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Canadian Tax Planning Deadlines for 2014

by Steve Suarez

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PRACTITIONERS' CORNER

Canadian Tax Planning Deadlines for 2014

by Steve Suarez

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The end of the calendar year, which for many taxpayers is also the end of the tax year, brings with it various tax-planning deadlines. Some of those deadlines are unique to 2014 and others arise every year. It is useful to review some of the most important deadlines in a cross-border tax context, and we do so in the context of a taxpayer that is a Canadian resident corporation (Canco).

I. Tax Deadlines Specific to 2014

A. Back-to-Back Loan Rules

The 2014 federal budget proposed adding antiavoidance provisions to two aspects of Canada's treatment of Canco's debt:

- *Interest withholding tax exigible on payments of interest made by Canco*: Canadian domestic law imposes nonresident withholding tax only on interest paid to nonresidents not dealing at arm's length with Canco and on participating interest (that is, computed using profits, revenue, and similar items); and
- *Interest deductibility limitations on interest expense incurred by Canco under Canada's thin capitalization rules*: Essentially, if Canco incurs debt owing to non-arm's-length nonresidents in excess of 150 percent of its "equity"[1] for these purposes, interest on that excess debt cannot be deducted by Canco and is treated as a dividend for withholding tax purposes.

For non-arm's-length nonresidents, the relevant rate of Canadian interest withholding tax will generally be 25 percent for recipients resident in a country with no

[1]For this purpose, the word "equity" consists of Canco's unconsolidated retained earnings, the paid-up capital of Canco shares held by nonresident shareholders holding at least 25 percent of Canco's shares, and contributed surplus attributable to those shareholders. *See* Section II.F, *infra*, for further discussion.

Table 1. Summary of Special Tax Deadlines for 2014

Event	Action/Deadline
New back-to-back loan rules limiting interest expense deductions or increasing Canadian interest withholding tax starting in 2015	Review existing debt financing of Canadian subsidiaries to see if new rules apply to deem debt owed to persons other than the actual creditor for thin capitalization and interest withholding tax purposes
Termination of exception from nonresident trust rules for trusts that have received contributions from persons who have been Canadian residents for less than 60 months	Tax reporting and payment obligations will apply to affected trusts for trust tax years ending after 2014 by virtue of being deemed Canadian residents and taxable on worldwide income
Amendment of the definition of investment business in foreign accrual property income rules to limit exception for regulated financial services business to controlled foreign affiliates of Canadian financial institutions for tax years starting after 2014	Canadian taxpayers (other than Canadian financial institutions) with controlled foreign affiliates earning income from property as locally regulated financial institutions will have to report that income as FAPI on an accrual basis

