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by Steve Suarez

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Canadian Year-End Tax Planning Deadlines for 2015

by Steve Suarez

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The end of the calendar year brings various recurring tax planning deadlines under the Income Tax Act (Canada). The author reviews some of the most important deadlines in a cross-border tax context, using as a model a Canadian resident corporation with a December 31 tax year-end.

The end of the calendar year (which for many taxpayers is also the tax year) brings with it various recurring tax planning deadlines under the Income Tax Act (Canada). It is useful to review some of the most important deadlines in a cross-border tax context, and these are discussed below with reference to a Canadian resident corporation (Canco) with a December 31 tax year-end.

I. Accrued but Unpaid Expenses

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 is reversed. An expense incurred (debt owed) 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 debt to a non-arm's-length person in the taxpayer's 2013 tax year, the taxpayer must actually pay the expense by the end of the 2015 tax year to avoid having to add back the amount in its income for the 2016 tax year (see Figure 1).

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 example that arises is for interest expense to be owed by one member of a corporate group to another. Form T2047 must be filed by the due date of the taxpayer's income tax return for the following year (2016 in the above example).

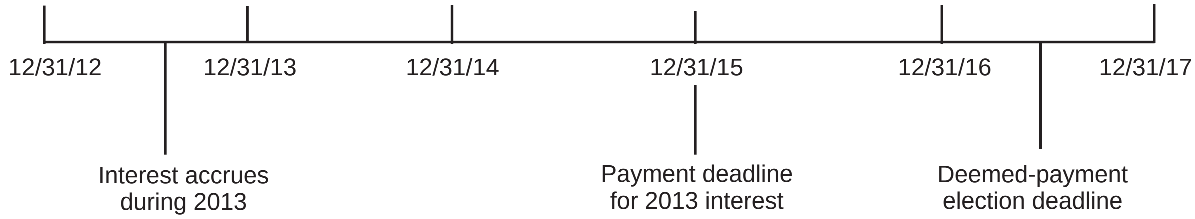
Another rule applies to a taxpayer's accrued but unpaid employee expenses — that is, salary, wages, pension benefits, retirement allowances, and other remuneration (except reasonable vacation or holiday pay or a deferred amount under a salary deferral arrangement). The taxpayer must pay any of those expenses 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.

II. Foreign Affiliate Dumping Rules

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 too broad, and encompass various transactions that should not be caught from a tax policy perspective, despite some positive changes made in 2014.

The FAD rules generally apply whenever a Canco controlled by a foreign corporation (parent) makes an

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



''investment'' in a non-Canadian corporation (Foreignco) in which Canco has a direct or indirect equity interest of at least 10 percent. When applicable, the rules will either reduce Canco's paid-up capital (PUC), which adversely affects Canco in various ways,[1] or deem Canco to have paid a dividend to the 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 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 those debts are repaid by Foreignco within the required 180-day period.

Further, if Canco's investment is a loan to Foreignco, Canco and the 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.[2] 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.[3]

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 the parent (or the parent's affiliates), triggering Canadian dividend withholding tax. However, when specific conditions are met, some or all of the deemed dividend can be replaced by a reduction in the PUC of one or more classes of the shares of Canco (or a related Canadian corporation). To achieve this result and avoid a deemed dividend under this 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). Under the applicable coming-into-force rules included with the enactment of this rule, the filing is deemed to have been made on a timely basis if the form is filed by the later of December 16, 2015, and Canco's tax return filing due date for its tax year that includes December 16, 2014.

III. Loans to Shareholders

There are limits on the extent to which a corporation can loan money to shareholders (or persons connected to shareholders) without the loan being treated as a de facto dividend. 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 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.[4] 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 this 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 owed to Canco that was incurred during its tax year that ended December 31, 2014, the deadline for repayment is December 31, 2015. 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

[1]PUC reflects amounts received by a corporation in exchange for issuing its shares and is a valuable tax attribute (particularly in a cross-border context). In particular, a corporation can make distributions on its shares as a return of PUC (instead of as a dividend) without dividend withholding tax applying, and PUC is included in a corporation's equity for thin capitalization purposes (*see* Section VI of this article).

