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### Important Deadlines Nearing for Canadian Taxpayers

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Summary by taxanalysts®

As the end of 2011 approaches, Canadian taxpayers should be aware of some important deadlines.

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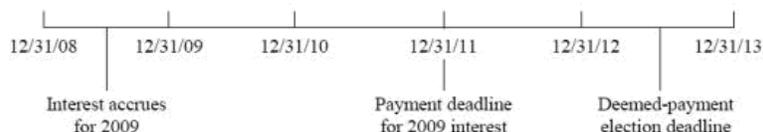
As the end of 2011 approaches, Canadian taxpayers should be aware of some important deadlines.

#### Accrued but Unpaid Expenses

When a taxpayer owes to a non-arm's-length person an amount that is deductible for tax purposes, there is a limit to how long it can go unpaid before the deduction is reversed. An amount to a non-arm's-length person incurred by the taxpayer in one tax year must be paid by the end of the second following tax year. If it remains unpaid by that time, the amount is added back into the taxpayer's income in the immediately following (third) tax year, effectively reversing any deduction taken. This means that if a taxpayer incurred a deductible expense to a non-arm's-length person in its 2009 tax year, the taxpayer must pay the expense by the end of the 2011 tax year to avoid having to add the amount back into its income for the 2012 tax year (see Figure 1 below).

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 prevent the income addback. However, Form T2047 must be filed by the time the taxpayer's income tax return for the third year (2012 in the example above) is due.

This situation commonly arises when one member of a corporate group owes interest to another member of the group. If the debtor is a Canadian resident and the creditor is a nonresident, the deemed interest payment created by this election may trigger Canadian withholding tax on the nonresident. Generally, under the Income Tax Act (Canada), Canadian interest withholding tax is limited to interest owed to non-arm's-length nonresidents<sup>1</sup> or participating interests.



#### Debts Owed to Corporations by Shareholders and Connected Persons

If a shareholder of a corporation (or someone connected to the shareholder) owes to the corporation an amount that remains outstanding for too long, the amount will be treated as income from the corporation for tax purposes. Subject to some exceptions, the general rule is that if a person is a shareholder of a corporation (or a person not dealing at arm's length with the shareholder) and has become indebted to the corporation (or to a related corporation), the amount of the debt is included in that person's income.

The principal exception to this rule is when the debt is repaid within one calendar year after the end of the corporation's tax year in which the debt arose (for example, for a debt incurred during a corporation's tax year

ending on December 31, 2010, the deadline for repayment is December 31, 2011). To qualify for the exception, the repayment cannot be part of a series of loans or debts and repayments.

If a loan or debt owed by a nonresident is caught by the rules and is not repaid within the permitted time period, the amount of the loan or debt is deemed to be a dividend received by the nonresident from the corporation and is subject to Canadian nonresident withholding tax at a 25 percent rate (unless reduced under an applicable tax treaty). This rule prevents, for example, a foreign parent of a Canadian subsidiary from using an indefinite loan (or series of loans and repayments) as a dividend alternative to extract cash from Canada while avoiding Canadian dividend withholding tax. (For an earlier discussion, see *Doc 2009-10831* or *2009 WTD 136-11*.)

These income inclusion rules do not apply to

- debtors that are corporations resident in Canada;
- amounts owed between nonresidents of Canada;
- certain loans to employees; or
- debts arising in the ordinary course of the creditor's business when there are bona fide arrangements for repayment made at the outset.

A debtor that is a foreign subsidiary of the corporation will generally not be caught by these rules; in other words, downstream loans are generally permitted.

#### **Interest on Debts Owed to Corporations by Shareholders and Connected Persons**

Another rule applies to the interest element of loans by a Canadian corporation to its shareholders and connected persons. If a shareholder of a corporation (or a person connected to the shareholder) has incurred a debt to the corporation (or to a related corporation), a specific rule requires the debtor to include in its income for tax purposes at least a minimum amount of interest on the loan or debt. This rule applies even if the loan or debt has been outstanding for only part of a year. 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 that is actually paid by the debtor within 30 days after the end of the year.

It is generally important to ensure that an appropriate amount of interest is paid within 30 days of the end of the relevant tax year in order to prevent a deemed income inclusion. When a loan or debt incurred by a nonresident is caught by this rule, the interest benefit is deemed to be a dividend received by the nonresident and is subject to Canadian nonresident withholding tax at the 25 percent domestic rate (unless reduced under an applicable tax treaty). This interest inclusion rule does not apply to debtors that are corporations resident in Canada or if the amount of the loan or debt has already been included in the debtor's income under the rules described in the previous section.

#### **Interest on Debts Owed by Nonresidents to Canadian-Resident Corporations**

When a nonresident person owes an amount to a Canadian-resident corporation, an additional rule applies to ensure that the Canadian corporation reports at least a minimum amount of interest on that debt for tax purposes. To the extent that the debt has remained outstanding for more than one year and the Canadian corporation includes in its income for a tax year an amount that is less than a "reasonable" rate of interest on the debt, the Canadian corporation must include in its income for the year an amount equal to interest on the outstanding debt computed at a prescribed rate, minus any interest actually received or included in income for that year.

