Corporate Tax - Canada

Canadian tax-planning deadlines for 2013

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Introduction

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. In both cases, it is useful to review some of the most important pending deadlines to ensure that opportunities for reducing or eliminating Canadian taxes are not missed. This update discusses the deadlines with reference to a corporation that is resident in Canada for Canadian tax purposes (Canco).

Deadlines unique to 2013

Extension of thin capitalisation rules
The thin capitalisation rules in Sections 18(4) to (8) of the Income Tax Act limit the amount of debt owing to related non-residents 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 non-residents'[1] – non-residents which either are 25%-plus shareholders (by votes or value) of Canco or do not deal at arm's length with such 25%-

plus Canco shareholders. Under the 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 non-resident group members).

For example, if Canco owes C$100 million to its foreign parent (or another foreign group member) and has only C$50 million of equity, it will be able to deduct interest expense relating to only C$75 million of that debt. Interest on the remaining C$25 million of debt will be non-deductible for Canadian tax purposes and will be recharacterised as a dividend to which Canadian non-resident withholding tax will apply at a 25% rate (subject to reduction under an applicable tax treaty), instead of as interest (which would generally be received by most US recipients free of Canadian withholding tax).

As a result of changes announced in the 2013 federal budget, the thin capitalisation 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 non-residents, 'specified non-residents' are defined as non-residents which either are 25%-plus beneficiaries (by value) of the trust or do not deal at arm's length with such 25%-plus beneficiaries. In addition, a trust's equity amount for a tax year(2) 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 non-residents before the beginning of each month in the year, minus the average amount of certain capital distributions made by the trust to specified non-residents before the beginning of each month in the year.(3)

Table 1: summary of special tax deadlines for 2013

Legislative or policy change	Action/deadline
Thin capitalisation rules will be extended to apply to Canadian resident trusts, and to non-resident corporations and trusts carrying on business in Canada or electing to be taxed as a Canadian resident under Section 216 of the Income Tax Act	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 capitalisation purposes before January 1 2014.

(and partnerships of which such a corporation or trust is a member), effective for tax years beginning after 2013.	
Mandatory reporting regime applies to tax avoidance transactions meeting two of three specific conditions (reportable transactions) if the transaction is either entered into after 2010 or 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.
The 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 investment tax credits. Investment tax credit inclusion rate will be eliminated for mining sector pre-production exploration expenditures incurred after 2013. Investment tax credit inclusion rate will be reduced for mining sector qualifying pre-production development expenditures incurred after 2013.	Consider potential for making such expenditures before January 1 2014 in order to maximise tax benefits.
Less generous capital gains exemption under the Canada-Barbados tax treaty will take effect on January 1 2014 if the November 2011	Residents of Barbados holding shares that derive their value principally from Canadian real property should consider whether

protocol to the treaty comes into force by the end of 2013.	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 non-resident withholding tax.

A trust to which these rules apply can designate the non-deductible interest as a payment of income of the trust to the non-resident recipient of the interest. In such case the trust will be able to deduct the payment in computing its income, but the payment will be subject to Canadian non-resident withholding tax at a 25% rate (subject to reduction under an applicable tax treaty) and potentially to tax under Part XII.2 of the Income Tax Act, depending on the character of the income earned by the trust.

Also effective for tax years beginning after 2013, the thin capitalisation rules will apply to non-resident corporations and trusts that either carry on business in Canada or elect to be taxed as a Canadian resident under Section 216 of the Income Tax Act (and to partnerships of which such a non-resident 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 non-resident entity and therefore does not have its own equity for purposes of the thin capitalisation rules, a 3:5 debt-to-assets ratio is used to determine a notional amount of equity for the branch.(4) In addition, loans from a non-resident that does not deal at arm's length with the non-resident corporation or trust are included in "outstanding debts to specified nonresidents". For a non-resident corporation, the application of the thin capitalisation rules could increase its liability for branch tax under Part XIV of the Income Tax Act.