[2]See Section III of this article for more discussion on these rules.

[3]A Canco is generally required to file its tax return for a particular tax year within six months of its year-end.

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

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) ITA. Essentially, the section 17.1 ITA 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 payable 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;[5]
- 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 ITA is not reduced under a 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[6] 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 ITA requires another 1.52 percent to 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 acquires control of a Canco that was not controlled by a nonresident corporation immediately before that time, 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 ITA 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.

IV. Benefit on Unpaid Interest

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[7] 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) ITA (described in Section III of this article).

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 could offset 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.

V. Debts Owing by Nonresidents

If a nonresident person owes an amount to Canco, a rule applies to ensure that Canco reports at least a minimum amount of interest on that debt. 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 its income for the year an amount equal to interest on the outstanding debt computed at a prescribed rate[8] (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 that nonresidents owe to Canco are repaid within the one-year time limit.[9]

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

[6]Currently 4.52 percent. *See* Canada Revenue Agency release on fourth-quarter interest rates (Sept. 16, 2015), *available at* http://news.gc.ca/web/article-en.do?mthd=tp&crtr.page=1&nid=1016839&crtr.tp1D=1.

[7]Currently 1 percent: *id.*

[8]*Id.*

[9]This 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.

Summary of Recurring Tax Deadlines

Event	Action/Deadline
Taxpayer incurred a deductible expense owed to a non-arm's-length person in its 2013 tax year.	Taxpayer must actually pay the expense by December 31, 2015 (or file a deemed-paid election), to avoid having to add back the deducted amount in income for its 2016 tax year.
Taxpayer accrues and deducts employee expenses (e.g., salary, wages, pension benefits) in its 2015 tax year.	Taxpayer must actually pay the expenses by June 28, 2016.
Foreign affiliate of foreign-controlled Canco incurs debt owed to Canco, to which the foreign affiliate dumping (FAD) rules would otherwise apply.	To exclude application of FAD rules, debts arising in the ordinary course of Canco's business (e.g., trade debt) must be repaid within the permitted 180-day period. For other debts, consider electing to opt into the section 17.1 ITA 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, and the resulting deemed dividend otherwise arising could be replaced with a reduction in the paid-up capital (PUC) of shares of Canco (or a related Canadian corporation).	When the FAD rules apply and the PUC of shares could be reduced in place of a deemed dividend under the PUC offset rule, the prescribed form with the required information must be filed in time to prevent the deemed dividend.
Canco shareholder (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 2014 tax year, except when debtor is a Canadian corporation.	Ensure the debt is repaid by December 31, 2015; 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).
Canco shareholder (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, 2016. 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 during Canco's 2015 tax year on which interest accrues at a rate less than a reasonable rate.	The debt must be repaid within one year after it arose; otherwise, Canco must include in its income for the 2015 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 (either a nonresident shareholder holding at least 25 percent of Canco's shares or a nonresident that does not deal at arm's length with such a shareholder) that remains outstanding at the end of Canco's 2015 tax year.	Review amounts owed to specified nonresidents and estimated Canco equity for the start of 2016 to ensure compliance with 1.5-1 debt-to-equity limit; if necessary, reduce the amount of such debt or increase Canco equity for thin capitalization purposes before January 1, 2016.
During 2015, 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.	The debt must be repaid within two years after it arose; otherwise, Canco must include the amount of the debt in its income for the 2015 tax year (unless an exception applies). For amounts included in income under this rule, compute and preserve tax attributes allowing Canco to offset year-by-year reserve.