Figure 1. Overview of Canadian Interest Withholding Tax

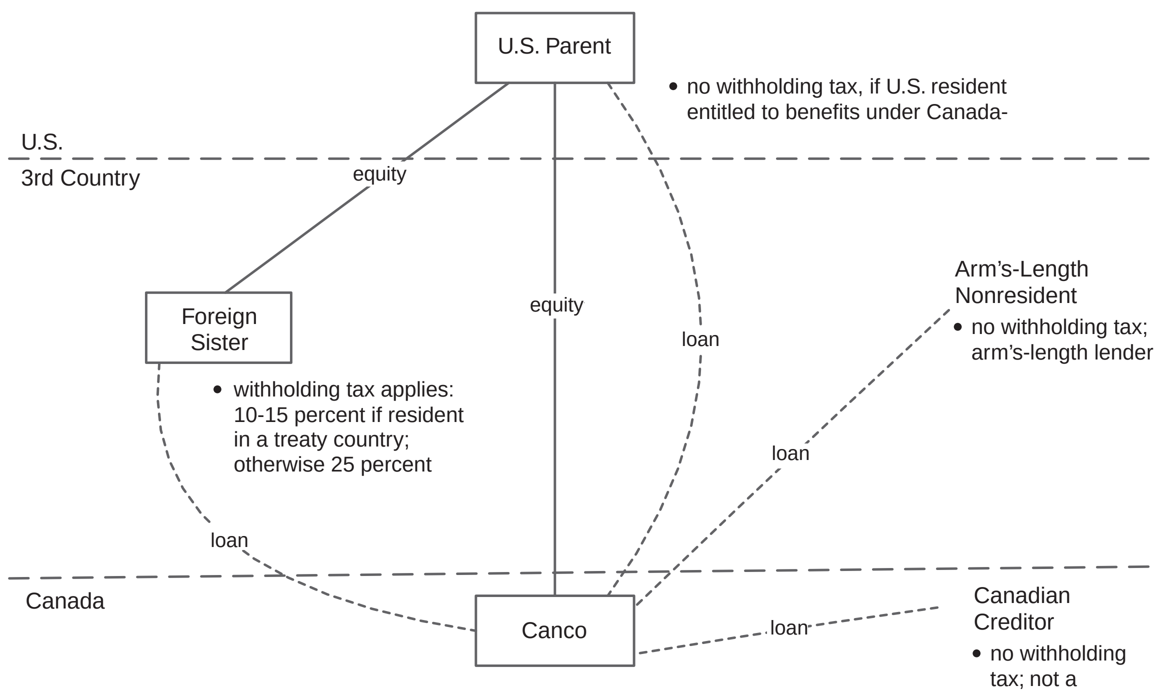
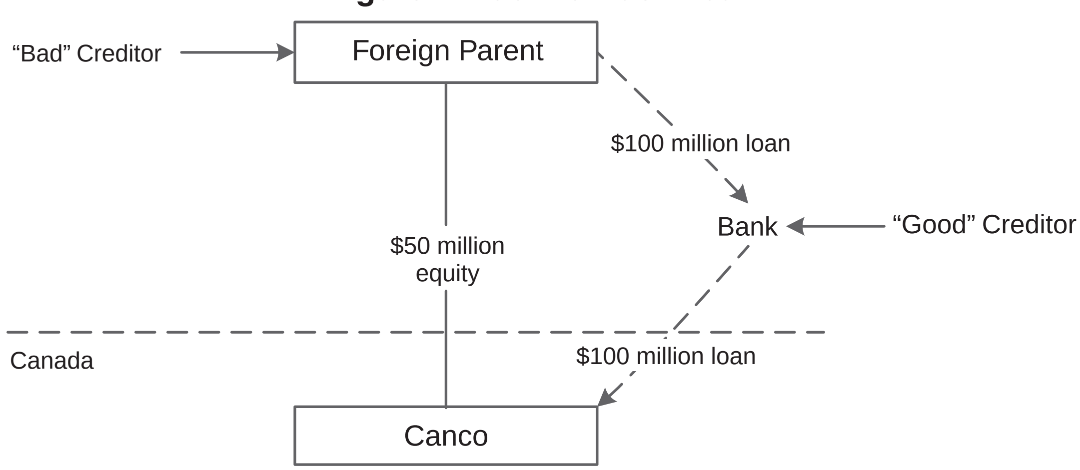


Figure 2. Back-to-Back Loan

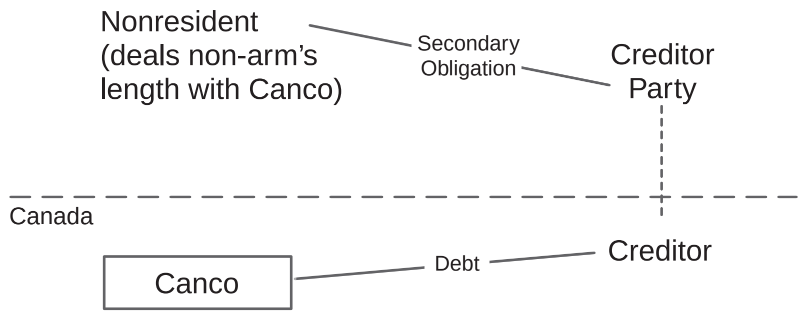


Canadian tax treaty; 0 percent for U.S. residents entitled to benefits under the Canada-U.S. tax treaty; and 10 or 15 percent for recipients resident in any other country with a Canadian tax treaty (see Figure 1).