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

Tax avoidance transaction reporting

The mandatory tax avoidance transaction reporting regime in Section 237.3 of the Income Tax Act 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.

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 anti-avoidance rule in the Income Tax Act – 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 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 that participate in, or that 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 promoter obtains in respect of the transaction or series confidential protection (ie,

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 general anti-avoidance rule).
- Contractual protection condition – a taxpayer, a person that entered into the transaction for the benefit of a taxpayer, an adviser or a promoter (or a person that does not deal at arm's length with any of them) has contractual protection in respect of the transaction or series.(5)

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 (CRA) 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.

Phased-in changes to investment tax credits

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

SR&ED

The 2012 federal budget made a number of changes to the tax regime for SR&ED, some of which will take effect in 2014. An investment tax credit can be claimed for qualifying SR&ED expenditures incurred in a tax year, while an enhanced investment tax credit may be claimed for a limited amount of qualifying expenditures incurred in a tax year by a Canadian-controlled private corporation. First, the general SR&ED investment tax credit rate applicable to SR&ED qualifying expenditure pool balances at the end of a tax year will be reduced from 20% to 15% for tax years that end after 2013, except that for a tax year that includes January 1 2014, the 5% reduction in the investment tax credit rate will be pro-rated.(7)

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 investment tax credits. 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 fulfilment of the contract. For taxpayers using the simplified proxy method to determine the amount of qualifying SR&ED expenditures eligible for an investment tax credit, the 60% inclusion allowance for overhead expenditures directly attributable to SR&ED activities available for 2013 will be reduced to 55% for 2014.

Also starting in 2014, taxpayers will be required to provide more detailed information on their SR&ED programme 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.

Resource sector

Taxable Canadian corporations that undertake certain mining sector activities relating to qualifying minerals in Canada are entitled to claim an investment tax credit equal to a percentage (originally 10%) 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 pre-production mining expenditures investment tax credit is being phased out. The existing investment tax credit, which was reduced from 10% to 5% for 2013, will be eliminated for pre-production exploration mining expenditures incurred after 2013. For pre-production development expenditures, the 10% rate available for qualifying expenditures made in 2013 will be reduced to 7% for qualifying expenditures made in 2014, to 4% for qualifying expenditures made in 2015 and then eliminated after 2015, subject to limited grandfathering.

Barbados treaty gains exemption change

Many of Canada's tax treaties exempt a non-resident 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 existing capital gains exemption in the Canada-Barbados 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 approach.(8) Thus under the existing Barbados tax treaty, if a non-resident owns shares of a holding company and that company holds shares of a subsidiary and the subsidiary holds Canadian real property interests, the non-resident 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 Canada-Barbados tax treaty, negotiated as part of the protocol signed by the two countries on November 8 2011.(9) While this protocol has not yet come into force at the time 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.

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.(10) The Canada-Serbia tax treaty, which was signed on April 27 2012, will take effect in both Canada and Serbia on January 1 2014. As a result, treaty-reduced rates of non-resident 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 works (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% to 5%. 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.

Recurring tax deadlines

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.

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. Where the non-arm's-length person is a non-resident, 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 that 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 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.

Foreign affiliate dumping rules – repayments and election

In the 2012 federal budget, the government introduced sweeping new foreign affiliate dumping 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.(11)

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 that 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 (eg, salary, wages, pension benefits) 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 (ie, trade debt) are repaid within the permitted 180-day period. For other debts, consider making election to opt into Section 17.1 of the Income Tax Act (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: • included in the debtor's income (if the debtor is Canadian resident); or • deemed to be a dividend subject to Canadian non-resident withholding tax (if the debtor is non-resident).
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: • a taxable benefit included in income (if the debtor is Canadian resident); or • a dividend subject to Canadian non-resident withholding tax (if the debtor is non-resident).
Non-resident owes an amount to Canco at a nil or low rate of interest during Canco's 2013 tax year.	Ensure that the debt is repaid within one year of arising; 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 non-resident (a non-resident that either is a 25%-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 non-residents 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 capitalisation 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 that the debt is repaid within two years of arising; 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.
Note: It is assumed for the purpose of these examples that the relevant tax year ends on December 31.	

