Therefore, by splitting the purchase price allocation, the transferring (existing) Swiss branch and the acquiring (new) Swiss branch could apply for a roll-over of book value and tax basis with the ensuing continued deferral of the CHF 50m deferred Swiss income tax charge (preservation of income tax basis due to tax neutral corporate reorganization in line with Swiss generally accepted accounting principles/tax accounting rules) while the transferring UK head office and the acquiring German head office could account for the additional CHF 200m which supported a FMV disposal as required under UK and German corporate law and accounting rules. However, in order to preserve the tax neutral roll-over of book value and tax basis in Switzerland due to a group internal reorganisation status, a five-year clawback was imposed on the transaction. Accordingly, a disposal of the selling UK entity or the buying German entity or the assets and liabilities transferred within the five year restriction period would have triggered retroactive income taxation as per the transfer date. Kimberly and Robert mentioned that this would not be a possible solution in the US, because there would be no legal basis to arbitrarily allocate the consideration in this manner.

To end the Session, Peter explained a last case of different assumptions between partners in a transaction. In a US-Swedish joint venture (JV), in which each partner had 50 per cent ownership and which was governed by Swedish law, the Swedish partner persuaded the US partner to sell one of his shares in the JV alleging that this was for consolidation purposes only and that this would not change the JV agreement. The US partner agreed to sell his share and became the minority shareholder. The US partner only realised that he was the minority shareholder when the JV agreement terminated after six months of the transaction, because the Swedish partner inserted a clause saying that JV agreement would terminate when JV Company terminates and this occurred six months later.

Foreign multinationals: beware new Canadian 'debt dumping' proposals

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A new rule announced in the Canadian federal budget of March 2012 targets foreign-controlled Canadian corporations, such as Canadian subsidiaries of multinational groups. This new rule (which is still being refined by Canadian tax authorities) applies to 'investments' made by such Canadian subsidiaries in foreign corporations (applicable to transactions occurring after 28 March 2012), and may trigger Canadian dividend withholding tax and/or reduce the Canadian subsidiary's ability to deduct interest expense on related-party debt.

Various elements of Canada's tax system are relatively generous by international standards. In particular:

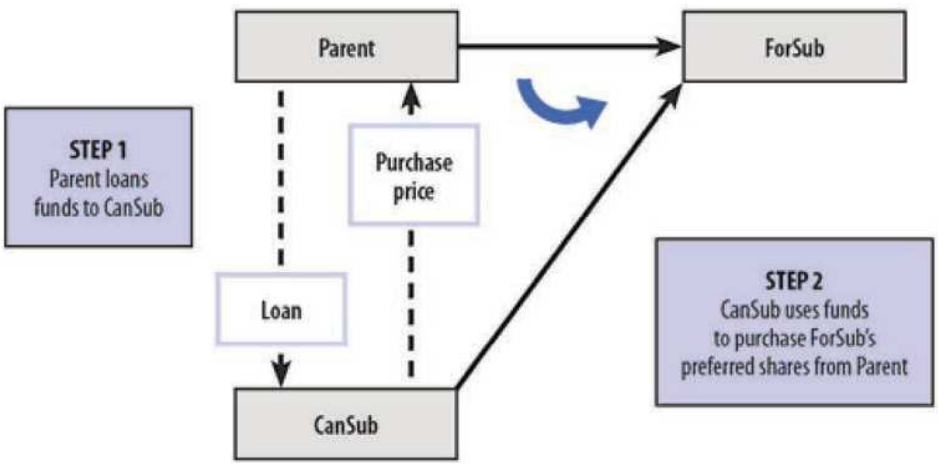
- where a Canadian corporation has a foreign subsidiary that is resident in a country with which Canada has a tax treaty or tax information exchange agreement (a 'treaty country'), essentially Canada does not tax dividends received from the foreign subsidiary to the extent that they are derived from active business income earned in a treaty country;
- interest expense incurred by a Canadian corporation for business purposes is generally deductible without regard to whether the borrowed funds will be used in Canada or elsewhere, even if the borrowed funds are used to invest in a foreign subsidiary any dividends from which will be exempt from Canadian tax as described above; and
- where a Canadian corporation makes a distribution to its shareholders, it can

generally choose between (1) paying a dividend (which triggers non-resident dividend withholding tax for a non-Canadian shareholder), or (2) effecting a return of ‘paid-up capital’ (PUC, being capital received by the corporation from shareholders on the issuance of shares), which reduces the shareholder’s basis in its shares of the Canadian corporation but does not trigger dividend withholding tax.