For both interest deductibility and withholding tax purposes, debts owed to arm's-length creditors (Canadian or foreign) are treated more favorably than those owed to non-arm's-length creditors. The Department of Finance is concerned about arrangements that ostensibly result in Canco paying interest to an arm's-length creditor but that in substance constitute the debt financing of Canco by a non-arm's-length nonresident. The simplest example is a back-to-back loan, illustrated in Figure 2, whereby Canco's foreign parent makes a loan to a bank that simply on-loans to Canco.

Starting in 2015 it will no longer be possible to determine the Canadian thin capitalization and interest withholding implications of a particular Canco debt simply by reference to who Canco's direct creditor is. Instead, Canco will be deemed to pay interest to a

Figure 3. Summary of Back-to-Back Loan Rules



Secondary obligation is a debt owing by Creditor Party to Nonresident:
- that has a causal connection ("because of") with Canco debt; or
- recourse under which is in any way limited to Canco debt.

Secondary obligation is a grant of rights in property by Nonresident to Creditor Party that gives Creditor Party something more than right on default to sell and pay down Canco debt and that:
- is provided for in Canco-Creditor debt agreement; or
- has a causal connection ("because of") with Canco debt.

non-arm's-length nonresident (and not the actual creditor) if the new back-to-back loan rules apply. In very general terms, the new rules will apply if the following conditions are met:

- Canco's actual creditor (Creditor) is either an arm's-length Canadian resident or a nonresident person;
- a secondary obligation meeting specific conditions exists between Creditor or someone not dealing at arm's length with Creditor (in either case, a Creditor Party) and a nonresident of Canada who does not deal at arm's length with Canco (Nonresident); and
- Nonresident is a ''worse'' creditor than Creditor from either a thin capitalization or interest withholding tax perspective — that is, Canco owing money to Creditor is tax advantageous compared with owing money to Nonresident.[2]

Figure 3 illustrates the essence of the rules. Essentially, a secondary obligation sufficient to trigger the application of the rules can be either:

- a debt owed to Nonresident by a Creditor Party, if the Canco-Creditor debt can be said to exist ''because of'' that other debt (for example, a classic back-to-back loan);[3] or
- Nonresident's grant of a specified right in property to a Creditor Party, if that right is either required under the terms of the Canco-Creditor debt or the Canco-Creditor debt can be said to be outstanding because of the specified right.

The idea behind the second scenario is to catch situations such as Nonresident depositing marketable securities with a Creditor Party that the Creditor Party can use for its own purposes, as opposed to simply lending money to the Creditor Party. A specified right generally does not exist if the Creditor Party's rights in Nonresident's property are limited to (i) the right upon default to sell the property and apply the proceeds against Canco's debt (or a ''connected'' debt owed to the same Creditor), and (ii) the right to pledge or encumber the property to secure payment of the Canco debt (or a connected debt owed to the same Creditor).[4]

The new rules apply starting in 2015, with no grandfathering for existing debt. As a result, Canadian subsidiaries of foreign multinational groups need to review their debt financing arrangements to identify situations in which the new rules may apply to either deem the Canco debt to be subject to thin capitalization restrictions or increase the amount of Canadian interest withholding tax exigible. Things to watch for include:

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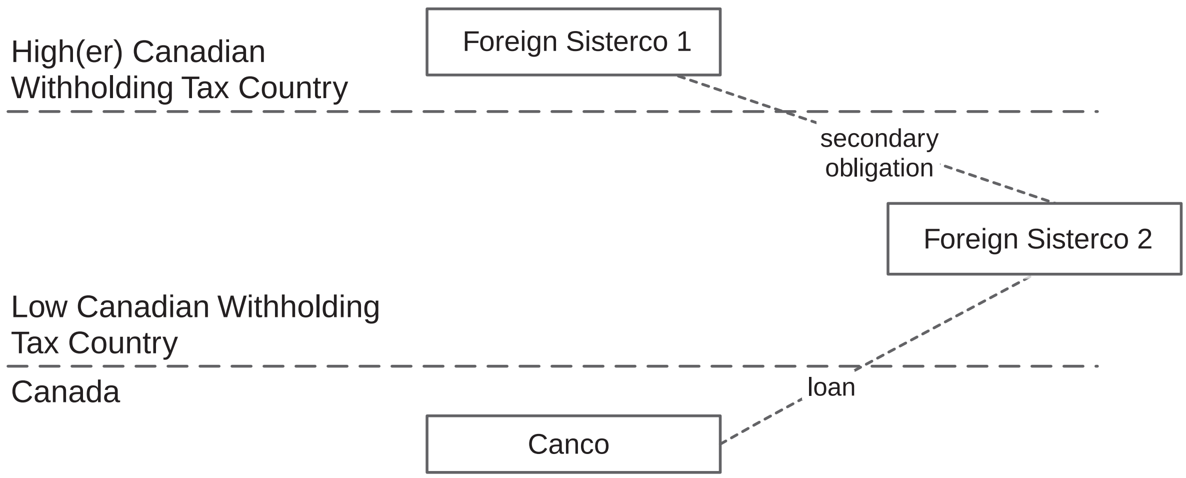
[2]For more detail on the final version of those rules, see Suarez, ''Canada Releases Revised Back-to-Back Loan Rules,'' *Tax Notes Int'l*, Oct. 27, 2014, p. 357 (see in particular the decision tree overview of the rules on p. 360).

[3]Or if Nonresident's recourse under the debt is in any way limited to Creditor's receivable from Canco.

[4]The explanatory notes accompanying the rules indicate that merely providing a security interest in property is not intended to constitute a secondary obligation if the security interest does not in and of itself provide a way for the Creditor Party to raise funds that it may use for a purpose other than reducing an amount owed to it under the Canco debt or a ''connected'' debt.

Figure 4. Creditor and Nonresident Both Non-Arm's-Length Persons



Canadian interest withholding tax rates for non-arm's-length creditors:
- U.S.: usually 0 percent.
- Other treaty countries: 10-15 percent.
- Non-treaty countries: 25 percent.

- obligations between a Creditor Party and a nonresident not dealing at arm's length with Canco that either are explicitly provided for in the Canco-Creditor debt agreement or have a causal connection with the Canco debt;
- security interests provided by nonresidents not dealing at arm's length with Canco that give the secured party more than the basic right to sell the secured property on a default and apply the proceeds against the Canco debt; and
- group cash-pooling arrangements.[5]

When considering the rules, it is important to note that the interest withholding tax element could apply even when Creditor is a nonresident that does not deal at arm's length with Canco, because different withholding tax rates apply to different countries. Put another way, one foreign group member can be a ''worse'' creditor than another group member who is Canco's actual creditor so as to potentially engage the rule (for example, see Figure 4). That will occur particularly when Canco's creditor is a U.S. resident, because Canada's tax treaty with the United States is the only one with a 0 percent interest withholding tax rate. That subtle element of the rules effectively constitutes an anti-treaty-shopping provision, unrestricted by any concept of what constitutes abuse — that is, it is per se deemed abusive when Creditor is entitled to a lower withholding tax than Nonresident, irrespective of why Creditor was chosen as Canada's lender and what the purpose of the secondary obligation was — and has been the source of significant controversy.

B. Immigration Trusts

For many years, Finance has been concerned about the use of nonresident trusts by Canadian residents to earn foreign-source income and defer Canadian tax indefinitely. Canada's rules for nonresident trusts provide that the trust may be deemed resident in Canada (so as to be taxable on worldwide income) if property has been contributed to the nonresident trust by a person who is a Canadian resident.

