FEATURED PERSPECTIVES

An Analysis of Canada's Latest International Tax Proposals

by Steve Suarez

Steve Suarez is a partner with Borden Ladner Gervais LLP in Toronto.

On August 29 Canada's Department of Finance released a package of income tax amendments (the August 29 release) that included (1) revised versions of draft legislation implementing proposals announced in the federal budget of February 11, 2014 (the 2014 budget), and (2) draft legislation dealing with other areas of the Income Tax Act (Canada). Several of the proposed amendments in the August 29 release deal with Canada's international tax rules, the most salient of which are:

- A new, broadly worded anti-treaty-shopping rule overriding Canada's tax treaties proposed in the 2014 budget. The government is deferring action on this, pending developments from the OECD.
- Significant expansion of antiavoidance elements of Canada's thin capitalization and interest withholding tax rules dealing with so-called back-to-back loans, also proposed in the 2014 budget. While the revised proposal addresses the most significant concern raised with the initial version, unfortunately it makes other changes that make the back-to-back loan rules even broader.
- Various technical changes to the foreign affiliate dumping rules that were originally announced in the 2012 federal budget, some of which had previously been included in a technical amendments package in August 2013.

I. Anti-Treaty-Shopping Proposals

By far the most important (and controversial) initiative in the 2014 budget was the proposed new rule that would effectively constitute a unilateral override by Canada of its bilateral tax treaties. The proposal would establish a new ''one of the main purposes'' test, separate and apart from the existing general antiavoidance rule already in the ITA, as a basis for determining whether Canada will grant benefits it has agreed to grant in its more than 90 tax treaties with other countries.

The deficiencies of this domestic law anti-treaty-shopping proposal are substantial and have been the subject of extensive commentary.[1] Procedurally, it is difficult to understand why Canada would act unilaterally to effectively override its tax treaties without seeking the agreement of its treaty partners, particularly because very few countries are the source of the perceived concern and the OECD's base erosion and profit-shifting project is undertaking its own work on a multilateral solution. Substantively, the proposal would have set a very low threshold for denying treaty benefits, using a vaguely worded test (''one of the main purposes'') with virtually no judicial guidance on its meaning.[2] No reasoning has been offered for why the granting of treaty benefits should depend on whether one of the taxpayer's main purposes of a transaction

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[1]For prior coverage, see Suarez, ''Canada to Unilaterally Override Tax Treaties with Proposed New Anti-Treaty-Shopping Rule,'' *Tax Notes Int'l*, Mar. 3, 2014, p. 797; Michael Kandev, ''Canada Intent on Stoppin' the Shoppin' and More,'' *Tax Notes Int'l*, Mar. 31, 2014, p. 1201; and Jack Bernstein, ''Canada's Proposed Anti-Treaty-Shopping Rule: A Practitioner's Dilemma,'' *Tax Notes Int'l*, June 2, 2014, p. 845.

[2]The absence of any meaningful Canadian authority on this phrase is amply laid out in Nathan Boidman, '''One of the Main Purposes' Test,'' *Canadian Tax Highlights* (Canadian Tax Foundation), May 2014.

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was to obtain treaty benefits,[3] and Canadians making payments to which withholding tax applies are in no position to determine whether the purpose test has been met so as to deny treaty reductions in withholding tax rates.

In the press release accompanying the August 29 release, Finance states that ''after engaging in consultations on a proposed anti-treaty shopping measure, the Government will instead await further work by the Organization for Economic Co-operation and Development and the Group of 20 (G-20) in relation to their Base Erosion and Profit Shifting initiative.'' This constitutes a very welcome development, and the government deserves credit for giving a multilateral solution a chance to develop.

The proposals made by the OECD in the March 14 discussion draft, ''BEPS Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances),'' raised significant concerns,[4] many of which remain following the September 16 release of the final action 6 deliverable. Tax authorities working in this area have yet to articulate a persuasive tax policy basis for denying treaty benefits simply because a taxpayer's purposes in undertaking a transaction include seeking those benefits. Tax treaties are supposed to influence behavior and aid cross-border investment that might otherwise not occur. Overbroad antiavoidance rules have a cost, just as tax avoidance does, and any solution must accept that taxpayers need meaningful interpretational certainty before undertaking transactions whose tax impact over many years must be factored into the initial investment decision. Broad, vaguely worded, one-size-fits-all rules that effectively amount to a subjective smell test and do not produce readily predictable outcomes will not achieve the commerce-aiding objective of tax treaties. In any event, Finance should be commended for making the right choice to wait for the OECD proposal on this issue.

II. Back-to-Back Loan Rules

A. Background

Also included in the 2014 budget was a proposal to address perceived tax avoidance relating to (1) Canada's interest stripping rules limiting the deductibility of interest expense on debt owing to connected nonresidents, and (2) withholding tax on interest paid or credited by a Canadian resident to a nonresident of Canada.[5] Briefly, Canadian domestic law imposes 25 percent withholding tax on interest paid by a Canadian to a nonresident only when (1) the nonresident does not deal at arm's length with the payer, or (2) the interest is participating interest. When the recipient is fiscally resident in a country with which Canada has a tax treaty, the withholding tax rate is generally reduced to 10 percent, with the rate on nonparticipating interest under the Canada-U.S. treaty being zero when the recipient meets the limitation on benefits requirements.

Canada's thin capitalization rules limit the extent to which a Canadian resident corporation[6] (Canco) can deduct interest expense payable to a nonresident who is either a 25-percent-plus shareholder of Canco or someone not dealing at arm's length with such a 25-percent-plus shareholder (in either case, a specified nonresident). If the amount of debt owing by Canco to specified nonresidents (restricted debt) in a given year exceeds 150 percent of Canco's equity,[7] the thin capitalization rules apply to the interest on the excess debt. The result is that such excess interest is:

- not deductible in computing Canco's income; and
- treated as a dividend (not interest) for nonresident withholding tax purposes.

At its core, the back-to-back loan rule is meant to address situations in which Canco's foreign parent corporation simply inserts an intermediary between itself and Canco in order to get around both the interest withholding tax and thin capitalization rules. In Figure 1, for example, if Foreign Parent makes a loan to an arm's-length bank that in turn makes a corresponding loan to Canco, ostensibly (1) the withholding tax rate on interest paid by Canco is zero, and (2) the thin capitalization rules do not apply to Canco's debt, in both cases because Canco's creditor (the bank) is an arm's-length party.

It is entirely reasonable that Finance would see this as inconsistent with the tax policy behind the relevant provisions and hence unacceptable. The difficulty comes when incremental changes are made to this base case to produce results that are economically similar to the base case. For each such variation that is considered close enough to be encompassed by the rule, some further variation on that exists that arguably should also be caught — that is, A is clearly offensive and B is close enough to A that it arguably should also be

[3]The proposal contains no requirement for any finding of abuse or misuse, unlike Canada's existing GAAR, which was amended to explicitly encompass tax treaties over 10 years ago.

[4]Comments received by the OECD (including those made by this author) on the BEPS action 6 discussion draft can be found at http://www.oecd.org/tax/treaties/comments-action-6-prevent-treaty-abuse.pdf.

[5]For prior coverage, see Suarez, ''Canada's Problematic Proposed New Loan Rules,'' *Tax Notes Int'l*, May 5, 2014, p. 441.

[6]The discussion that follows is framed with reference to a debtor that is a Canadian corporation, even though Canada's thin capitalization rules now apply to debt incurred by other entities as well.