The combination of these rules means that in some cases Canadian corporations incur interest expense that reduces their Canadian taxes owing, even though the debt was incurred to earn income that may never be taxable in Canada (eg, investing in a foreign subsidiary).

In some cases multinational groups with Canadian subsidiaries have taken advantage of these rules to engage in so-called ‘debt dumping.’ There are several variations of the meaning of this term, but essentially it involves the Canadian subsidiary incurring debt to acquire shares in a foreign member of the multinational group: for example, purchasing them from its foreign parent in exchange for a promissory note (see Figure 1). Where the shares purchased by the Canadian subsidiary represent an investment with little likelihood of appreciation and/or with debt-like features (eg, fixed-value preferred shares), Canadian tax authorities have considered the deduction of interest expense on debt incurred to acquire such shares particularly offensive.

Figure 1 – Debt dumping



2012 Federal Budget: ‘Foreign Affiliate Dumping’

Proposals released in the Canadian government’s annual budget in March 2012 are directed specifically at the type of investments described above, but encompass a much broader range of transactions, many of which have nothing to do with the sort of debt dumping that was found to be offensive. Multinational groups with Canadian subsidiaries need to be extremely careful when their Canadian subsidiaries undertake transactions that may trigger this new rule.

The new rule applies when a Canadian corporation (Canco) that is controlled by a non-resident corporation (Parent) ‘invests’ in another non-resident corporation (Forco), if immediately thereafter Forco is (or as part of the series of transactions that includes the investment becomes) a ‘foreign affiliate’ of Canco.[1] For this purpose, Canco ‘invests’ in Forco by acquiring shares of Forco, making a contribution to Forco’s capital, loaning money to (or otherwise becoming a creditor of) Forco other than in the ordinary course of its business, acquiring an option in Forco shares or debt, or completing any other transaction ‘similar in effect’ to the foregoing.

When this new rule applies:

- Canco is deemed to have paid a dividend to Parent equal to the value of any property (other than shares of Canco) transferred by Canco or any obligation assumed by Canco in respect of the investment. This will trigger non-resident dividend withholding tax; and

- to the extent that Canco has issued any shares of itself in connection with its 'investment', no amount may be added to the 'paid-up capital' (PUC) of those shares (PUC represents the value of property received by a Canadian corporation in exchange for issuing shares of itself). The denial of any PUC addition is harmful because (1) a Canadian corporation can make a distribution of its PUC without it being treated as a dividend, and (2) Canada's thin capitalization rules limiting Canco's ability to deduct interest on debt owing to non-arm's-length non-residents are based on how much PUC (and retained earnings) Canco has.

In effect, Canco is treated as having paid a dividend on its shares rather than having engaged in a value-for-value transaction, except to the extent that it has paid for the property it acquires by issuing shares of itself (and to that extent no recognition is given for the additional investment in Canco's equity).

Business purpose test

The new rule is subject to a limited exception: it applies only if the investment may not reasonably be considered to have been made by Canco (instead of Parent or another foreign group member) primarily for *bona fide* purposes other than to obtain a Canadian tax benefit. Government officials have made clear that the 'business purpose' exception is meant to be inapplicable in most cases. The test is not whether the investment itself is primarily motivated by business reasons, but rather whether Canco is the most logical entity within the group to make the investment in Forco, ignoring tax considerations: a highly subjective exercise. For this purpose the new rule includes a variety of factors to be considered in making this determination, some of which do not reflect the way in which multinational groups make business decisions.[2] The new rule is summarised in Table 1, and applies to transactions occurring after 28 March 2012 (with transitional relief provided for previously contemplated transactions only when occurring between arm's-length parties under a binding written agreement made before 29 March that are completed by the end of 2012).

Deficiencies in proposed rule

The Canadian tax community has expressed alarm over the sweeping scope of this new rule, which Department of Finance officials have acknowledged may apply in situations where no untoward tax result occurs and may result in double taxation. Instead of a targeted rule directed at limiting interest deductibility in circumstances deemed to be offensive (for example by denying any increase to 'equity' for purposes of the debt/equity limit in the thin capitalization rules), the government has opted for a rule which in its present form clearly goes far beyond its stated purpose and produces inappropriate results in many cases.