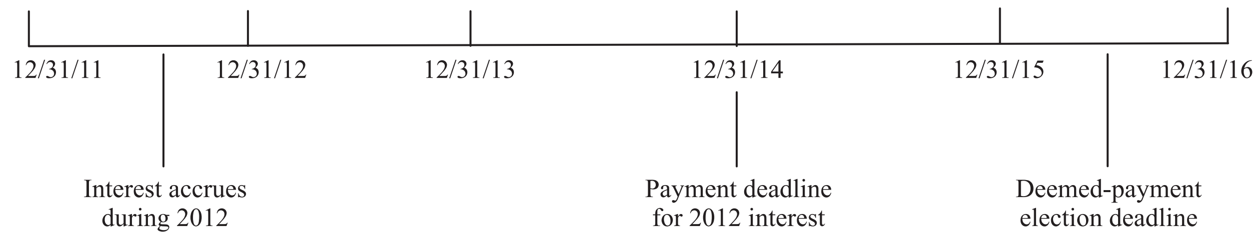
For that purpose, an individual who has been resident in Canada less than 60 months is excluded as a Canadian resident contributor to the nonresident trust. As a result, new residents of Canada have been able to establish a nonresident trust to earn income free of Canadian tax during their first five years of Canadian residence. The 2014 federal budget eliminated that 60-month exemption, effective for trust tax years that end after 2014.[6] As a result, income earned by those ''immigration trusts'' will be taxable in Canada as it accrues.

[5]That is, when the argument could be made that a negative Canco balance with the lender exists ''because'' another group member has a positive balance with the lender.

[6]For trusts to which the exemption applied during the portion of 2014 before February 11, and to which no contributions were

(Footnote continued on next page.)

Figure 5. Accrued Non-Arm's-Length Interest and Section 78(1)



C. Foreign Accrual Property Income

To prevent undue deferral of Canadian tax on foreign-source passive income earned indirectly by Canadian residents through controlled foreign corporations, the foreign accrual property income regime in Canada's Income Tax Act takes some forms of passive or deemed-passive income (FAPI) earned by a controlled foreign affiliate (CFA) of a Canadian resident and imputes a proportionate share of it to the Canadian resident.[7] Among the types of income deemed to constitute FAPI is income from an investment business, being defined essentially as a business whose principal purpose is to earn income from property.

Income from a financial services business carried on by the CFA that is regulated as a financial institution under the laws of its home country has been exempted from the definition of the term ''investment business'' for many years. However, in the 2014 federal budget, Finance announced a change in law that limits the financial services business exception to CFAs of Canadian taxpayers that are themselves regulated Canadian financial institutions (for example, banks, trust companies, and insurance companies).[8] Thus, effective for tax years beginning after 2014, other Canadian taxpayers will no longer be able to rely on the exception from the investment business definition for financial services income earned by their CFAs regulated as such in their home country.

II. Recurring Tax Deadlines

A. Accrued but Unpaid Expenses (Section 78 ITA)

When a taxpayer owes a deductible amount to a non-arm's-length person, there is a limit to how long it can go unpaid before the deduction gets reversed. An expense 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. That means that if a taxpayer incurred a deductible expense to a non-arm's-length person in its 2012 tax year, the taxpayer must actually pay the expense by the end of the 2014 tax year to avoid having to add back the amount in income for the 2015 tax year (see Figure 5).

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 will avoid the income addback. When the non-arm's-length person is a nonresident, the deemed payment of the expense will often trigger Canadian withholding tax. A common situation that arises is for interest expense to be owed by one member of a corporate group to another. The form must be filed by the due date of the taxpayer's income tax return for that following year (2015 in the above example).

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 within 179 days after the end of the tax year in which it was incurred. If the expense is not paid within that time, 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. Foreign Affiliate Dumping Rules — Repayments, Elections, and PUC Reductions

In the 2012 federal budget, the government introduced sweeping new foreign affiliate dumping (FAD) rules. Those complex rules (generally applicable to transactions occurring after March 28, 2012) are overbroad and encompass various transactions that should

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made after that date. For other trusts, the exemption simply ends for tax years ending on or after February 11.

