the transaction or series;
  - contingent on obtaining a tax benefit from the transaction or series; or
  - attributable to the number of persons who participate in, or who have been provided access to, advice given by an adviser or promoter about the tax consequences of the transaction or series (or a similar transaction or series).
- *Confidential protection condition:* An adviser or a promoter obtains in respect of the transaction or series "confidential protection"; that is, anything that prohibits the disclosure of the details or structure of the transaction or series under which a tax benefit results (or would result but for the GAAR).
- *Contractual protection condition:* A taxpayer, a person who entered into the transaction for the benefit of a taxpayer, an adviser, or a promoter (or a person who does not deal at arm's length with any of them) has "contractual protection" in respect of the transaction or series.<sup>5</sup>

<sup>5</sup>"Contractual protection," which excludes a fee described in the fee condition, includes any form of:

- insurance (other than standard professional liability insurance) or other protection (such as an indemnity, compensation, or a guarantee) that protects against a failure of the transaction or series to achieve a tax benefit or that pays for or reimburses any expense, fee, tax, interest, penalty, or similar amount that may be incurred in a dispute regarding a tax benefit from the transaction or series; or
- undertaking by a promoter (or by a person who does not deal at arm's length with a promoter) that provides assistance in a dispute regarding a tax benefit from the transaction or series.

For reportable transactions that arose in 2010, 2011, or 2012, the information return had to be filed by October 23, 2013. For reportable transactions arising in 2013, the information return must be filed by June 30, 2014. Failure to file as and when required has numerous adverse consequences, including penalties, the denial of tax benefits, and the extension of the period during which the Canada Revenue Agency can reassess the taxpayer. Those required to file an information return relating to a reportable transaction (or relevant series of transactions) include:

- persons obtaining a tax benefit; and
- advisers and promoters entitled to a fee from the transaction or series of transactions.

### C. Phased-In Changes to ITCs

The 2012 federal budget phased in reductions to the scope of certain investment tax credits (ITCs), which are dollar-for-dollar reductions in taxes payable (not merely reductions in taxable income) provided for making qualified expenditures.<sup>6</sup> If making qualifying expenditures after 2013 would result in a reduced ITC entitlement compared with making such expenditures during 2013, affected taxpayers should consider accelerating the timing of such expenditures if possible, to maximize the tax benefit.

#### 1. SR&ED

The 2012 federal budget made a number of changes to the tax regime for scientific research and experimental development (SR&ED), some of which will take effect in 2014. An ITC can be claimed for qualifying SR&ED expenditures incurred in a tax year, while an enhanced ITC may be claimed for a limited amount of qualifying expenditures incurred in a tax year by a Canadian-controlled private corporation (CCPC).

First, the general SR&ED ITC rate applicable to SR&ED qualifying expenditure pool balances at the end of a tax year will be reduced from 20 percent to 15 percent for tax years that end after 2013, except that for a tax year that includes January 1, 2014, the 5 percent reduction in the ITC rate will be pro-rated.<sup>7</sup>

Second, capital expenditures for property acquired after 2013, and amounts paid or payable in respect of the use of, or the right to use, property during any period that is after 2013, will no longer be eligible for SR&ED deductions and ITCs. Such expenditures include otherwise eligible contract payments made by a taxpayer to the extent that the payments are in respect of a capital expenditure made in fulfillment of the contract.

<sup>6</sup>See Steve Suarez, "Canadian 2012 Federal Budget: Tightening the Screws," *Tax Notes Int'l*, Apr. 16, 2012, p. 247.

<sup>7</sup>The enhanced 35 percent SR&ED ITC rate available to eligible CCPCs on up to \$3 million of qualified SR&ED expenditures annually remains unchanged.

For taxpayers using the simplified proxy method to determine the amount of qualifying SR&ED expenditures eligible for an ITC, the 60 percent inclusion allowance for overhead expenditures directly attributable to SR&ED activities available for 2013 will be reduced to 55 percent for 2014.