In general terms, the foreign affiliate dumping rules apply whenever a Canco controlled by a foreign corporation (Parent) makes an 'investment' in a non-Canadian corporation (Foreignco) in which Canco has a 10%-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 capitalisation rules); or
- deem Canco to have paid a dividend to Parent (triggering Canadian dividend withholding tax).

One of the few exceptions to the foreign affiliate dumping 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 (eg, trade debt), if such debt is 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 foreign affiliate dumping rules and instead to be subject to the interest imputation regime in Section 17.1 of the Income Tax Act. 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.(12)

Debts owing to Canco by shareholders

There are limits to 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) of the Income Tax Act is that if a person is a shareholder of 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.(13) If the debtor is a non-resident person, the amount of the debt is deemed to be a dividend received by the non-resident and is subject to Canadian non-resident withholding tax at a 25% rate (unless reduced under an applicable tax treaty).

The principal exception to this rule is where the indebtedness is repaid within one calendar year of 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 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 of the Income Tax Act will apply to the debt instead of Section 15(2) of the Income Tax Act. Essentially, the Section 17.1 regime ensures that Canco realises 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 non-resident corporation (Foreignco) that either controls Canco or does not deal at arm's length with another non-resident corporation that controls Canco;(14)
- Canco and its non-resident controlling corporation file the required joint election;
- Section 15(2) of the Income Tax Act 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 of the Income Tax Act 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(15) for whatever part of the year that the debt remains outstanding, minus any interest on the debt actually included in income for the year (eg, if the debt actually bears interest at 3%, the Section 17.1 regime requires another 2.02% 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 foreign parent corporation. Where a non-resident corporation acquires control of a Canco that was not controlled by a non-resident corporation immediately before that time, a 180-day grace period is given to allow the non-resident parent time to review and clean up outstanding debts owing to Canco.

The election to opt in to 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 first became owing. However, Canco may late-file the election within three years of the relevant due date if it pays a penalty.

Interest benefit on low-interest debts

If a shareholder of 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 of the end of the year. Where a debtor is a non-resident person, any interest benefit is deemed to be a dividend received by the non-resident and is subject to Canadian non-resident withholding tax at a 25% 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:

- to debtors that are Cancos; or
- where the amount of the loan or indebtedness has been included in income under the rules in Section 15(2) of the Income Tax Act.

If the debt was incurred for income earning purposes (eg, 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.

Interest on non-residents' debts to Canco

Where a non-resident 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 the debt has remained outstanding for more than one 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).

These rules make it important to ensure that no or low-interest debts owing to Cancos by non-residents are repaid within the one-year time limit.(16)

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

- debt described above that has been deemed to be a dividend and subjected to non-resident withholding tax under Section 15(2) of the Income Tax Act;
- amounts owing by an unrelated non-resident 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 of Canco which relates to an active business carried on by the controlled foreign affiliate (or another Canco controlled foreign affiliate); and
- debt that Canco and its foreign parent corporation have elected to make subject to the new interest inclusion rule in Section 17.1 of the Income Tax Act described above.

Canco debts to specified non-residents

As discussed above, the thin capitalisation rules prevent Canco (or a partnership of which Canco is a member) from deducting interest on outstanding debts to specified non-residents(17) to the extent that such debt exceeds 1.5 times Canco's equity. For this purpose, Canco's outstanding debt to specified non-residents 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 (ie, 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 non-resident 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 non-resident shareholders of Canco for each calendar month ending in the year, divided by the number of such calendar months.