This rule governing direct debts is supported by an indirect debts provision that applies when a Canadian corporation 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 the Canadian corporation so that the direct-debt rules apply.

These rules make it important to ensure that interest-free and low-interest debts are repaid within the one-year period allowed. Some debts are excluded from the application of these rules, including:

- a debt described in section 2 that has been deemed to be a dividend and subjected to nonresident withholding tax;

- amounts owed by an unrelated nonresident if the amount arose in connection with goods sold or services provided by the Canadian-resident corporation in the ordinary course of its business and under arm's-length terms and conditions; and
- a debt owed by a closely held controlled foreign affiliate (CFA) of the Canadian corporation in connection with an active business carried on by the CFA (or another CFA of the taxpayer).

### Reportable Transactions

Under the proposed mandatory reporting regime for "aggressive" tax avoidance transactions announced in the 2010 federal budget, a taxpayer must file an information return for any tax avoidance transaction entered into after 2010 (or that is part of a series of transactions that began before 2011 but is completed after 2010) if it satisfies two out of three "hallmarks" regarding its fee structure, confidential protection, and/or contractual protection. (For prior coverage, see *Doc 2010-4813* [📄](#) or *2010 WTD 45-1* [📄](#).)

The filing deadline for the information return for a reportable transaction is on or before June 30 of the calendar year following the year in which the transaction first became a reportable transaction for the taxpayer. However, for a transaction that is part of a series of transactions that began before 2011 but is completed after 2010, the Department of Finance has indicated in the explanatory notes to the draft legislation that the information return will be deemed to have been filed by the June 30, 2011, deadline as long as it is filed by the end of 2011.<sup>2</sup>

### Corporate Members of Partnerships

As a result of the 2011 federal budget, corporate members of partnerships generally can no longer defer the taxation of income earned through a partnership that has a fiscal year-end that differs from the corporation's own tax year-end. (For prior coverage, see *Doc 2010-4813* [📄](#) or *2010 WTD 45-1* [📄](#).) For tax years ending after March 22, 2011, a corporation that has a significant interest in a partnership (generally, an entitlement to more than 1 percent of the income or loss of the partnership, either alone or together with related and affiliated persons) must include in its income its accrued share of the partnership's income for the portion of the partnership's tax year that falls within the corporation's tax year. For partnerships already in existence before the budget announcement, a corporation may be eligible to benefit from transitional relief that allows the initial 2011 stub period income to be reported over a five-year period from 2012 to 2016.

In many cases, taxpayers will seek to avoid these complex new rules by electing to change the fiscal period of the partnership to correspond with the tax year of one or more corporate partners. The deadline for filing such an election is the first filing due date of any corporate partner for its first tax year ending after March 22, 2011, which means that some corporate partners would have had to file the election as early as September 23, 2011. The Canada Revenue Agency (CRA) had stated that no elections would be accepted after the due date.<sup>3</sup> However, on December 16, the Department of Finance issued a press release indicating its intention to extend the time for filing an election by treating late-filed elections as having been filed on time if filed on or before January 31, 2012. (For the release, see *Doc 2011-26656* [📄](#) [📄](#).)

These new rules also apply to joint venture arrangements, which in the past have benefited from the CRA's now-withdrawn administrative policy allowing the joint venture to establish its own fiscal period. Income from a joint venture must now be computed for each participant, based on the participant's own fiscal period. At the Canadian Tax Foundation's 2011 Annual Conference last month, the CRA announced that joint venture participants will be allowed to elect to receive the five-year transitional relief applicable to partnerships described above. However, to claim that relief, joint venturers must file an election to that effect on or before the filing due date for their first tax year ending after March 22, 2011.<sup>4</sup>

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### FOOTNOTES

<sup>1</sup> If the creditor is a U.S. resident entitled to benefits under the Canada-U.S. income tax treaty, the exemption is extended to non-arm's-length creditors.

<sup>2</sup> See <http://www.fin.gc.ca/drleg-apl/ita-lir10n-eng.pdf> at page 210.

<sup>3</sup> See <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/dfril/chngfscl-eng.html>.

<sup>4</sup> See CRA document 2011-0429581E5, dated November 29, 2011.

#### END OF FOOTNOTES

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#### Tax Analysts Information

**Jurisdiction:** Canada

**Subject Areas:** Corporate taxation  
Deferral of taxes  
Dividends  
Information reporting  
Partnership taxation

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**Cross Reference:** For an earlier discussion of debt management strategies between nonresident parent companies and their Canadian subsidiaries, see *Doc 2009-10831*  or *2009 WTD 136-11* .  
For the proposed mandatory reporting regime announced in the 2010 federal budget, see *Doc 2010-4813*  or *2010 WTD 45-1* .)  
For prior coverage of the limitation on deferral for some partnership income, see *Doc 2011-6076*  or *2011 WTD 57-2* .

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