Also starting in 2014, taxpayers will be required to provide more detailed information on their SR&ED program claim forms, and a new penalty of \$1,000 per claim will apply where information about the claim preparer and the billing arrangement is missing, incomplete, or inaccurate.

#### 2. Resource Sector

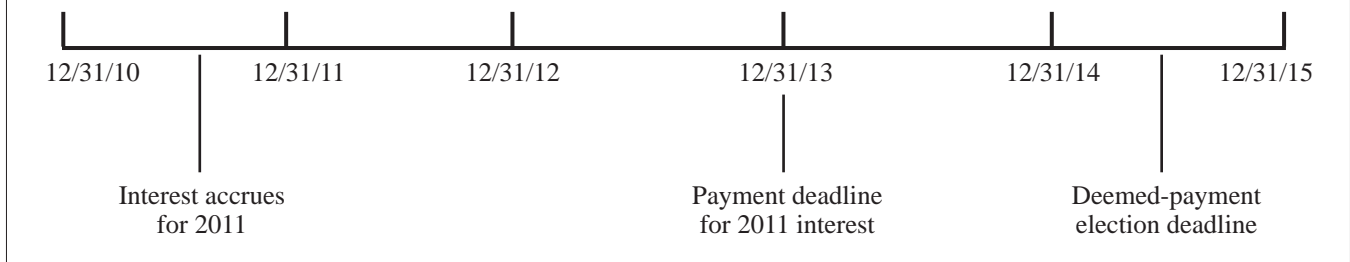
Taxable Canadian corporations that undertake certain mining sector activities relating to qualifying minerals in Canada are entitled to claim an ITC equal to a percentage (originally 10 percent) of the amount of qualifying expenditures incurred before the mine is producing in reasonable commercial quantities on "grass roots" exploration to determine the existence, location, extent, or quality of a mineral deposit in Canada, or activities undertaken to bring a new mine in Canada into production.

As a result of the 2012 federal budget, the preproduction mining expenditures ITC is being phased out. The current ITC, which was reduced from 10 percent to 5 percent for 2013, will be eliminated for preproduction *exploration* mining expenditures incurred after 2013. For preproduction *development* expenditures, the 10 percent rate available for qualifying expenditures made in 2013 will be reduced to 7 percent for qualifying expenditures made in 2014, to 4 percent for qualifying expenditures made in 2015, and then eliminated after 2015, subject to limited grandfathering.

### D. Barbados Treaty Gains Exemption Change

Many of Canada's tax treaties exempt a nonresident of Canada from Canadian tax on gains arising from the disposition of shares unless the shares derive their value principally from real property situated in Canada, directly or indirectly. The treaty language used to describe "real property situated in Canada" usually captures shares in other entities "below" the corporation whose shares are being disposed of, if those lower-tier shares themselves derive their value principally from real property situated in Canada.

However, the current capital gains exemption in the Barbados-Canada tax treaty is broader: It exempts gains from the disposition of shares of a corporation unless the property of the corporation "consists" principally of immovable property situated in Canada. The CRA has acknowledged that where the relevant treaty language uses the term "consists" without any reference to "directly or indirectly," the determination is based solely on the assets held *directly* by the corporation, without applying a look-through or consolidation

**Figure 2. Accrued Non-Arm's-Length Interest and Section 78(1)**

approach.<sup>8</sup> Thus under the current Barbados tax treaty, if a nonresident owns shares of a holding company and that company holds shares of a subsidiary and the subsidiary holds Canadian real property interests, the nonresident can dispose of the holding company shares without being subject to Canadian tax because the real property interests are not held directly by the holding company.

This more generous language is being replaced as a result of changes to the capital gains article of the Barbados-Canada tax treaty, negotiated as part of the protocol signed by the two countries on November 8, 2011.<sup>9</sup> While this protocol has not yet come into force as of the date of writing, if it does come into force by the end of 2013, the more restrictive language will take effect for tax years beginning on or after January 1, 2014. Residents of Barbados holding shares that derive their value principally from Canadian real property should consider whether disposing of such shares before the end of 2013 would be beneficial in their circumstances.