[7]Equity for this purpose consists of Canco's unconsolidated retained earnings, the paid-up capital (PUC) of Canco shares held by nonresident 25-percent-plus shareholders, and contributed surplus attributable to those shareholders.

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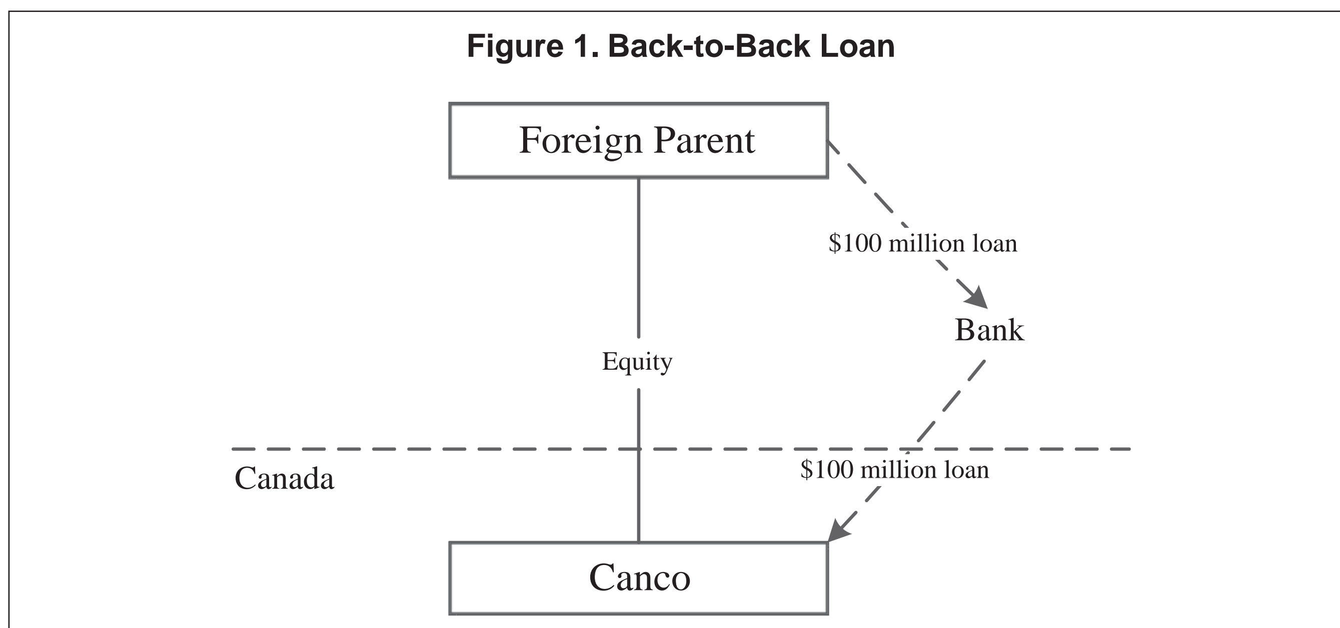
Figure 1. Back-to-Back Loan



caught, but should the fact that C is similar to B be enough to include C as well? As each variation moves further away from the core abuse scenario, it becomes harder to justify expanding where the line is drawn.

The original version of the back-to-back loan proposals clearly cast the net too broadly, essentially treating any secured guarantee of Canco's debt by a nonresident (as commonly occurs within multinational groups for purely commercial reasons) as the equivalent of a back-to-back loan (unsecured guarantees were not included). Notional cash pooling arrangements were also identified as potentially being caught, as was the posting of cash collateral to support borrowing activities. Treating these arrangements as the equivalent of back-to-back loans is unnecessary to achieve the desired tax policy result, and it will simply increase the cost of borrowing for the corporate group (including its Canadian members).

B. Revised Proposal

The version included within the August 29 release clearly reflects an intention to address the most obvious overreach of the original proposals, and again Finance should be commended for a willingness to rethink the proposal. While significant issues with the revised version remain (and indeed in some respects the revised rule is actually broader than the original version), due credit should be given for the changes that have been made.

The revised proposal contains the same basic architecture as the original version. In order for either branch (thin capitalization or interest withholding) of the back-to-back loan rule to apply, both of the following conditions must exist (see Figure 2):

- Canco has an obligation to pay an amount (the Canco debt) to a person or partnership (Creditor); and
- a secondary obligation meeting specific criteria exists between a nonresident of Canada (Nonresident) and Creditor or a person or partnership not dealing at arm's length with Creditor (in either case, a Creditor Party).

When these conditions exist, essentially:

- the thin capitalization element of the back-to-back loan rule will apply if Creditor is a good lender and Nonresident is a bad lender for thin capitalization purposes;[8] and
- the withholding tax element of the back-to-back loan rule will apply if the interest withholding rate applicable to Creditor is lower than the rate applicable on an interest payment from Canco to Nonresident.

The revised proposal makes specific changes to what constitutes a secondary obligation. Most importantly, it appears that Nonresident providing a Creditor Party with a mere security interest in property in support of the Canco debt will not in and of itself cause the rule to apply. Also, a new de minimis condition to the application of the rule has been created that is intended to prevent the rule from applying when the Canco debt

[8]That is, Nonresident is a specified nonresident (someone a loan from whom would be restricted debt for thin capitalization purposes), and Creditor is neither a specified nonresident nor a Canadian resident not dealing at arm's length with Canco so as to itself be subject to the thin capitalization rules on a loan from Nonresident).

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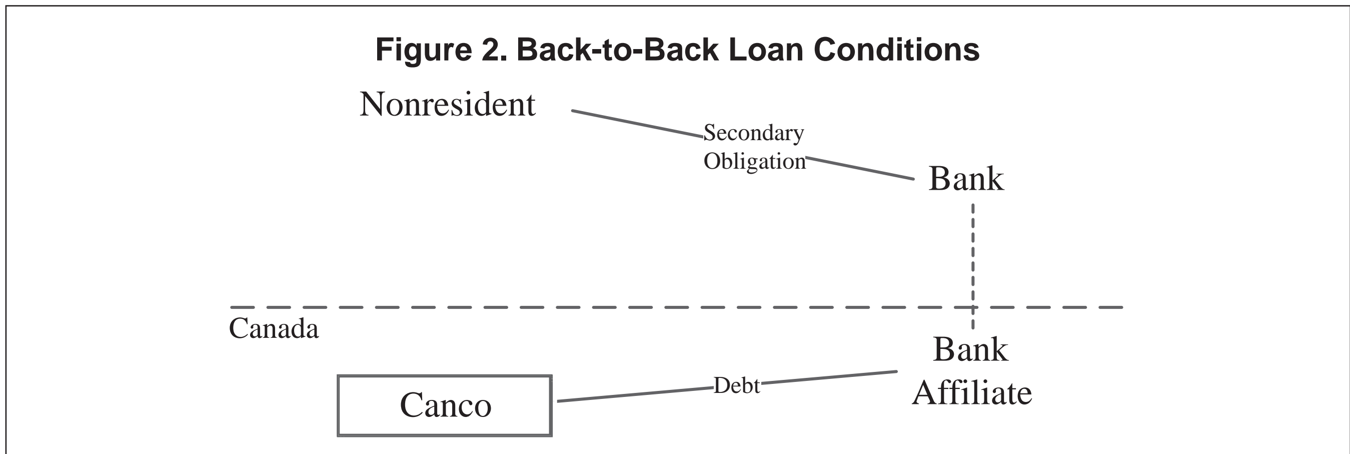

Figure 2. Back-to-Back Loan Conditions

is a relatively small part of a larger multinational group borrowing. However, the revised proposal also makes changes that expand the scope of the rule considerably, such that the revised proposal would actually seem broader than the original version.

