tax notes international
Volume 72, Number 1 ■ October 7, 2013

Crown Appeals Loss in Canadian Outbound Planning Case

by Steve Suarez

Reprinted from *Tax Notes Int'l*, October 7, 2013, p. 26

COUNTRY DIGEST

Crown Appeals Loss in Canadian Outbound Planning Case

The Crown on September 30 initiated an appeal[1] to the Federal Court of Canada in *Lehigh Cement Limited v. The Queen* (2013 TCC 176), a case that could have a serious impact on the scope of the antiavoidance rule in section 95(6)(b) of the Income Tax Act (Canada).

The case involves the application of the antiavoidance rule to a Canadian corporation receiving dividends from an affiliated U.S. limited liability company that had in turn loaned funds to a related non-Canadian corporation.

Under Canada's controlled foreign corporation regime, dividends received by a Canadian corporation from a foreign affiliate are generally excluded from Canadian tax under a 100 percent dividends received deduction to the extent that the dividends are attributable to active business income earned by the foreign affiliate.

In some circumstances, interest income received by the dividend-paying foreign affiliate is treated as active business income (and hence, may allow for a tax-exempt dividend paid back to Canada) if the interest is deductible in computing the active business income of a debtor that is itself carrying on an active business and a foreign affiliate of the Canadian taxpayer that meets certain ownership tests.[2]

It is therefore common for a Canadian corporation to set up a foreign financing subsidiary for the purpose of making loans to related foreign operating companies so that the interest income earned by the foreign finance company can be repatriated to Canada without Canadian tax.

Lehigh concerned the government's attempt to deny the dividends received deduction to the Canadian taxpayer under the antiavoidance rule, which reads:

> For the purposes of this subdivision (other than section 90) . . .
>
> (b) where a person or partnership acquires or disposes of shares of the capital stock of a corporation or interests in a partnership, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition or disposition is deemed not to have taken place, and where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests, as the case may be, are deemed not to have been issued.

The application of this rule to deem the Canadian taxpayer not to have acquired the shares of the LLC would have denied foreign affiliate status to the LLC, and the dividends received deduction to Lehigh.

In May the Tax Court of Canada allowed the taxpayer's appeal and held that section 95(6)(b) ITA did not apply. However, the court reached that conclusion on a basis that has caused substantial concern within the Canadian tax community.

The Tax Court interpreted the scope of the antiavoidance provision broadly but ruled that it did not apply in *Lehigh* because no Canadian tax savings occurred relative to a comparable transaction chosen by the court — namely, a direct equity investment by the Canadian taxpayer in the foreign operating company.

By not ''rejecting the government's wide reading of the basic ambit of section 95(6),'' (see) the Tax Court left open the potential for the antiavoidance rule to apply in a variety of circumstances generally considered by the tax community to be outside the scope of that rule.

The Canadian tax community will be following this case closely, as the scope of section 95(6)(b) ITA greatly affects the limits of acceptable outbound planning by Canadian corporations with foreign subsidiaries. ◆

◆ *Steve Suarez, Borden Ladner Gervais LLP, Toronto*

[1]FCA case A-327-13.

[2]At the time of the transactions in *Lehigh*, the debtor had only to have been related to the Canadian taxpayer.