### E. New Tax Treaties

The tax treaty between Canada and Hong Kong, which was signed on November 11, 2012, will generally take effect in Canada on January 1, 2014, and in Hong Kong on April 1, 2014.<sup>10</sup> The Canada-Serbia tax treaty, which was signed on April 27, 2012, will take effect in both Canada and Serbia on January 1, 2014.

<sup>8</sup>See CRA document 2008-0304441I7, Mar. 23, 2009.

<sup>9</sup>See <http://www.fin.gc.ca/treaties-conventions/notices/barbados-barbade-eng.asp>.

<sup>10</sup>Notices of Canadian tax treaty developments and copies of Canadian tax treaties are posted on the Department of Finance's website at [http://www.fin.gc.ca/treaties-conventions/treatystatus\\_-eng.asp](http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp). The withholding tax provisions of the Canada-Hong Kong tax treaty will take effect in Canada on January 1, 2014, and most other Canadian tax provisions will have effect for tax years beginning on or after January 1, 2014. In respect of Hong Kong taxes, the treaty will generally take effect for tax years beginning on or after April 1, 2014. However, the capital gains and shipping and air transport provisions of the treaty are effective from October 29, 2013 (the date the treaty entered into force).

As a result, treaty-reduced rates of nonresident withholding tax on interest, dividends, and royalties will apply to amounts paid or credited by residents of Canada to residents of Hong Kong or Serbia (or vice versa) on or after the relevant treaty's effective date in 2014. In addition, the new tax treaty between Canada and Poland, which was signed on May 14, 2012, and replaces the original 1987 treaty between the two countries, will take effect in both Canada and Poland on January 1, 2014. Withholding tax rates in the new Canada-Poland treaty are either lower than or the same as rates in the earlier treaty, except for the withholding tax rate on copyright royalties in respect of the production or reproduction of literary, dramatic, musical, or artistic work (other than motion picture films or works on film, videotape, or other means of reproduction for use in connection with television broadcasting), which will increase from 0 percent to 5 percent. Except for such copyright royalties, it will generally be advantageous to delay payments of interest, dividends, and royalties between residents of these treaty jurisdictions until the relevant treaty's withholding tax provisions take effect.

## II. Recurring Tax Deadlines

### A. Accrued but Unpaid Expenses

Where a taxpayer owes an amount to a non-arm's-length person that is deductible for tax purposes, there is a limit to how long it can go unpaid before the deduction gets reversed. An amount incurred by the taxpayer to a non-arm's-length person in one tax year must be paid by the end of the second following tax year of the payer. If it remains unpaid by that time, the amount is added back into the taxpayer's income in the immediately following tax year, effectively reversing any deduction previously taken. This means that if a taxpayer incurred a deductible expense to a non-arm's-length person in its 2011 tax year, the taxpayer must actually pay the expense by the end of the 2013 tax year to avoid having to add back the amount in income for the 2014 tax year. (See Figure 2.)

Alternatively, the taxpayer and non-arm's-length person can file a joint Form T2047 to deem the amount to have been paid and loaned back to the taxpayer, which