1. Secondary Obligations — Revised Proposal

A secondary obligation between a Creditor Party and Nonresident may trigger the revised back-to-back loan rule in two circumstances:

- A Creditor Party has an obligation to pay an amount (the Creditor Party debt) to Nonresident that meets at least one of three conditions:
  - — Nonresident's recourse under the Creditor Party debt is in any way limited to the Canco debt;
  - — the Creditor Party debt was entered into on condition that the Canco debt be entered into, or vice versa;[9] or
  - — it can reasonably be concluded that if the Creditor Party debt did not exist, some or all of the Canco debt would not be outstanding or its terms and conditions would be different.[10]
- A Creditor Party has a specified right in a property (a Creditor Party property) that was granted directly or indirectly by Nonresident and that meets either of two conditions:
  - — that specified right is required under the terms of the Canco debt; or
  - — it can reasonably be concluded that if the Creditor Party did not have that specified right, some or all of the Canco debt would not be outstanding or its terms and conditions would be different.

A specified right regarding a property at any time means a right to (at that time) use, mortgage, assign, pledge, encumber, sell, or dispose of it. The explanatory notes accompanying the revised proposal state that a Creditor Party ''will not be considered to have a specified right in respect of a property solely by virtue of having been granted a security interest in the property.'' Why this could not have been stated explicitly in the draft legislation is unclear, but it is well established that Canadian tax courts will use these explanatory notes as an interpretative aid in administering the provisions of the ITA, and so this statement should have real meaning.[11] As such, it would certainly appear that the revised back-to-back loan rules will not apply simply because a nonresident has provided security to a Creditor Party to support the Canco debt (although it is essential to carefully review the precise terms of the security arrangement to see whether the security holder's rights for the property allow it to do things that would constitute a specified right).[12] This constitutes a significant improvement over the original proposal.

Unfortunately, however, other changes in the revised version of the back-to-back loan rules expand their scope significantly. For example, the revised proposal deletes a requirement in the original proposal that the secondary obligation has been entered into as part of the same series of transactions that includes the creation of the Canco debt. Moreover, the scope of Creditor Party debt that can constitute a secondary obligation is actually greater under the revised proposal compared with the original version, since under the revised version now a secondary obligation will exist if:

[9]The vice versa element did not exist in the original proposal.

[10]This form of secondary obligation did not exist in the original proposal.

[11]The wording of the term ''specified right'' suggests that once a default or similar event occurs that gives the Creditor Party the right to pledge or sell the relevant property, a specified right likely comes into existence at that time.

[12]For example, it is understood that some standard form derivatives agreements give a holder of property securing the obligations the right to pledge it.

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- recourse under the Creditor Party debt is limited to the Canco debt *in whole or in part*;
- the Canco debt was entered into on condition that the Creditor Party debt be entered into; or
- it is merely reasonable to conclude that if the Creditor Party debt did not exist, some or all of the Canco debt would not be outstanding or its terms and conditions would be different.

The last of these is especially troubling because there are many benign circumstances imaginable in which the presence of the Creditor Party debt might conceivably have affected the terms and conditions of the Canco debt in some way or another. As a result, very little nexus between two debts is required to create a secondary obligation, particularly with (1) the removal of the requirement in the original version that the Canco debt and the Creditor Party debt be part of the same series of transactions, and (2) the absence of any materiality threshold for the Creditor Party debt's effect on the terms and conditions of the Canco debt. It is hoped that the final version of the back-to-back loan rule will set the bar higher. It will be difficult in practice to demonstrate that the presence of the Creditor Party debt had no effect whatsoever (no matter how immaterial) on the terms and conditions or amount outstanding of the Canco debt, and indeed there is no obvious tax policy reason to treat any such Creditor Party debt as the equivalent of a back-to-back loan: They are simply not comparable. The result is that the revised version of the back-to-back loan rules is even broader than the original proposal and beyond what seems logical as a matter of tax policy or workable from a practical perspective.

2. New De Minimis Test

A significant improvement in the revised proposal is a new test that seems to be intended to address situations in which the Canco debt is part of a larger multinational group financing arrangement, this being a major complaint from the business community with the original proposal.

Expressed generally, the de minimis condition provides that the back-to-back loan rule will not apply if all secondary obligations regarding the Canco debt are less than 25 percent of the sum of the Canco debt plus specific other debts. More specifically, under the de minimis condition, the back-to-back loan rule will not apply to a particular Canco debt if A/B < 25 percent, for which:

A = all Creditor Party debts and the fair market value of all Creditor Party property for that Canco debt; and

B = the amount of the Canco debt, plus the amount of any other debt owing to Creditor by Canco or a person or partnership not dealing at arm's length with Canco (in either case, a Canco Party) if that other debt:

— arose under the same agreement creating the Canco debt or an agreement connected to that Canco debt agreement; and

— is secured by a security interest granted to Creditor in a Creditor Party property, if each such security interest also secures every other Canco Party debt included within item B.

The de minimis test is stated in the accompanying explanatory notes as being ''intended to provide possible relief where [Creditor] enters into multiple cross-collateralized debts owing to [Creditor] by multiple group entities, including [Canco].'' The explanatory notes include examples of the application of the de minimis test to cross-collateralized debts and to a notional cash pooling arrangement whereby a foreign parent puts money on deposit with a bank to support borrowings from that bank by a Canadian subsidiary and a foreign subsidiary.

While Finance is to be commended for trying to accommodate typical multinational group borrowing arrangements, unfortunately the de minimis test as proposed is at best only a partial solution. Fundamentally, the 25 percent de minimis threshold is too low, and the conditions required for another debt owing by a Canco Party to be included in the denominator of the 25 percent test (that is, in item B above) are too strict:

- the creditor must be Creditor itself, as opposed to any Creditor Party;
- the security interests relating to the different debts must correspond quite closely for a Canco Party debt to be included in the denominator; and
- the different debts must arise under the agreement creating the Canco debt or an agreement that is connected to that agreement.

There is no obvious reason to require such a high degree of interconnectivity between the Canco debt and other Canco Party debts to include the latter in the denominator for purposes of the de minimis test, particularly given how much lower the degree of connectivity is between the Canco debt and the amount owing to Nonresident to create a Creditor Party debt and thereby trigger the rule. The de minimis exception may sometimes be helpful, but it will be difficult to prove satisfactorily in many cases, and it will not help at all in many other cases in which nothing offensive occurs from a tax policy perspective.

