BUDGET 2018: CROSS BORDER TAX PLANNING MEASURES TARGETED

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Budget 2018 introduced several international tax measures designed to address certain transactions through which taxpayers are potentially able to either strip surplus out of Canada free of tax or earn passive property income offshore while deferring or, in some cases, avoid altogether, Canadian taxation.

Cross-Border Surplus Stripping using Partnerships and Trusts

Paid-up capital in respect of shares ("**PUC**") is a valuable tax attribute, particularly for non-residents with Canadian subsidiaries. Unlike dividends, PUC can be returned by a Canadian corporation to its foreign shareholders free of Canadian withholding tax at any time and generally without regard to the level of the corporation's earnings. PUC is also one of the components in the computation of the "equity amount" in respect of a corporation for purposes of the Canadian thin capitalization rules. Generally, interest that is paid or payable by a Canadian corporation on debt owing to certain non-arm's length non-residents, that exceeds 1.5 times the equity amount of the corporation, will not be deductible and, in most cases, will be re-characterized as a dividend subject to withholding tax. As a result, the higher the equity amount in respect of shares of a Canadian corporation held by certain non-residents, the higher the amount of related-party interest-bearing debt that can generally be used to repatriate funds from Canada in the form of deductible interest, which, in the case of interest paid to related US residents, would be paid free of Canadian withholding tax.

Generally, the PUC in respect of shares of a Canadian corporation is equal to the amount that the corporation has received as consideration for the issuance of such shares. The starting point for the computation of PUC is the amount that is added to the stated capital account of a corporation that is maintained for the shares in question. Normally, such amount will be equal to the cash amount paid for the shares or the fair market value of any property transferred to the corporation in consideration for the issuance of the shares. Such amount is then adjusted pursuant to various rules contained in the Income Tax Act (Canada) (the "**Tax Act**").

One such rule, contained in section 212.1 of the Tax Act, is an anti-avoidance rule that is meant to prevent a non-resident shareholder of a Canadian corporation from using certain tax exemptions applicable to the sale of shares of a corporation, which are generally contained in Canada's numerous bilateral tax treaties, to artificially increase PUC, or strip surplus out of a Canadian corporation on a tax-free basis, using certain non-arm's length transactions. A typical example would involve a non-resident shareholder of a wholly-owned Canadian corporation (the subject corporation), with shares having PUC of $20 but a fair market value of $100, forming a new Canadian corporation (the purchaser corporation) to which it would transfer the shares of the subject corporation, generally on a tax-free basis pursuant to most of Canada's bilateral tax treaties, for shares of the purchaser corporation (alternatively, the transaction could be structured such that, in addition to shares, the purchaser corporation would issue a non interest-bearing promissory note to the non-resident shareholder, which can be repaid at any time free of Canadian withholding tax). Often, the subject corporation and the purchaser corporation would subsequently be amalgamated. But for the application of section 212.1, this would have resulted in a step-up in the PUC of the shares held by the non-resident shareholder from $20 to $100. However, the application of section 212.1 to such non-arm's length transfers prevents this step-up in PUC from occurring by limiting the amount of PUC of the shares of the purchaser corporation to the amount of PUC of the shares of the subject corporation (i.e., $20 in our example above). In addition, where non-share consideration is also paid by the purchaser corporation to the non-resident shareholder, the PUC of the shares of the purchaser corporation will be reduced by the amount of such non-share consideration and, if the amount of the non-share consideration exceeds the PUC of the shares of the subject corporation, the amount of such excess will be deemed to be a dividend paid by the purchaser corporation to the non-resident shareholder.

While section 212.1 applies to situations where shares of a corporation resident in Canada are transferred to another corporation resident in Canada, it does not address situations involving a transfer of shares of a Canadian resident corporation to other types of holding vehicles, such as a partnerships or trusts, or where interests in a partnership or a trust (that may themselves own shares of a Canadian resident corporation) are transferred by a non-resident person to a Canadian resident corporation. As noted in Budget 2018, this "gap" in the rules could, subject to the application of the general anti-avoidance rule, allow a non-resident shareholder of a Canadian resident subject corporation to form a partnership, transfer the shares of the subject corporation to the partnership, and then transfer the partnership interest to a newly formed wholly-owned Canadian resident purchaser corporation, and achieve the result that section 212.1 seeks to prevent.