**Table 2. Summary of Recurring Tax Deadlines**

Transaction	Action/Deadline
Taxpayer incurred a deductible expense owing to a non-arm's-length person in its 2011 tax year.	Taxpayer must ensure it actually pays the expense by December 31, 2013 (or files a deemed-paid election), to avoid having to add back the deducted amount in income for its 2014 tax year.
Taxpayer accrues and deducts employee expenses (for example, salary, wages, pension benefits, and so forth) in its 2013 tax year.	Taxpayer must ensure that it actually pays the expenses by June 28, 2014.
Foreign affiliate of foreign-controlled Canco incurs debt owing to Canco to which the foreign affiliate dumping rules would otherwise apply.	To exclude application of foreign affiliate dumping rules, ensure that debts arising in the ordinary course of Canco's business (that is, trade debt) are repaid within the permitted 180-day period; for other debts, consider making election to opt into section 17.1 ITA regime (and out of foreign affiliate dumping rules) before Canco's tax return filing due date for the year in which such debt became owing.
Shareholder of Canco (or a person not dealing at arm's length with Canco shareholder) became indebted to Canco (or to a related corporation) during Canco's 2012 tax year, except where debtor is a Canadian corporation.	Ensure the debt is repaid by December 31, 2013; if not (and no exception applies), the amount of the debt is either (1) included in the debtor's income (if the debtor is Canadian resident) or (2) deemed to be a dividend subject to Canadian nonresident withholding tax (if the debtor is nonresident).
Shareholder of Canco (or a person not dealing at arm's length with Canco shareholder) owes an amount to Canco (or to a related corporation) on which interest accrues at a rate less than an arm's-length rate.	Unless an exception applies, the debtor must pay the creditor a minimum amount of interest on the debt by January 30, 2014; otherwise the debtor is deemed to have received either (1) a taxable benefit included in income (if the debtor is Canadian resident) or (2) a dividend subject to Canadian nonresident withholding tax (if the debtor is nonresident).
Nonresident owes an amount to Canco at a nil or low rate of interest during Canco's 2013 tax year.	Ensure the debt is repaid within one year after it arose; otherwise Canco must include in its income for the 2013 tax year interest computed at a prescribed rate on the outstanding debt (less any interest on the debt otherwise included in Canco's income for the year).
Canco owes an amount to a specified nonresident (a nonresident who either is a 25 percent-plus shareholder of Canco or does not deal at arm's length with such a shareholder) that remains outstanding at the end of Canco's 2013 tax year.	Review amounts owing to specified nonresidents and estimated Canco "equity" for start of 2014 to ensure compliance with 1.5-1 debt-to-equity limit; where necessary reduce the amount of such debt or increase Canco "equity" for thin capitalization purposes before January 1, 2014.
During 2013, a foreign affiliate of Canco is owed an amount by Canco or a person not dealing at arm's length with Canco (other than a controlled foreign affiliate of Canco) that arose after August 19, 2011.	Ensure the debt is repaid within two years after it arose; otherwise Canco must include the amount of the debt in its income for the 2013 tax year (unless an exception applies). Compute and preserve tax attributes allowing Canco to claim offsetting year-by-year reserve.
<i>Note:</i> It is assumed for the purpose of these examples that the relevant tax year ends on December 31.	

will avoid the income addback. Where the non-arm's-length person is a nonresident, the deemed payment of the expense will often trigger Canadian withholding tax. A common situation where this arises is interest expense owing by one member of a corporate group to another. This form must be filed by the time the taxpayer's income tax return for that following year (2014 in the above example) is due.

Another rule applies to a taxpayer's accrued but unpaid employee expenses, that is, salary, wages, pension benefits, retiring allowances, and other remuneration (except reasonable vacation or holiday pay or a deferred amount under a salary deferral arrangement). The taxpayer must pay any such expense by 179 days after the end of the tax year in which it was incurred. If the expense is not paid within that time period, the

taxpayer will not be able to deduct it in the year it was incurred but only in the year when it is actually paid.

**B. FAD Rules — Repayments and Election**

In the 2012 federal budget, the government introduced sweeping new "foreign affiliate dumping" (FAD) rules. These complex rules (generally applicable to transactions occurring after March 28, 2012) are overbroad and encompass a number of transactions that should not be caught from a tax policy perspective.<sup>11</sup>

<sup>11</sup>For a detailed review of these rules and amendments proposed by the Department of Finance on August 16, 2013, see (Footnote continued on next page.)

In very general terms, the FAD rules apply whenever a Canco that is controlled by a foreign corporation (Parent) makes an "investment" in a non-Canadian corporation (Foreignco) in which Canco has a 10 percent-plus direct or indirect equity interest. Where applicable, these rules will either:

- reduce Canco's paid-up capital (which adversely affects Canco in various ways, including the calculation of its equity for purposes of the thin capitalization rules discussed in sections I.A and II.F of this article); or
- deem Canco to have paid a dividend to Parent (triggering Canadian dividend withholding tax).