[7]For further discussion of the FAPI regime, see Mining Tax Canada, ''Investment Outside of Canada,'' *available at* http://miningtaxcanada.com/investment-outside-of-canada/.

[8]In the budget documents, Finance expressed concern that Canadian taxpayers other than financial institutions were taking advantage of that exception inappropriately to earn income from proprietary investment and trading activities through CFAs.

Table 2. Summary of Recurring Tax Deadlines

Event	Action/Deadline
Taxpayer incurred a deductible expense owing to a non-arm's-length person in its 2012 tax year.	Taxpayer must ensure it actually pays the expense by December 31, 2014 (or files a deemed-paid election), to avoid having to add back the deducted amount in income for its 2015 tax year.
Taxpayer accrues and deducts employee expenses (for example, salary, wages, and pension benefits) in its 2014 tax year.	Taxpayer must ensure that it actually pays the expenses by June 28, 2015.
Foreign affiliate of foreign-controlled Canco incurs debt owing to Canco to which the foreign affiliate dumping (FAD) rules would otherwise apply.	To exclude application of FAD 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 electing to opt into the ITA section 17.1 regime (and out of FAD rules) before Canco's tax return filing due date for the year in which that debt became owing.
Foreign-controlled Canco makes an ''investment'' in a foreign affiliate that triggers application of the FAD rules when a deemed dividend otherwise arising could be replaced with a reduction in the paid-up capital (PUC) of Canco's shares (or shares of a related Canadian corporation).	When the FAD rules apply and PUC of shares could be reduced in place of a deemed dividend under the PUC offset rule, ensure that prescribed form with required information is filed in time to prevent deemed dividend.
Shareholder of Canco (or a person not dealing at arm's length with a Canco shareholder) became indebted to Canco (or to a related corporation) during Canco's 2013 tax year, except when debtor is a Canadian corporation.	Ensure the debt is repaid by December 31, 2014; if not (and no exception applies), the amount of the debt is either (1) included in the debtor's income (if the debtor is a 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 a 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, 2015; 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 zero or low rate of interest during Canco's 2014 tax year.	Ensure the debt is repaid within one year after it arose; otherwise, Canco must include in its income for the 2014 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 shareholder holding at least 25 percent of Canco or does not deal at arm's length with such a shareholder) that remains outstanding at the end of Canco's 2014 tax year.	Review amounts owing to specified nonresidents and estimated Canco equity for the start of 2015 to ensure compliance with 1.5-1 debt-to-equity limit; when necessary, reduce the amount of that debt or increase Canco equity for thin capitalization purposes before January 1, 2015.
During 2014, 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 2014 tax year (unless an exception applies). Compute and preserve tax attributes allowing Canco to claim offsetting year-by-year reserve.

not be caught from a tax policy perspective, despite some positive changes made in 2014.[9]

The FAD rules generally apply whenever a Canco controlled by a foreign corporation (Parent) makes an ''investment'' in a non-Canadian corporation (Foreignco) in which Canco has at least a 10 percent direct or indirect equity interest. When applicable, the rules will either reduce Canco's paid-up capital (PUC), which adversely affects Canco in various ways,[10] or deem Canco to have paid a dividend to Parent (triggering Canadian dividend withholding tax).

One of the few exceptions to the FAD rules is an investment that is a debt owed by Foreignco to Canco

[9]For a detailed review of the rules (and 2014 changes), see Suarez, ''An Analysis of Canada's Latest International Tax Proposals,'' *Tax Notes Int'l*, Sept. 29, 2014, p. 1131.

arising in the ordinary course of Canco's business (for example, trade debt), if Foreignco pays that debt 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 permitted 180-day period.