Despite a genuine effort to respond to concerns with the original proposal, it remains hard to discern what it is beyond simple back-to-back loans and genuine functional equivalents that Finance views as truly objectionable and how much there is in practice that would not be adequately covered by a more straightforward rule supported by the existing GAAR to capture abusive situations. It is hoped that Finance is open to further discussion with the business community to develop a simpler proposal that clearly sets out what is and is not abusive. The back-to-back loan rules apply starting in

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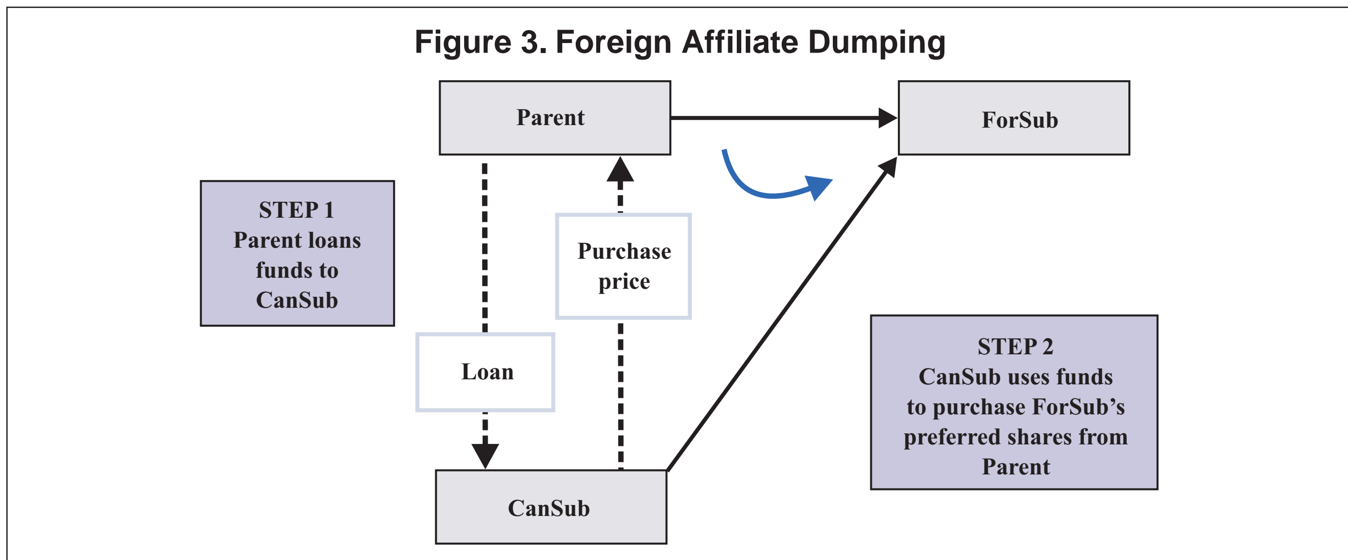

tax years beginning after (or to interest paid or credited after) 2014, with no grandfathering relief provided for existing debt.

III. Foreign Affiliate Dumping Amendments

Originally introduced in the 2012 federal budget,[13] the foreign affiliate dumping (FAD) rules reflect a perceived abuse of Canada's foreign affiliate rules dealing with foreign subsidiaries of Canadian corporations. Essentially, the FAD rules start from the premise that a Canadian corporation that is controlled by a foreign corporation generally shouldn't have foreign subsidiaries, and that these situations need to be policed so as to prevent investments in foreign affiliates as a method of either generating interest expense that reduces Canadian corporate income tax or extracting corporate surplus from Canada without triggering appropriate Canadian dividend withholding tax.[14]

A. Background

Under Canada's system of dealing with foreign subsidiaries of Canadian corporations, active business income earned by a foreign affiliate[15] of Canco is generally not subject to Canadian tax (either as it accrues or on repatriation to Canada). Moreover, interest expense incurred by Canco to invest in equity of a foreign affiliate is generally tax deductible against Canco's income. Finance was concerned that foreign multinational groups were causing their Canadian members to make investments in foreign affiliates that do not generate significant income taxes in Canada either (1) to generate interest expense deductions in Canada that reduce Canco's Canadian corporate income tax, or (2) as a way of distributing surplus cash out of Canada without paying Canadian dividend withholding tax.[16] Figure 3 illustrates the classic foreign affiliate dump that prompted these rules.

The FAD rules are targeted at transactions whereby foreign affiliates were dumped into Canada, but they go far beyond this fact pattern. Essentially, they apply when a corporation resident in Canada (Canco) that is controlled by a foreign corporation (Parent) makes an investment[17] in a corporation resident outside Canada

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[13]For prior coverage, see Suarez, ''Canadian 2012 Federal Budget: Tightening the Screws,'' *Tax Notes Int'l*, Apr. 16, 2012, p. 247.

[14]For prior coverage, see Suarez, ''New Foreign Affiliate 'Dumping' Rules Constitute Major Canadian Tax Policy Change,'' *Tax Notes Int'l*, Dec. 17, 2012, p. 1145; and Suarez, ''Canada Releases Foreign Affiliate Dumping Amendments,'' *Tax Notes Int'l*, Sept. 2, 2013, p. 864.

[15]Generally, a corporation resident outside Canada will be a foreign affiliate of Canco if:
- Canco owns at least 1 percent of the foreign corporation's shares (directly or indirectly); and

(Footnote continued in next column.)

- Canco and all persons related to Canco collectively own at least 10 percent of the foreign corporation's shares (directly or indirectly).

[16]For example, by purchasing equity of non-Canadian members of the multinational group.

[17]An investment in Foreignco may take a number of different forms, including:
- Foreignco becoming indebted to Canco (for example, a loan from Canco);
- the acquisition of Foreignco shares, directly or via an indirect acquisition (acquisition of shares of another Canadian corporation, more than 75 percent of the value of whose assets consists of shares of foreign affiliates); or
- a contribution of capital to (or conferral of a benefit on) Foreignco.

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(Foreignco) that is a foreign affiliate of Canco. More specifically and subject to very limited exceptions, the charging provision of the FAD rules applies when:

- Condition (1): Canco is controlled by Parent at the time of Canco's investment, or becomes so controlled as part of the same series of transactions that includes the making of Canco's investment (the Relevant Series); and
- Condition (2): Foreignco is a foreign affiliate of Canco immediately after the investment, or becomes a Canco foreign affiliate as part of the Relevant Series.

While the details are much more complicated, a simplified description of the relevant analysis (illustrated in Figure 4) is as follows:

- *Charging Rule*: Determine if both conditions of the charging rule are met.
- *Exceptions*: If both conditions are met, determine whether any exceptions to the FAD rules apply.[18]
- *Consequences*: If no exception applies, determine whether the result of the FAD rules applying is Canco being deemed to have paid a dividend (triggering dividend withholding tax) or a reduction in Canco's paid-up capital (PUC).[19] In some cases it is possible for a Canadian corporation other than Canco to be deemed to have paid any dividend or to have its PUC reduced, or for a nonresident entity other than Parent to be deemed to have received any deemed dividend.

The August 29 release helpfully amends the charging rule by providing a safe harbor for some relatively narrow fact patterns in response to prior submissions.[20] It also includes important changes to other elements of the FAD rules. In some cases the changes were included in a previously announced package of technical amendments released on August 16, 2013, while others are new. The amendments to the FAD rules in the August 29 release come into force at different times; for example, some apply to transactions and events occurring after March 28, 2012 (subject to an election to have them apply after August 14, 2012), while others apply only after August 28, 2014. As such, it is important for taxpayers who have undertaken transactions after March 29, 2012, to review these amendments carefully to see if they have been affected or if new filing requirements have been created.

B. Exceptions to the FAD Rules

1. PLOIs

The first exception to the FAD rules is for specific loans by Canco to Foreignco pertinent loans or indebtedness (PLOIs) in respect of which Canco and Parent jointly elect, whereby Canco is deemed to earn at least a minimum amount of interest income on the loan.[21] The basic principle is that if Canco's investment is generating enough taxable income in Canada, there is no need to invoke the FAD rules.