One of the very few exceptions to the FAD rules is an "investment" that is a debt owing by Foreignco to Canco arising after March 28, 2012, in the ordinary course of Canco's business (for example, trade debt), if such debts are paid by Foreignco within 180 days (other than as part of a series of loans and repayments). It is therefore important to ensure that trade debts are repaid within the required 180-day period.

Moreover, if Canco's "investment" is a loan to Foreignco arising after March 28, 2012, Canco and Parent can file an election to cause such debt not to be subject to the FAD rules, and to instead be subject to the interest imputation regime in section 17.1 ITA. (See Section II.C of this article for more on these rules.) The election must be made on a debt-by-debt basis and filed on or before the due date of Canco's tax return for the tax year in which such debt became owing after March 28, 2012.<sup>12</sup>

### C. Debts Owing to Cocos by Shareholders

There are limits on the extent to which a corporation can loan money to shareholders (or persons connected to shareholders) as a substitute for paying dividends. The general rule in subsection 15(2) ITA is that if a person is a shareholder of a Canco (or a person not dealing at arm's length with such a shareholder) and has become indebted to Canco (or to a corporation related to Canco), the amount of the debt is included in that person's income.<sup>13</sup> If the debtor is a nonresident person, the amount of the debt is deemed

to be a dividend received by the nonresident and is subject to Canadian nonresident withholding tax at a 25 percent rate (unless reduced under an applicable tax treaty).

The principal exception to this rule is where the indebtedness is repaid within one calendar year after the end of Canco's tax year in which the indebtedness arose, for example, for a debt incurred during the tax year of Canco ending on December 31, 2012, the deadline for repayment is December 31, 2013. To qualify for the exception, the repayment cannot be part of a series of loans or indebtedness and repayments. It is therefore very important to make sure that outstanding amounts that could trigger an income inclusion (or deemed dividend) are repaid within the required time limit.

Alternatively, if Canco is controlled by a foreign corporation, an election can be made such that section 17.1 ITA will apply to the debt instead of subsection 15(2) ITA. Essentially, the section 17.1 ITA regime ensures that Canco realizes a sufficient amount of actual and/or deemed interest income on the debt each year, comparable to an arm's-length debt. This election applies to a debt that meets the following conditions:

- the debt becomes owing to Canco after March 28, 2012;
- the debtor is a particular nonresident corporation (Foreignco) that either controls Canco or does not deal at arm's length with another nonresident corporation that controls Canco<sup>14</sup>;
- Canco and its nonresident controlling corporation file the required joint election;
- subsection 15(2) ITA would otherwise apply to the debt; and
- the amount included in Canco's income for a tax year in respect of the debt under section 17.1 ITA is not reduced under a relevant tax treaty.

Where these conditions are met, Canco must include a minimum amount of interest on the debt in its income for the relevant tax year. That minimum amount of interest is computed at a prescribed rate<sup>15</sup> for whatever part of the year that the debt remains outstanding, minus any interest on the debt actually included in income for the year (for example, if the debt actually bears interest at 3 percent, the section 17.1 ITA regime requires another 2.02 percent to be included in Canco's income). In this way, Canco can elect to report a minimum amount of actual and/or deemed interest on the debt, as an alternative to having the debt deemed to be a dividend paid by Canco to its

Steve Suarez, "New Foreign Affiliate 'Dumping' Rules Are Major Tax Policy Change for Canada," *Tax Notes Int'l*, Dec. 17, 2012, p. 1145; and Suarez, "Canada Releases Foreign Affiliate Dumping Amendments," *Tax Notes Int'l*, Sept. 2, 2013, p. 864.

<sup>12</sup>Cocos are generally required to file their tax return for a particular tax year within six months of their year-end.