Further, if Canco's investment is a loan to Foreignco, Canco and Parent can file an election to cause that debt not to be subject to the FAD rules and to instead be subject to the interest imputation regime in section 17.1 ITA.[11] That election must be made on a debt-by-debt basis and filed by the due date of Canco's tax return for the tax year in which the debt was incurred.[12]

If the FAD rules do apply to an investment made by Canco, the typical result is that Canco is deemed to have paid a dividend on its shares held by Parent (or Parent affiliates), triggering Canadian dividend withholding tax. However, when specific conditions are met, some or all of the deemed dividend is replaced by a reduction in the PUC of one or more classes of the shares of Canco (or a related Canadian corporation). For the PUC reduction to prevent the deemed dividend under that PUC offset rule, Canco must file prescribed information regarding the details of the PUC reduction and the affected classes of shares. That information must be filed by Canco's tax return filing due date for the year that includes the dividend time (late filing and an application for a refund of dividend withholding tax are possible under some conditions).

C. Debts Owed to Cancos by Shareholders and Connected Persons (Sections 15(2) and 17.1 ITA)

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 section 15(2) ITA is that if a person is a shareholder of a Canco (or a person not dealing at arm's length with that 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.[13] 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 rate of 25 percent (unless reduced under an applicable tax treaty).

The principal exception to that rule is when 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 December 31, 2013, the deadline for repayment is December 31, 2014. To qualify for the exception, the repayment cannot be part of a series of loans or other transactions and repayments. It is therefore important to ensure 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 nonresident corporation, an election can be made so that section 17.1 ITA will apply to the debt instead of section 15(2). Essentially, the section 17.1 regime ensures that Canco realizes a sufficient amount of actual or deemed interest income on the debt each year, comparable to an arm's-length debt. That election applies to a debt that meets the following conditions:

- the debt became 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;[14]
- Canco and its nonresident controlling corporation file the required joint election;
- section 15(2) ITA would otherwise apply to the debt; and
- the amount included in Canco's income for a tax year in connection with the debt under section 17.1 is not reduced under a relevant tax treaty.

If those 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[15] for whatever part of the year the debt remains outstanding, minus any interest on the debt actually included in income for the year (for example, if the debt bears interest at 3 percent, section 17.1 requires another 1.94 percent be included in Canco's income). In that way, Canco can elect to report a minimum amount of actual or deemed interest on the debt as an alternative to having the debt deemed to be a dividend paid by Canco to its foreign parent corporation. When a nonresident corporation

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[10]A reduction in the PUC of a corporation's shares will reduce the corporation's equity for thin capitalization purposes (see Section II.F, *infra*) and cause future equity distributions on the corporation's shares to be treated as dividends (triggering dividend withholding tax) rather than returns of capital.

[11]*See* Section II.C, *infra*, for more discussion on these rules.

[12]Cancos are generally required to file their tax return for a particular tax year within six months of their year-end.

[13]The section 15(2) ITA income inclusion rule does not apply to (1) debts owing by another Canco, (2) amounts owing between nonresidents of Canada, (3) specific loans to employees, and (4) debts arising in the ordinary course of the creditor's business when there are bona fide arrangements for repayment made at the outset.

[14]Look-through provisions extend those rules to debts owed by and to partnerships in most cases.

[15]Currently 4.94 percent. *See* Canada Revenue Agency release on fourth-quarter interest rates (Sept. 12, 2014), *available at* http://news.gc.ca/web/article-en.do?mthd=index&crtr.page=1&nid=883979.

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

The election to opt into the section 17.1 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 was incurred. However, Canco may file the election late — within three years after the relevant due date — if it pays a penalty.

D. Interest Benefit on No/Low Interest Debts Owed to Cancos by Shareholders and Connected Persons (Section 80.4(2) ITA)

If a shareholder of a Canco (or a person connected to such a shareholder) has incurred a debt to Canco (or a related corporation) and the interest rate on that debt is less than an arm's-length rate, the debtor must 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 if the 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. When 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).