Budget 2018 proposes to address the perceived "gap" by amending the Tax Act to add a comprehensive "look-through" rule for partnerships and trusts that will allocate the assets, liabilities and transactions of a partnership or trust to its members or beneficiaries, respectively, based on the relative fair market value of their interests such that, for purposes of applying section 212.1, a transfer by a non-resident person of an interest in a partnership which, in turn, owns shares of a Canadian resident corporation will be treated as if the non-resident person transferred the shares of the Canadian resident corporation directly.

A rule similar to section 212.1 applies in the context of corporate immigrations. In this regard, Budget 2018 also proposes amendments to the corporate immigration rules to prevent the use of partnerships and trusts to circumvent the application of the corporate immigration anti-avoidance rule.

Although no detailed legislative proposals were tabled with the release of Budget 2018, once the amendments are enacted, the measure will apply to transactions occurring on or after February 27, 2018.

Finally, in addition to PUC, contributed surplus is also one of the components of the computation of the "equity amount" in respect of a corporation for purposes of the Canadian thin capitalization rules. There are certain provisions in the Tax Act that allow a corporation to convert contributed surplus into PUC on a tax-free basis. Budget 2018 proposes specific amendments to the Tax Act that will exclude any contributed surplus that arose at a time when a corporation was a non-resident of Canada from the "equity amount" in respect of a corporation, as well as any contributed surplus that arose in connection with a disposition to which section 212.1 applies.

Foreign Affiliate Rules Tightened

Budget 2018 is also proposing certain modifications to the foreign affiliate rules in the Tax Act. The two principal proposed changes are in response to the implementation of certain structures that essentially circumvent the rules requiring that foreign accrual property income ("**FAPI**") of a controlled foreign affiliate of a Canadian taxpayer be taxed on an accrual basis in the hands of the Canadian taxpayer. For these purposes, FAPI generally includes all income from property of a passive nature, and specifically includes income from an "investment business", which is defined for these purposes as a business, the principal purpose of which is to derive income from property. However, the definition of an investment business specifically excludes certain businesses that would otherwise be considered to be an investment business where certain conditions are met, including that the affiliate carrying on the business employ more than five full-time employees in the active conduct of that business (referred to as the "six employee test"). The rationale behind this exception is that, if an affiliate's investment business activities are so significant that they require more than five full-time employees, the affiliate's business should be considered to be an active business and, therefore, income derived from that business should be excluded from FAPI.

Budget 2018 identified ways (each referred to in Budget 2018 as "tracking arrangements") in which Canadian taxpayers may be circumventing the application of the FAPI rules and thereby avoiding Canadian taxation of an affiliate's income on an accrual basis. "Tracking arrangements" involve taxpayers pooling their business assets in a common affiliate and implementing some form of tracking arrangement, either through the equity interests in the affiliate or through contractual arrangements, to retain control over the assets contributed and the return on such assets.

Tracking Arrangements

The primary "tracking arrangement" identified in Budget 2018 involves different foreign affiliates, presumably carrying on the same or similar investment businesses, which, when considered separately, would not warrant employing more than five full-time employees. Since the six employee test is applied on a business-by-business basis, as opposed to an affiliate by affiliate basis, none of these affiliates' businesses, considered separately, would be able to qualify for the exception to the investment business definition. However, if the affiliates were to pool all of their financial and other assets together in a common foreign affiliate, which then carries on the cumulative investment activities previously carried on by the separate corporations (and which, when aggregated, can now justify employing more than 5 full-time employees), taxpayers could take the position that the affiliate is carrying on a single investment business with more than five full-time employees and, therefore, claim that the business was excluded from the definition of investment business (and thus the resulting income of the affiliate was not FAPI).

Budget 2018 proposes to introduce a rule that, for the purposes of the investment business definition, would deem specific activities carried on by a foreign affiliate to be a separate business carried on by the affiliate where the income attributable to the specific activities accrues to the benefit of a specific taxpayer under what is referred to in Budget 2018 as a "tracking arrangement". As a result, each deemed separate business of the affiliate would need to satisfy the more than five full-time employee test on its own in order for the deemed separate business not to constitute an investment business.

No draft implementing legislation was released with Budget 2018 in respect of the foregoing proposals and, therefore, it is not known how the Department of Finance will define what constitutes a "tracking arrangement" for these purposes. This measure is intended to apply to taxation years of foreign affiliates that begin on or after February 27, 2018.