<sup>13</sup>This subsection 15(2) income inclusion rule does not apply to:

- debts owing by another Canco;
- amounts owing between nonresidents of Canada;
- certain loans to employees; and
- debts arising in the ordinary course of the creditor's business where there are bona fide arrangements for repayment made at the outset.

<sup>14</sup>Look-through provisions extend these rules to debts owed by and to partnerships in most cases.

<sup>15</sup>Currently 5.02 percent; see <http://www.cra-arc.gc.ca/nwsrm/rlls/2013/m09/nr130923-eng.html>.

foreign parent corporation. Where a nonresident corporation acquires control of a Canco that was not controlled by a nonresident corporation immediately before that time, a 180-day grace period is given to allow the nonresident parent time to review and clean up outstanding debts owing to Canco.

The election to opt in to the section 17.1 ITA regime is made on a debt-by-debt basis. Generally, Canco is required to file the election for a particular debt by its tax return filing due date for the tax year in which the debt first became owing. However, Canco may late-file the election within three years after the relevant due date if it pays a penalty.

#### D. Interest Benefit on Low-Interest Debts

If a shareholder of a Canco (or a person connected to such a shareholder) has incurred a debt to Canco (or to a related corporation) and the rate of interest on that debt is less than an arm's-length rate, a specific rule requires the debtor to actually pay at least a minimum amount of interest on the debt each year, or be deemed to have received a taxable benefit that is included in income. An interest benefit will be included in the debtor's income for a tax year to the extent that interest on the loan or debt computed at a prescribed rate exceeds interest on the loan or debt for the period actually paid to Canco within 30 days after the end of the year. Where a debtor is a nonresident person, any interest benefit is deemed to be a dividend received by the nonresident and is subject to Canadian nonresident withholding tax at a 25 percent rate (unless reduced under an applicable tax treaty).

This rule applies even where the loan or debt has been outstanding for only part of a year. However, it does not apply (1) to debtors that are Cancos; or (2) where the amount of the loan or indebtedness has been included in income under the rules in section 15(2) ITA described in Section II.C of this article.

If the debt was incurred for income earning purposes (for example, a loan to buy common shares), the debtor may be entitled to an interest expense deduction for Canadian tax purposes that offsets the interest benefit included in income. Otherwise, it will be important to ensure that an appropriate amount of interest is in fact paid to Canco within 30 days of the end of the relevant tax year.

#### E. Interest on Nonresidents' Debts to Cancos

Where a nonresident person owes an amount to a Canco, a specific rule applies to ensure that the Canco reports at least a minimum amount of interest on that debt for tax purposes. Specifically, to the extent that (1) the debt has remained outstanding for more than one year, and (2) Canco includes in its income for a tax year an amount that is less than a "reasonable" rate of interest on the debt, Canco must include in income for the year an amount equal to interest on the outstanding debt computed at a prescribed rate (less any interest on the debt otherwise included in Canco's income

for that year). These rules make it important to ensure that no or low-interest debts owing to Cancos by nonresidents are repaid within the one-year time limit.<sup>16</sup>

Certain debts are excluded from the application of this rule, including:

- debt described in Section II.C of this article that has been deemed to be a dividend and subjected to nonresident withholding tax under subsection 15(2) ITA;
- amounts owing by an unrelated nonresident where the amount arose in respect of goods sold or services provided by Canco in the ordinary course of its business and on arm's-length terms and conditions;
- debt owing by a closely held controlled foreign affiliate (CFA) of Canco which relates to an active business carried on by the CFA (or another CFA of Canco); and
- debt that Canco and its foreign parent corporation have elected to make subject to the new interest inclusion rule in section 17.1 ITA described in Section II.C of this article.