To begin with, the new rule applies whether or not Canco incurs any debt, despite the fact that interest deductions from 'debt dumping' were the stated basis for this initiative.

The new rule also applies even where the investment made by Canco generates income that is fully taxable in Canada, such that no erosion of the Canadian tax base is occurring.

The new rule also produces punitive results that make little sense as a matter of tax policy. For example, under present law where Parent

Table 1 – Summary of foreign affiliate dumping proposal

Canco controlled by a foreign Parent makes an 'investment' in a non-resident corporation (Forco) that is or becomes a foreign affiliate of Canco 'Investment': • Canco acquires share of Forco • Canco makes contribution of capital to Forco • Amount becomes owing by Forco to Canco outside of ordinary course of business • Canco acquires Forco debt from a third party (except from an arm's length third party in ordinary course of business) • Canco acquires options or interests in Forco shares or debt • any transaction similar in effect to any of the foregoing	→	Yes	→	It is unreasonable to consider that the investment was made by Canco (instead of Parent or another non-arm's length non-resident) primarily for bona fide purposes other than reducing or deferring Canadian tax	→	Yes	→	Consequences: • Canco deemed to pay a dividend to Parent equal to value of property (other than Canco shares) transferred by Canco or obligations assumed or incurred by Canco in respect of the investment • no increase in PUC of any Canco shares because of the investment

transfers Forco shares worth $100 to Canco in exchange for Canco shares, $100 would be added to Canco's PUC to reflect the investment made in Canada. The transaction could be reversed the next day by Canco distributing the Forco shares to Parent as a $100 tax-free return of PUC, and the parties would be in the same position they were at the outset. However, under the new rule where nothing is added to Canco's PUC on the first step, the second step will either be a dividend (triggering withholding tax) or reduce pre-existing Canco PUC arising from earlier investments into Canada (eventually triggering dividend withholding tax at a later date). This is simply not a logical tax policy result.

Similarly, to the extent that Canco pays Parent $100 for the Forco shares, the result of the new rule is that Canadian dividend withholding tax applies even though Canco's equity value is unchanged (unlike an actual dividend, where Canco receives nothing for its $100). Yet since no PUC increase occurs, a distribution of the Forco shares back to Parent the next day will either result in another $100 dividend or reduce PUC from pre-existing investments in Canco by $100. Effectively the new rule double-counts the dividend Canco is deemed to pay.

A variety of other concerns with this rule have also been raised:

- as noted, there is no exception for investments made by Canco that generate taxable income in Canada (eg, an interest-bearing loan);
- the new rule applies to 'investments' made by Canco in its existing foreign subsidiaries, *viz.*, it applies to purely 'downstream' transactions;
- the new rule can apply without Parent or any other foreign group member acquiring any property from Canco (for example, a Canco purchase from an arm's-length seller);
- where a Canco with foreign subsidiaries is acquired by a foreign multinational group, the new rule produces anomalous results;
- as currently drafted, various internal corporate reorganisations involving a Canco with foreign subsidiaries would appear to engage the new rule;
- these rules do not distinguish between multinational corporate groups and other foreign investors with different objectives, such as private equity funds;
- unlike Canada's general anti-avoidance rule, there is no exception for transactions that do not result in an abuse or misuse of the relevant statutory or treaty provisions; and
- there are a number of interpretational uncertainties regarding the new rule (with no safe harbour exceptions) that will make it difficult for taxpayers to conclude that they are not caught by it, with the potential result that multinationals will likely decide that treasury, investment and other functions are best performed outside of Canada.

A revised version of the draft legislation enacting the new rule is expected later in 2012, which will hopefully reflect a number of these concerns (although public statements to date from government officials have not suggested that major changes are expected). Multinational groups and others with Canadian subsidiaries should be exercising caution with respect to transactions involving those Canadian subsidiaries, and watching for further developments.

Notes

1 Basically this means that Canco owns 10 per cent or more of any class of Forco's shares, directly or indirectly.

2 For example, whether Canco made the investment in Forco 'at the direction or request' of a foreign group member, and whether Canco senior management who are resident and located in Canada have principal decision-making authority over making and managing the investment.