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

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 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 Debts Owed by Nonresidents to Cancos (Section 17 ITA)

If a nonresident person owes an amount to Canco, a rule applies to ensure Canco reports at least a minimum amount of interest on that debt. Specifically, if the debt has remained outstanding for more than a year, and 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). That rule makes it important to ensure that no- or low-interest debts nonresidents owe to Canco are repaid within the one-year limit.[16]

Some debts are excluded from that rule, including:

- debt described in Section II.C that has been deemed a dividend subject to nonresident withholding tax under section 15(2) ITA;
- amounts owed by an unrelated nonresident that arose in connection with goods sold or services provided by Canco in the ordinary course of its business and on arm's-length terms and conditions;
- debt owed by a closely held CFA of Canco that 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 interest inclusion rule in section 17.1 ITA, described in Section II.C.

F. Debts Owed by Cancos to Specified Nonresidents (Section 18(4) ITA)

As discussed in Section I.A, the thin capitalization rules prevent Canco[17] from deducting interest on outstanding debts to specified nonresidents[18] to the extent that such debt exceeds 1.5 times Canco's equity. For that purpose, Canco's outstanding debt to specified nonresidents is determined by adding the maximum amount of that debt at any time in each calendar month that ends in the relevant tax year and dividing that by the number of calendar months (to produce 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[19] of Canco for each calendar month ending in the year, divided by the number of those calendar months; and

[16]That rule governing direct debts is supported by an indirect debts provision, which applies when a nonresident owes an amount to an intermediary because of a loan or transfer that Canco has made to the intermediary. In those circumstances, the nonresident is deemed to owe an amount directly to Canco, so that the direct-debt rules apply.

[17]The thin capitalization rules apply not only to Cancos, but also to Canadian resident trusts and to corporations and trusts not resident in Canada that either carry on business in Canada or elect to be taxed as Canadian residents. Partnerships in which those kinds of entities are members are also generally included.

[18]A specified nonresident as regards Canco is defined as a nonresident person who either owns at least 25 percent of Canco's shares (by votes or value, and including any shares held by non-arm's-length persons); or does not deal at arm's length with shareholders holding at least 25 percent of Canco's shares.

[19]That is, a shareholder holding at least 25 percent of Canco's shares who is a nonresident.

- the total of the start-of-month PUC of Canco shares owned by specified nonresident shareholders of Canco for each calendar month ending in the year, divided by the number of those calendar months.

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). Those 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 2015 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 Debts Owed to Canco Foreign Affiliates (Section 90(6) ITA)

The upstream loan rules announced in 2011 discourage the use of interest-free loans from a foreign affiliate to its Canadian parent as a way to repatriate foreign profits to Canada tax free, instead of the foreign affiliate paying a dividend to the Canadian parent (which could result in Canadian tax).[20]

The upstream loan rules generally require Canco to include in income an amount owed to a foreign affiliate of Canco[21] by specified debtors — that is, Canco and anyone not dealing at arm's length with Canco (other than a controlled foreign affiliate of Canco). The rules apply to debts arising after August 19, 2011,[22] and are modeled on the existing domestic shareholder debt rules in section 15(2) ITA.[23] 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 it arose (if that repayment is not part of a series of loans or other transactions and repayments); and
- debt arising in the ordinary course of the creditor's business (or a loan made in the ordinary course of the lender's ordinary business of lending money) if bona fide arrangements for repayment within a reasonable time were made at the outset.[24]

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

If those rules 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[25] for a tax year if specified conditions are met. Essentially, those conditions look to whether, when the debt was incurred and continuously thereafter, Canco had sufficient tax attributes regarding the relevant foreign affiliate so 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 incurring Canadian tax. Those 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 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. ◆

[20]For an overview of Canada's system of taxing dividends received by a Canco from a foreign affiliate, see Mining Tax Canada, *supra* note 7.

[21]Or a partnership of which a Canco foreign affiliate is a member.

[22]Debts that were outstanding on that date are grandfathered until Aug. 19, 2016. Antiavoidance rules have also been enacted that catch back-to-back loan arrangements.

[23]*See* Section II.C, *supra*.

[24]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 specific conditions.

[25]That is, a deduction that is added back to income the following year.