#### F. Canco Debts to Specified Nonresidents

As discussed in Section I.A above, the thin capitalization rules prevent Canco (or a partnership of which Canco is a member) from deducting interest on outstanding debts to specified nonresidents<sup>17</sup> to the extent that such debt exceeds 1.5 times Canco's "equity." For this purpose, Canco's outstanding debt to specified nonresidents is determined by adding up the maximum amount of such debt at any time in each calendar month that ends in the relevant tax year, and dividing that by the number of such calendar months (that is, an average). Canco's "equity" is calculated as the sum of the following three amounts:

- Canco's unconsolidated retained earnings *at the beginning of the year*;
- the total of the start-of-month contributed surplus received by Canco from specified nonresident shareholders of Canco for each calendar month ending in the year, divided by the number of such calendar months; and
- the total of the start-of-month paid-up capital of Canco shares owned by specified nonresident shareholders of Canco for each calendar month ending in the year, divided by the number of such calendar months.

<sup>16</sup>This rule governing direct debts is supported by an indirect debts provision, which applies where a Canco has made a loan or transfer to an intermediary that in turn makes a loan or transfer to the nonresident. In those circumstances, the nonresident is deemed to owe an amount directly to Canco, so that the direct-debt rules apply.

<sup>17</sup>See *supra* note 1.



Thus, the amount of Canco's retained earnings for thin capitalization purposes is calculated only at the beginning of the tax year, in contrast to the other relevant amounts (all of which are calculated as monthly averages during the year). These computational timing differences make it particularly important for Canco to periodically monitor its debt and equity for thin capitalization purposes, and to review its retained earnings before the beginning of 2014, so that adjustments can be made as required to stay within the 1.5-1 debt-to-equity limit (that is, reducing debt or increasing equity).

### G. 'Upstream Loan' Rules

"Upstream loan" rules in subsection 90(6) ITA first announced in 2011 discourage the use of interest-free loans from a foreign affiliate to its Canadian parent as a means of repatriating foreign profits to Canada on a tax-free basis, instead of the foreign affiliate paying a dividend to the Canadian parent (which could result in Canadian tax, depending on the facts).

The upstream loan rules generally require Canco to include in income an amount owed to a foreign affiliate of Canco<sup>18</sup> by "specified debtors," being Canco and anyone not dealing at arm's length with Canco (other than a CFA of Canco). The rules apply to debts arising after August 19, 2011,<sup>19</sup> and are modeled on the existing domestic shareholder debt rules in subsection 15(2) ITA. (See Section II.C of this article.) The following debts are excluded from the application of the upstream loan rules:

- debt described in Section II.C that is subject to section 15(2) ITA;

- debt repaid within two years of the date the debt arose (provided such repayment is not part of a series of loans or indebtedness and repayments); and
- debt arising in the ordinary course of the creditor's business where there are bona fide arrangements for repayment within a reasonable time made at the outset.<sup>20</sup>

It is therefore very important to make sure that outstanding amounts that could trigger an income inclusion are repaid within the permitted two-year period, wherever possible.

If these rules do create an income inclusion for Canco (that is, the debt was not repaid within two years), they permit Canco to claim a fully or partially offsetting reserve<sup>21</sup> for a tax year if specified conditions are met. Essentially, these conditions look to whether, at the time the debt was incurred and continuously thereafter, Canco had sufficient tax attributes relating to the relevant foreign affiliate such that some or all of the amount owing to the foreign affiliate could have been paid to Canco as a dividend from the foreign affiliate without Canadian tax arising. These conditions must be met for *each tax year* the debt is outstanding for Canco to continue to be able to claim a year-by-year reserve. Accordingly, for each year in which an offsetting reserve is claimed, Canco should update the computation of the relevant tax attributes and ensure that they remain unimpaired and available. Any amount included in Canco's income under this rule and later repaid to the creditor foreign affiliate can generally be deducted in the year of repayment. ◆

<sup>18</sup>Or a partnership of which a Canco foreign affiliate is a member.

<sup>19</sup>Debts that were outstanding on that date are grandfathered until August 19, 2016. Antiavoidance rules have also been enacted that catch back-to-back loan arrangements.

<sup>20</sup>A separate exception is provided for debt arising in the ordinary course of a life insurer's business carried on outside Canada if it meets certain conditions.

<sup>21</sup>That is, a deduction that is added back to income the following year.