Some debts are excluded from this rule, including:

- debt described in Section III of this article that has been deemed to be a dividend subjected 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 controlled foreign affiliate (CFA) of Canco that relates to an active business carried on by the CFA (or another CFA of Canco); and

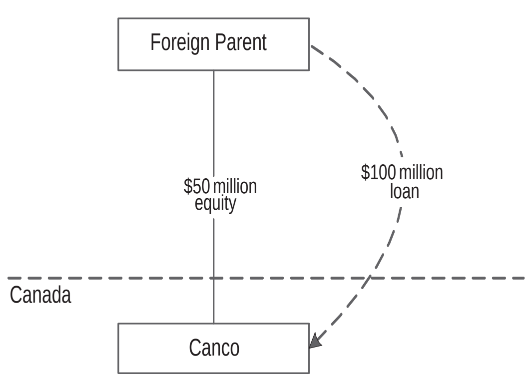
- debt that Canco and its foreign parent corporation have elected to make subject to the interest inclusion rule in section 17.1 ITA (described in Section III of this article).

VI. Thin Capitalization

Canada's thin capitalization rules restrict the amount of interest-deductible debt that a Canco[10] can incur in connection with debts owed to related nonresidents so as to limit the potential for cross-border intragroup interest stripping. Essentially, these rules prevent Canco from deducting interest on outstanding debt owed to "specified nonresidents"[11] to the extent that the debt exceeds 150 percent of Canco's equity.

For example, a Canco that owes $100 million to its foreign parent and has only $50 million of equity for thin capitalization purposes will be able to deduct interest expense relating to only $75 million of that debt (see Figure 2). Interest on the remaining $25 million of debt will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend, to which 25 percent Canadian nonresident dividend withholding tax will apply (subject to reduction under an applicable tax treaty), instead of as interest.

Figure 2. Basic Thin Capitalization Example



The 1.5-1 debt-to-equity ratio used in the thin capitalization rules requires annual computation of Canco's outstanding debts to specified nonresidents and Canco's equity. For this 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 amount by the number of those calendar months (that is, to produce an average). Under back-to-back loan rules that became effective in 2015, debts owed by Canco to a creditor who is not a specified nonresident may be deemed to be included in its outstanding debt to specified nonresidents if certain secondary obligations exist between Canco's actual creditor and a specified nonresident regarding Canco. (Prior coverage: *Tax Notes Int'l*, Oct. 27, 2014, p. 357.)

Canco's equity is calculated as the sum of the following three amounts:

- Canco's unconsolidated retained earnings at the beginning of the year;
- Canco's total of the start-of-month contributed surplus contributed by its specified nonresident shareholders[12] for each calendar month ending in the year, divided by the number of those calendar months; and
- the total of the start-of-month PUC of Canco shares owned by its specified nonresident shareholders 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). The various computational nuances make it particularly important for Canco to monitor its debt and equity for thin capitalization purposes and to review its retained earnings before the beginning of 2016, 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). In particular, careful consideration should be given to actions that would have the negative effect of reducing retained earnings as of the start of 2016.

VII. Loans From Foreign Subsidiaries

The upstream loan rules first 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).[13]

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[10]The thin capitalization rules apply not only to Cancos, but also to Canadian resident trusts and to nonresident corporations and trusts 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.

[11]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 who does not deal at arm's length with shareholders holding at least 25 percent of Canco's shares.

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

[13]For an overview of Canada's system of taxing dividends received by a Canco from a foreign affiliate, see http://miningtaxcanada.com/investment-outside-of-canada.

The upstream loan rules generally require Canco to include in its income an amount owed to a foreign affiliate of Canco[14] 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, 2012,[15] and are modeled on the existing domestic shareholder debt rules in section 15(2) ITA (discussed in Section III of this article). The following debts are excluded from the application of the upstream loan rules:

- debt described in Section III of this article 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 are made at the outset.[16]

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

[15]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.

[16]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.

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 these rules do apply to 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[17] for a particular 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 owed 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 that the debt is outstanding in order for Canco to continue 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. ◆

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