Controlled foreign affiliate status

Budget 2018 also suggested that Canadian taxpayers may be circumventing the application of the FAPI rules by using tracking arrangements to ensure that a foreign affiliate that is earning FAPI is not a controlled foreign affiliate of the Canadian taxpayer. As previously noted, only FAPI of a controlled foreign affiliate of a Canadian taxpayer is subject to tax on an accrual basis in the hands of the Canadian taxpayer. For these purposes, a foreign affiliate will be considered a controlled foreign affiliate of a Canadian taxpayer if the Canadian taxpayer controls the foreign affiliate, or would control the foreign affiliate if the Canadian taxpayer held all of the shares of the foreign affiliate that are held by (i) the Canadian taxpayer; (ii) persons with which the Canadian taxpayer does not deal at arm's length; (iii) any four other persons that are resident in Canada; and (iv) any non-resident persons that do not deal at arm's length with the persons in (iii).

Budget 2018 suggested that certain groups of Canadian taxpayers are using “tracking arrangements” to avoid controlled foreign affiliate status. Pursuant to such tracking arrangements, a group of Canadian taxpayers, presumably all of whom deal at arm’s length, once again collectively pool their assets in a single foreign affiliate and each Canadian taxpayer would retain control over its assets contributed and any returns from those assets would accrue exclusively to such Canadian taxpayer’s benefit. Provided the group of Canadian taxpayers is sufficiently large such that none of the Canadian taxpayers controls the foreign affiliate, each separate Canadian taxpayer can potentially take the position that the foreign affiliate is not a “controlled foreign affiliate” of that Canadian taxpayer. As a result, by artificially diluting control of a foreign affiliate, but not actually relinquishing any control of a particular business that is carried on by that foreign affiliate and that is generating FAPI, a Canadian taxpayer may effectively be able to avoid having FAPI taxed in its hands on an accrual basis, even though the Canadian taxpayer has retained full economic control over the assets of the business (and the income stream from those assets) that are generating the FAPI.

To address this type of planning, Budget 2018 proposes a rule that would deem a foreign affiliate of a Canadian taxpayer to be a controlled foreign affiliate of the Canadian taxpayer if FAPI attributable to activities of the foreign affiliate accrues to the benefit of the Canadian taxpayer under a “tracking arrangement”. As in the case of the changes proposed in Budget 2018 in respect of the investment business definition, no proposed implementing legislation accompanied the release of the Budget. This measure is intended to apply to taxation years of a foreign affiliate that begin on or after February 27, 2018.

Other measures affecting foreign affiliates

Where the principal purpose of a business carried on by a foreign affiliate is to derive income from trading or dealing in indebtedness, the income from that business is generally treated as FAPI of the affiliate. Similar rules apply to income of an affiliate derived from an investment business. Each of these rules contains an exception to the FAPI characterization of income for certain regulated foreign financial institutions; however, only the exception in respect of the “investment business” definition includes a minimum capital requirement. In order to ensure consistency, Budget 2018 proposes to add a similar minimum capital requirement to the trading or dealing in indebtedness rules. This measure will apply to taxation years of a foreign affiliate that begin on or after February 27, 2018.

In addition, Canadian taxpayers with foreign affiliates are currently required to file a Form T1134 in respect of each of its foreign affiliates within 15 months after the end of the taxpayer’s taxation year. Budget 2018 proposes to significantly reduce this timeframe by more closely aligning a Canadian taxpayer’s T1134 reporting requirement with the general filing due-date for the Canadian taxpayer by requiring the Forms to be filed within six months after the end of the taxpayer’s taxation year. For many Canadian multinational corporations, this reduced timeframe could prove to be a challenge, given that some of the information pertaining to its foreign affiliates may not be available within 6 months of the Canadian taxpayer's year end, and the focus of such Canadian multinationals is likely to be on completing their Canadian domestic tax filing obligations. This measure will apply to taxation years of a Canadian taxpayer that begin after 2019.

Finally, Budget 2018 contended that audits in respect of foreign affiliates are generally time consuming and they often involve issuing requirements for information located in foreign jurisdictions, as well as requesting information from a foreign jurisdiction that is tax treaty or TIEA partner. A three-year extended reassessment period currently exists in respect of assessments made as a consequence of a transaction involving a taxpayer and a non-resident with whom the taxpayer does not deal at arm's length. Although this three-year extension currently applies to many transactions involving foreign affiliates, it does not apply to all income associated with a foreign affiliate. As a result, Budget 2018 proposes to extend the reassessment period for a Canadian taxpayer by three years in respect of income arising in connection with a foreign affiliate of the Canadian taxpayer.

This measure will apply to taxation years of a Canadian taxpayer that begin on or after February 27, 2018.

by Michel Ranger

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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