This exception remains unchanged in the August 29 release, although an important related change (originally included in the August 16, 2013, version) is being made to the thin capitalization rules. Basically, to the extent that Canco has itself incurred indebtedness in order to make a loan that constitutes a PLOI, Canco's indebtedness will not be subjected to the thin capitalization limitations on interest deductibility. Thus, for example, if Parent makes a loan to Canco that Canco in turn uses to make a loan to Foreignco that is a PLOI, the thin capitalization rules will not apply to the Parent-Canco loan: The interest expense from that loan can be deducted for Canadian tax purposes (for example, against the interest income from the PLOI owing by Foreignco). This is a logical and welcome initiative, and the August 29 release actually broadens it somewhat by encompassing not only loans made to Canco but also loans made to any Canadian resident corporation not dealing at arm's length with Canco, to accommodate situations in which there is more than one member of the Canadian group.

2. Closest Business Connection

The second exception from the FAD rules is a rule that Finance describes as being intended to allow Canco to make a ''strategic acquisition of a business that is more closely connected to its business than to that of any nonresident member of the multinational group.''[22] As a practical matter, the preconditions to this closest business connection (CBC) exception are

[18]The FAD rules do not apply to:

- specific forms of debt investments;
- investments occurring on specific corporate reorganizations such as a merger of Canco with another entity; and
- investments in Foreigncos deemed to have a closest business connection to Canco.

[19]The PUC of a class of a corporation's shares essentially represents amounts received by the corporation from persons subscribing for these shares on their issuance. PUC is a valuable tax attribute because:

- property distributed by a corporation as a return of PUC does not attract dividend withholding tax; and
- Canada's thin capitalization rules use PUC as part of the limit on permissible interest expense.

[20]For example, the August 29 release includes a previously announced change from the August 16, 2013, version meant to preclude the charging rule from applying to transactions occurring as part of a creeping takeover, namely, transactions occurring at a time when Parent owns less than 25 percent of Canco (by votes and value), but as part of the same series of transactions that ultimately results in Parent acquiring control of Canco.

[21]The prescribed rate is adjusted quarterly; for the fourth quarter of 2014 it is 4.94 percent.

[22]*See* explanatory notes accompanying the August 16, 2013, proposals.

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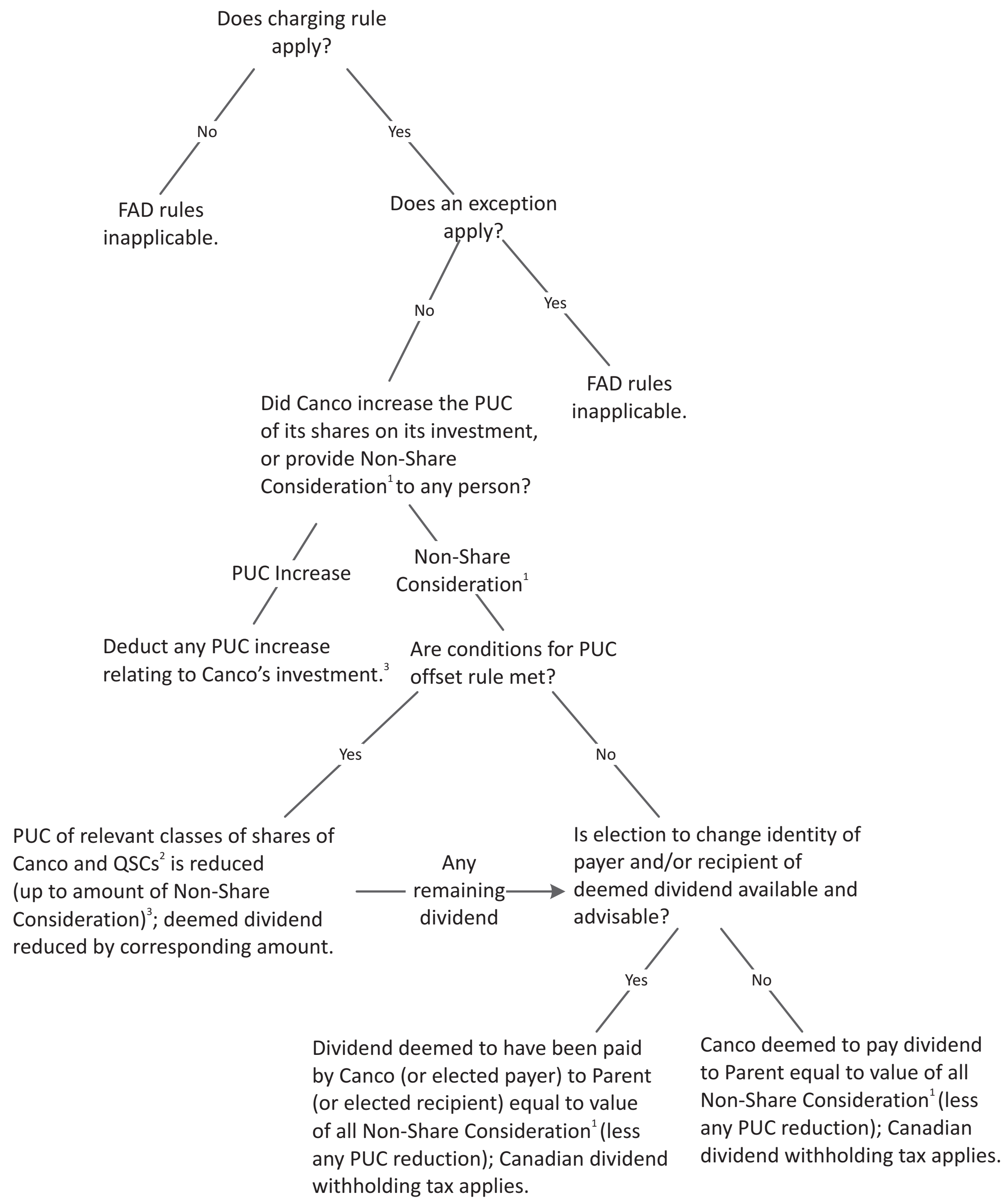
Figure 4. Summary of FAD Analysis



1. "Non-Share Consideration" means any property (other than Canco shares) transferred by Canco, any obligation assumed by Canco, or any benefit conferred by Canco or any property transferred to Canco that reduces an amount owing to it, to the extent reasonably relating to Canco's investment.
2. A QSC is a Canadian resident corporation (1) that is controlled by Parent or a nonresident corporation not dealing at arm's length with Parent, (2) that owns shares of Canco directly or indirectly, and (3) at least one share of which is owned by Parent or a nonresident corporation not dealing at arm's length with Parent.
3. PUC that has been reduced may be subsequently reinstated in certain circumstances.

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very difficult to satisfy (or to prove they have been satisfied), and as a result it is unlikely to be of use to many taxpayers.