Thus, the amount of Canco's retained earnings for thin capitalisation 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 monitor periodically its debt and equity for thin capitalisation 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 (ie, reducing debt or increasing equity).

Upstream loan rules

The upstream loan rules in Section 90(6) of the Income Tax Act, 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(18) by 'specified debtors', being 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(19) and are modelled on the existing domestic shareholder debt rules in Section 15(2) of the Income Tax Act. The following debts are excluded from the application of the upstream loan rules:

- debt described above that is subject to Section 15(2) of the Income Tax Act;
- debt repaid within two years of the date that the debt arose (provided that 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.(20)

It is therefore 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 (ie, the debt was not repaid within two years), they permit Canco to claim a fully or partially offsetting reserve(21) for a tax year if specified conditions are met. Essentially, these conditions look to whether, at the time that 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 that 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.

For further information on this topic please contact Steve Suarez or Stephanie Wong at Borden Ladner Gervais LLP by telephone (+1 416 367 6000), fax (+1 416 367 6749) or email (ssuarez@blg.com or swong@blg.com). The Borden Ladner Gervais LLP website can be accessed at www.blg.com.

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Endnotes

(1) On August 16 2013 draft legislative amendments were released by the Department of Finance which propose to exclude from the calculation of outstanding debts to specified non-residents 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. The amendment, which applies to tax years that end after March 28 2012, is intended to ensure that the thin capitalisation rules do not impede the ability of Canco's parent to finance 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.

(2) An elective transitional rule allows a trust to compute its equity as at March 21 2013 (the date on which the changes to the thin capitalisation 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.

(3) Excluded from the capital distribution calculation are distributions that are:

- included in the specified non-resident's income under Section 104 (13) of the Income Tax Act;
- subject to non-resident trust income withholding tax; or

- paid or payable to a person other than a specified non-resident beneficiary of the trust.

(4) Based on this 3:5 debt-to-assets ratio, the equity amount for a non-resident corporation or trust is generally computed as 40% 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 of the Income Tax Act 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) that are not included in its outstanding debts to specified non-residents.

(5) '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 (eg, an indemnity, compensation or 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 that 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.

(6) See Suarez, "Canadian 2012 Federal Budget: Tightening the Screws", *Tax Notes Int'l*, April 16 2012, p 247.

(7) The enhanced 35% SR&ED investment tax credit rate available to eligible Canadian-controlled private corporations on up to C$3 million of qualified SR&ED expenditures annually remains unchanged.

(8) See CRA document 2008-0304441I7, March 23 2009.

(9) See www.fin.gc.ca/treaties-conventions/notices/barbados-barbade-eng.asp.

(10) Notices of Canadian tax treaty developments and copies of Canadian tax treaties are posted on the Department of Finance's website at 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 on which the treaty entered into force).

(11) For a detailed review of these rules and amendments proposed by the Department of Finance on August 16 2013, see Suarez, "New Foreign Affiliate 'Dumping' Rules Are Major Tax Policy Change for Canada", *Tax Notes Int'l*, December 17 2012, p 1145; and Suarez, "Canada Releases Foreign Affiliate Dumping Amendments", *Tax Notes Int'l*, September 2 2013, p 864.

(12) A Canco is generally required to file its tax return for a particular tax year within six months of its year end.

(13) The Section 15(2) income inclusion rule does not apply to:

- debts owing by another Canco;
- amounts owing between non-residents 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.

(14) Look-through provisions extend these rules to debts owed by and to partnerships in most cases.

(15) Currently 5.02% – see www.cra-arc.gc.ca/nwsrm/rlss/2013/m09/nr130923-eng.html.

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

(17) See *supra* note 1.

(18) Or a partnership of which a Canco foreign affiliate is a member.

(19) Debts that were outstanding on that date are grandfathered until August 19 2016. Anti-avoidance rules have also been enacted that catch back-to-back loan arrangements.

(20) 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.

(21) That is, a deduction that is added back to income the following year.

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