The CBC exception is based on showing that officers of Canco were sufficiently in control of, and responsible for, Canco's investment in Foreignco. Specifically, the CBC exception requires that Canco officers (most of whom are resident and working principally in Canada or specific other countries):

- exercised principal authority over Canco's decision to make the investment in question;
- are reasonably expected to continue to exercise principal decision-making authority over Canco's investment; and
- will have their performance evaluation and compensation based on the operating results of Foreignco to a greater extent than the performance evaluation and compensation of any officer of any other non-Canadian member of the multinational group (excluding Foreignco or corporations controlled by either Foreignco or specific controlled foreign affiliates).[23]

The August 29 release proceeds with a previously announced change to allow officers of a Canadian corporation that does not deal at arm's length with Canco (as well as officers of Canco) to qualify as good officers for purposes of these tests. This change could be useful in situations in which there are multiple Canadian members of the multinational group. But unfortunately the fundamental limitations of the CBC exception remain, such that it will continue to be of very little practical benefit to most taxpayers. The proper fix would be an exception for bona fide business transactions made without a primary tax motivation, as existed in the original March 2012 version of the FAD rules.

The CBC exception also includes a favorable indirect funding rule that essentially provides that if a direct investment by Canco in Foreignco would have come within the CBC exception, achieving the same result by having Canco make an investment in another controlled foreign affiliate that in turn uses the investment within 30 days to make a loan to Foreignco will not trigger the FAD rules, so long as Foreignco uses the proceeds of the loan to earn active business income. The August 29 release expands this exception to broaden the range of qualifying uses to which Canco's investment can be put. Essentially, the exception will apply so long as the intermediate controlled foreign affiliate uses the property received from Canco to invest in Foreignco in such a way that any resulting income earned by the intermediate entity would be recharacterized as active business income related to Foreignco's business under Canada's CFC rules. An example would be a loan made by the intermediate controlled foreign affiliate to Foreignco, which uses the loan proceeds to acquire shares of a third foreign affiliate of Canco that carries on an active business.

3. Corporate Reorganizations

The final exception to the FAD rules applies to various forms of corporate reorganizations and distributions that technically constitute an investment in the sense that shares or debt of Foreignco (or in some cases a Canadian corporation) are being acquired, but without any substantive new transfer of value by Canco to Foreignco. The August 29 release makes a number of technical changes to this exception, generally providing relief.

Among the various changes included in the August 29 release are the following:

- the existing exception for Canco acquiring shares of Foreignco from a related Canadian resident corporation is expanded to include Canco acquiring debt of Foreignco as well;
- a useful new exception is created for Canco acquisitions of shares or debt of Foreignco occurring as part of an intragroup restructuring occurring after Canco has acquired control of another Canadian corporation that owns shares or debt of Foreignco;
- on an amalgamation of two or more related corporations to form Canco, the existing exception is expanded to correspond to the two preceding bullets, namely, to include Foreignco debt thereby acquired by Canco and accommodate post-acquisition of control restructurings; and
- the existing exception for Canco's acquisition of Foreignco shares on a number of specific exchanges and distributions provided for in the ITA is expanded to include a transfer of Foreignco shares to a partnership of exclusively Canadian partners in exchange for consideration that includes an interest in the partnership.

A further corporate reorganization exception exists for so-called indirect investments by Canco — that is, shares of another Canadian corporation, more than 75 percent of the assets of which consist of shares of Foreigncos. This exception is amended to incorporate the various changes described in the preceding bullets, as well as to enact previously announced changes to include within the corporate reorganization exception an amalgamation in which the resulting corporation is not Canco but a corporation in which Canco owns shares.

One tightening change (previously included in the August 16, 2013, proposals) is to exclude from the corporate reorganization exception property received as a repayment of a PLOI. When Canco's acquisition of property is received as whole or partial repayment of a

[23]For this purpose, persons who are officers of both Canco (or under the revised proposals, any Canadian corporation not dealing at arm's length with Canco) and specific non-Canadian members of the multinational group are deemed not to qualify as good officers.

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PLOI, the corporate reorganization exception cannot prevent the FAD rules from applying. As such, one cannot use the corporate reorganizations exception to acquire property on the repayment of a PLOI if acquiring that property directly would otherwise constitute an investment to which the FAD rules apply — for example, Foreignco issuing shares of itself to Canco in order to repay a PLOI. This prevents Canco from making a debt investment in Foreignco that is excluded from the FAD rules by virtue of a PLOI election and then exchanging the PLOI for another potentially bad property (for example, shares of Foreignco) and using the corporate reorganization exception to prevent the FAD rules from applying to that.

C. Consequences of Applying FAD Rules

When the charging rule applies and no exception is available, the basic result is as follows:

- If Canco has transferred any property (other than Canco shares) or incurred any obligation[24] in connection with its Foreignco investment, the value thereof is treated as a dividend paid by Canco to Parent.[25] This will generally trigger Canadian dividend withholding tax at a rate of 25 percent under the ITA, reduced to as little as 5 percent if the dividend recipient is resident in a country with which Canada has a tax treaty. Note that when Parent's share ownership of Canco is less than 100 percent, the FAD rules do not limit the dividend deemed to have been paid to Parent to Parent's proportionate amount of Canco's equity.
- If Canco has increased the PUC of its shares for its investment — for example, by issuing shares of itself to pay for the Foreignco investment — that PUC is reduced correspondingly. This loss of PUC effectively turns future Canco distributions that could otherwise have been treated as non-dividend PUC returns into dividends that will trigger dividend withholding tax.

These initial results may be modified in two ways:

- *PUC Offset*: In some cases, some or all of a deemed dividend otherwise resulting is automatically replaced with a corresponding reduction of the PUC of the shares of Canco or a related Canadian corporation (a qualifying substitute corporation (QSC)),[26] thereby deferring Canadian dividend withholding tax.
- *Election to Change Dividend Payer or Recipient*: An election can be made to change the dividend payer or recipient. Specifically, a dividend that would otherwise be deemed to be paid by Canco can instead be deemed to be paid by a QSC, and a dividend that would otherwise be deemed to have been received by Parent can instead be deemed to be received by another nonresident corporation not dealing at arm's length with Parent. Making this election (the substitution election) may reduce the Canadian dividend withholding tax exigible under an applicable tax treaty on a deemed dividend. Importantly, the version of the substitution election in the August 29 release no longer affects whether a deemed dividend is replaced by a PUC reduction under the PUC offset rule.

PUC that has been reduced under the FAD rules may in some circumstances later be reinstated to allow Canco (or a QSC) to make non-dividend distributions of property to its shareholders relating to the investment that originally triggered the PUC reduction under the FAD rules.

1. PUC Offset

The PUC offset mechanism whereby a deemed dividend is replaced by a PUC reduction is usually advantageous because it defers the imposition of Canadian dividend withholding tax until a later event (such as a distribution of property effected as a return of capital) that would otherwise use available PUC to prevent dividend withholding tax. Moreover, if PUC that has been reduced is later reinstated under the PUC reinstatement mechanism, the deferral of tax may be permanent.

The August 29 release significantly amends the PUC offset mechanism, causing it to apply in two circumstances and automatically (without any election being made). The more commonly applicable PUC offset rule will cause a deemed dividend to be replaced by a PUC reduction only for one or more cross-border class of shares of Canco or any QSCs. A cross-border class of shares is a class of shares of Canco or a QSC:

- in which Parent (or a nonresident corporation not dealing at arm's length with Parent) owns shares; and

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[24]Or received any property as a reduction of any amount owed to it.

[25]Any dividend under the current FAD rules is deemed paid at the time of Canco's investment. However, if Parent does not control Canco at the time of Canco's investment, under the August 29 release the dividend time is the earlier of: (1) the first time after the investment that Parent acquires control of Canco; or (2) one year after Canco's investment. This delay in the timing of any deemed dividend (or PUC offset replacing a deemed dividend) may be helpful if Canco's investment occurs before Parent acquires control of Canco (and as part of the relevant series of transactions). After the acquisition of control, Parent may be entitled to a lower dividend withholding tax rate under an applicable tax treaty (or there may be additional PUC that can be reduced in place of a deemed dividend).

[26]A QSC must have some direct or indirect share ownership in Canco (that is, it must be above Canco), and some QSC shares must be owned by Parent or a nonresident corporation that is not dealing at arm's length with Parent.

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- no more than 30 percent of which is owned by Canadian residents not dealing at arm's length with Parent.

The cross-border class limitation ensures that any PUC reduction will affect Parent and its affiliates in a meaningful way. This principle is further supported by a new antiavoidance rule that deems a class of shares not to be a cross-border class if specific transactions have been undertaken in order to increase the amount of a PUC offset on it.

Under this category of PUC offset, the deemed dividend otherwise resulting is reduced dollar-for-dollar by the amount of PUC in all cross-border classes of shares. When the deemed dividend produced by the FAD rules is less than the total available PUC of all cross-border classes of shares, the PUC reduction is applied to the class of cross-border shares for which Parent (or a non-arm's-length nonresident) owns the greatest proportionate share; any remaining unreduced dividend is then applied against the PUC of the cross-border class with the next-highest Parent ownership, and so on.[27] The intent is to ensure that this first category of PUC offset affects Parent and its affiliates to the greatest extent possible.

An example of this PUC offset mechanism is provided in Figure 5, in which Cansub makes an investment in the shares of Foreignco by purchasing them for $90 million, potentially triggering a $90 million deemed dividend. The cross-border classes of shares are those issued by Canco 1 and Canco 2, the deemed dividend is reduced to zero, and the PUC of the shares of Canco 1 and Canco 2 is reduced by $60 million and $30 million, respectively.[28]

The second form of PUC offset is more limited. It applies only to:

- a class of shares of Canco or a QSC that is, at the dividend time,[29] 100 percent owned by persons dealing at arm's length with Canco; and
- the extent of the PUC of that class of shares that was created on a transfer of property (directly or indirectly) to Canco, which Canco then used to make the investment that triggered the FAD rules.

To that extent, the deemed dividend otherwise resulting from that investment is replaced by the reduction of the PUC. In effect, PUC that was generated in the course of making the investment that triggers the FAD rules is reduced in place of a deemed dividend otherwise resulting.

The revised PUC offset rule contains an important filing requirement obligating Canco to file a prescribed form with the PUC and shareholder information relevant to the operation of the rule. Critically, if the form is not filed on time, the amount of any PUC reductions otherwise occurring under the PUC offset rule is deemed to be paid by Canco as a dividend to Parent — namely, the PUC reductions do not eliminate the deemed dividend. While late filing (upon payment of interest and penalties) may be available in some circumstances, the result seems unnecessarily harsh. The revised PUC offset rule is generally applicable to transactions and events occurring after March 28, 2012, potentially creating a retroactive filing requirement for transactions that have been completed. The required form is deemed to have been filed on a timely basis if it is filed within 30 days after the legislation that includes the revised PUC offset rule is formally enacted into law (likely near the end of this year).

2. PUC Reinstatement

When the PUC of a class of shares has been reduced by the FAD rules, some or all of that PUC may be reinstated later in two circumstances. The first case in which PUC may be reinstated is when:

- the Canco investment that triggered the FAD rules was:
  - — a contribution to Foreignco's capital;
  - — an acquisition of shares of Foreignco; or
  - — an acquisition of shares of another Canadian corporation, more than 75 percent of whose property is shares of one or more Foreigncos;
- the corporation that suffered the PUC reduction is making a distribution of property that reduces its PUC (that is, a return of capital rather than a dividend); and
- the property being distributed is shares of Foreignco.[30]

In these circumstances, the amount of the PUC reinstated is the portion of the value of the distributed shares that relates to the initial investment made by

[27]Because the PUC of each share within any class of shares is the same, a reduction in the PUC of a cross-border class will affect all the holders of shares of that class, not just Parent and its affiliates — it is not possible to reduce the PUC of some shares of a class (that is, those owned by Parent) and not others. If the Parent ownership percentage of two relevant cross-border classes is identical, then the PUC reduction is applied to both classes pro rata to their respective PUC amounts.

[28]A $90 million potential deemed dividend is applied to a total of $120 million of available cross-border PUC across two classes of cross-border shares with equal Parent group share ownership percentages (100 percent) to produce a 75 percent reduction in the PUC of each class — for example, $90 million/ $120 million x $80 million = a $60 million PUC reduction for Canco 1.

[29]*See supra* note 25.

[30]Or shares of another foreign affiliate of the distributing corporation that were substituted for those Foreignco shares.

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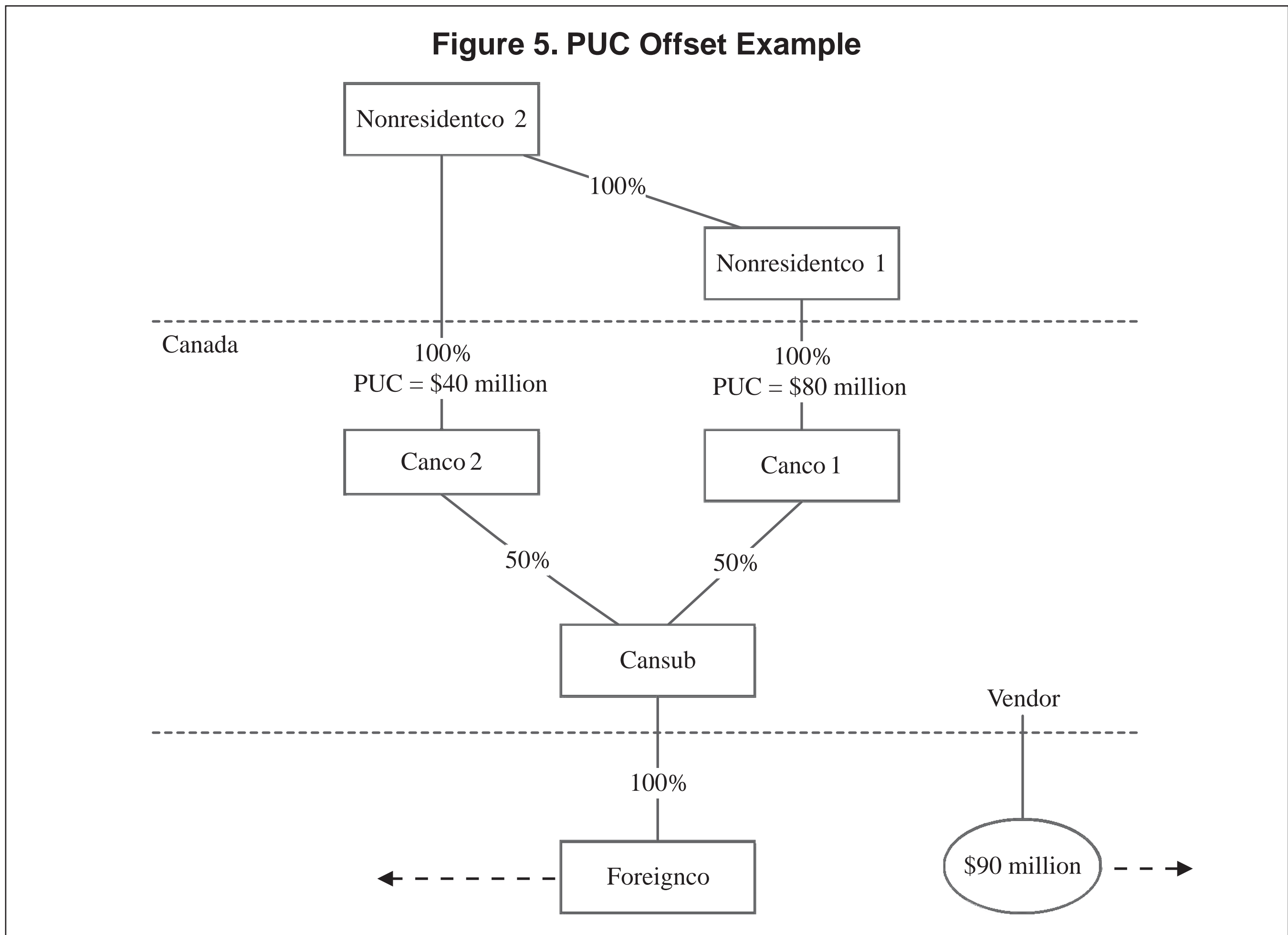

Canco (not exceeding the PUC reduction that previously occurred for that investment, of course).[31] Effectively, this form of PUC reinstatement allows an investment that produced a PUC reduction to be extracted from Canada later as a return of reinstated PUC without dividend withholding tax (up to the original value of the investment — any subsequent appreciation in value is not protected).

Figure 6 illustrates the operation of this form of PUC reinstatement for a Canadian corporation (Cansub) that originally purchased all of the shares of Foreignco for $100 million. This investment resulted in the PUC of the shares of Canco (a QSC regarding Cansub) automatically being reduced by $100 million under the PUC offset rule. When Cansub later distributes 60 percent of the Foreignco shares to its shareholders and Canco in turn distributes the Foreignco shares it received (48 percent) to Nonresidentco as a return of capital, the value of the shares distributed by Canco is $57.6 million,[32] 100 percent of which relates to the original $100 million investment. Because Canco is distributing 48 percent of the originally acquired Foreignco shares, $48 million of the originally reduced PUC is available to be reinstated, grossed up to $60 million[33] in this case to reflect that Canco bore the entire $100 million PUC reduction even though it only owns 80 percent of Cansub.

The second form of PUC reinstatement is available for PUC that has previously been reduced as a result of any form of investment (not only share investments) that caused the FAD rules to apply. The subsequent event triggering this second form of PUC reinstatement is the receipt of property by either the corporation that suffered the earlier PUC reduction (that is, Canco or a QSC) or another Canadian resident corporation not

[31]If not all of the Foreignco shares that constituted Canco's original investment are being distributed, only a proportionate amount of the previously reduced PUC can be reinstated on the subsequent distribution.

[32]80 percent x 60 percent x $120 million.

[33]$48 million divided by Canco's 80 percent share ownership of Cansub.

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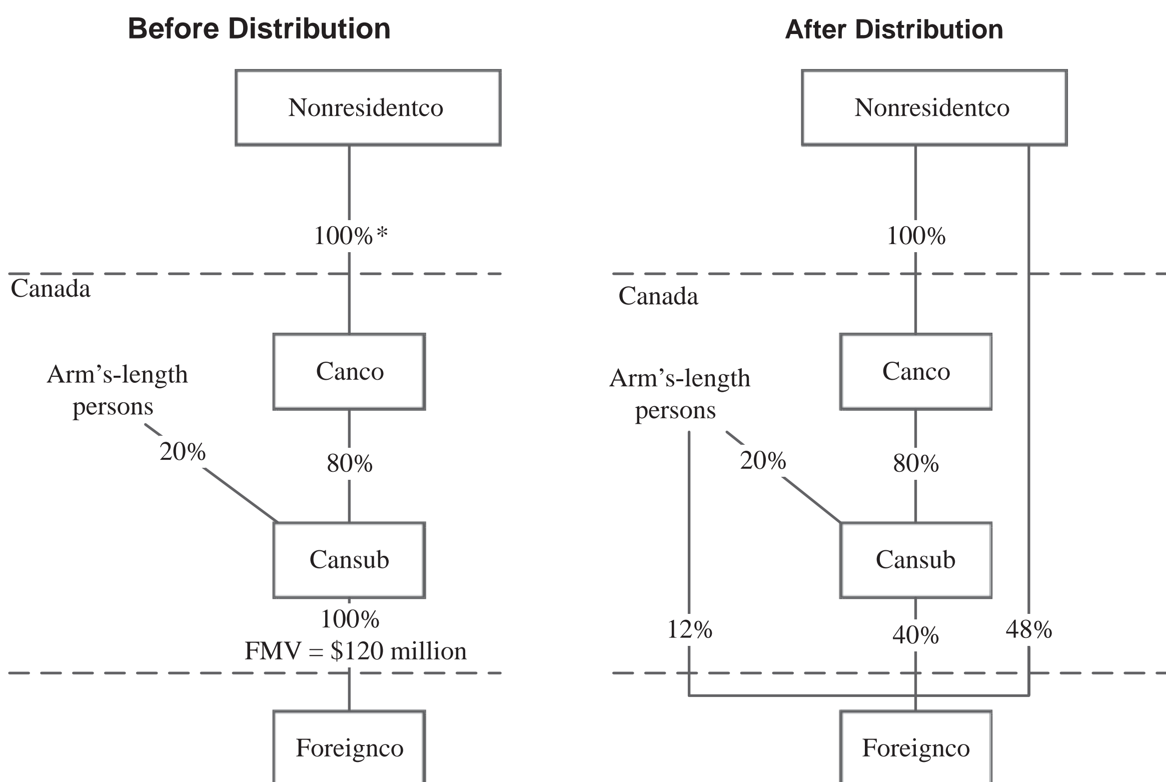
Figure 6. PUC Reinstatement Example



*PVC previously reduced by $100 million on Cansub purchase of Foreignco shares for $100 million.

dealing at arm's length with it. Essentially, PUC is reinstated when such a corporation receives various forms of income regarding the initial investment, such as:

- when the initial investment was Foreignco shares, proceeds of disposition from those shares,[34] or property received as a dividend or a return of capital on those shares;[35] or
- when the initial investment was Foreignco debt, interest or principal paid thereon, or sale proceeds therefrom.

The explanatory notes describe the purpose of this form of PUC reinstatement as follows:

> [The amount of PUC reinstated is] generally the amount received by a corporation resident in Canada on shares of, or debts owing by, [Foreignco] that can be traced to the investment that resulted in the prior reduction of PUC of shares of [Canco or the QSC]. The concept is that, if property is received in Canada from a disposition of a share, or debt, of [Foreignco] or from dividends, interest or returns of capital from [Foreignco], the value of that property represents a return of invested amounts and can no longer be considered an amount invested in [Foreignco]. Reinstating PUC therefore puts the particular corporation in the same position as if the amount had not been invested in the first instance.

This constitutes a meaningful expansion of the PUC reinstatement rule that will be useful in various situations. ◆

[34]Or other shares that relate to those shares.

[35]Or shares of a foreign affiliate of the PUC-reduced corporation that were substituted for the Foreignco shares.

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