JUNE 2014 ELECTION DEADLINES FOR RETROACTIVE APPLICATION OF NEW FOREIGN AFFILIATE REORGANIZATION RULES

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For those who have worked with the foreign affiliate reorganization rules in the Canadian *Income Tax Act* (the "Act"),[1] an unprecedented era of uncertainty is drawing to a close. With June 2014 deadlines for several one-time elections to apply the new rules retroactively, taxpayers will soon be able to determine with finality the full tax consequences of historic foreign affiliate transactions going back to December 20, 2002.

A Decade of Uncertainty

The foreign affiliate rules dealing with mergers, liquidations, and other distributions have been in flux since the release of a comprehensive package of draft proposals on February 27, 2004. The Department of Finance subsequently issued a series of comfort letters proposing to further modify these draft rules in significant respects. Meanwhile, Canadian corporations were faced with a highly uncertain regime when planning and implementing reorganizations involving their foreign affiliates, potentially governed by multiple possible regimes including the then current rules and various versions of the proposed rules and modifications.

On August 19, 2011, the Department of Finance released its definitive package of these foreign affiliate reorganization proposals. This release included new and broader versions of the foreign affiliate merger rollover in paragraph 95(2)(*d*.1), the lower-tier foreign affiliate liquidation rollover in paragraph 95(2)(*e*), the top-tier foreign affiliate liquidation rollover in subsection 88(3), and new subsection 90(2) deeming most *pro rata* foreign affiliate distributions to be dividends, together with the new election in Regulation 5901(2)(*b*) permitting dividends to be treated as pre-acquisition surplus dividends. With some modifications, these August 19, 2011, foreign affiliate proposals were incorporated into a massive technical Bill (Bill C-48), and were ultimately enacted into law on June 26, 2013, generally with effect for transactions occurring after August 19, 2011.[2]

However, the Department of Finance quite properly recognized the difficulty taxpayers had faced over the prior decade when transactions had to be completed without knowing exactly which particular foreign affiliate rules would ultimately apply. To address this historic uncertainty, Bill C-48 included a number of important, one-time transitional election opportunities allowing taxpayers to apply the final amendments (or modified versions) retroactively, even before August 19, 2011, to transactions occurring after December 20, 2002. Some of the available elections are due on or before June 26, 2014 (one year after Bill C-48 received Royal Assent), while others are due by the 2013 tax return filing deadline (June 30, 2014, for calendar year corporations).

With this package of retroactive election opportunities, the Department of Finance has given Canadian corporate taxpayers an important, time-limited choice for their historic, pre-August 19, 2011, foreign affiliate transactions. They can either disregard the foreign affiliate proposals up to that time and simply apply the then-enacted provisions (i.e., the old rules, together with all their acknowledged restrictions and defects), or instead, elect now to apply the new, improved, and generally more favourable foreign affiliate reorganization rules retroactively to those historic, pre-August 19, 2011, transactions.

To deal with this elective retroactivity, Bill C-48 permits reassessments, outside the normal reassessment period limits, "to the extent necessary", in order to take into account the retroactively applied foreign affiliate rules and corresponding elections. In many cases, the principal consequences of an election for retroactive application of these foreign affiliate rules would be adjustments to the taxpayer's historical surplus balances and adjusted cost base attributes.

The balance of this article describes the new foreign affiliate reorganization provisions as well as some of the key elections that should now be considered by Canadian corporations with foreign affiliates. Where there were historic transactions after December 20, 2002, involving foreign affiliate dividends, capital reductions, share repurchases, liquidations, or mergers, it may now be possible for taxpayers to clarify, protectively confirm, or even change the intended tax consequences of those transactions by making one or more of these elections before the applicable June 2014 deadline.

Regulation 5901(2)(b) and Subsection 90(2) — Foreign Affiliate Distributions

Regulation 5901(2)(*b*) permits a corporation to deem a dividend otherwise paid out of the surplus balances of its foreign affiliate to instead be a dividend paid out of the pre-acquisition surplus of the foreign affiliate. As a pre-acquisition surplus dividend, the effect is to reduce the shareholder's adjusted cost base of the foreign affiliate shares rather than access the relevant surplus balances of the foreign affiliate. If the basis of the shares is reduced to a negative amount, subsection 40(3) deems the negative amount to be a capital gain in respect of the foreign affiliate shares. Subsection 93(1.11) then deems an automatic subsection 93(1) election to deem the capital gain to instead be a dividend paid out of the relevant surplus balances. Thus a Regulation 5901(2)(*b*) election can upend the traditional surplus ordering rules by treating a foreign affiliate dividend as analogous to a capital distribution that reduces basis and by deferring the automatic elevation of surplus balances (including potentially adverse surplus attributes such as taxable surplus and hybrid surplus) until basis is first fully depleted.

Subsection 90(2) is a corollary rule that deems most foreign affiliate distributions made to shareholders on a *pro rata* basis to be dividends. Thus, a distribution which, for corporate law purposes, is a capital distribution (and would otherwise be treated as reducing the shareholder's adjusted cost base of the shares) will instead be deemed to be a dividend. However, taxpayers can electively replicate the intended "basis grind" effect of a capital distribution either by electing under new subsection 90(3) to treat the capital distribution as a "qualifying return of capital" or by electing under Regulation 5901(2)(*b*) to deem the dividend to be a pre-acquisition surplus dividend.

By default, new Regulation 5901(2)(*b*) and subsections 90(2), 90(3), and 93(1.11) all apply with respect to foreign affiliate distributions made after August 19, 2011. Bill C-48 permits taxpayers to electively apply Regulation 5901(2)(*b*) (together, as a package with subsections 90(2) and 93(1.11))[3] retroactively to foreign affiliate distributions made after December 20, 2002.[4]

To further elect to apply Regulation 5901(2)(*b*) to any particular foreign affiliate dividend, a taxpayer must further specifically elect in respect of that dividend before its tax filing due date for the taxation year in which the dividend was paid. For historical dividends where this election would now be late, Bill C-48 defers this deadline to June 26, 2014.[5]

By electing to apply Regulation 5901(2)(*b*) retroactively, and thereby electing to apply subsection 90(2) retroactively to deem each post-December 20, 2002 foreign affiliate distribution to be a dividend (regardless of whether it was, in fact, paid as a dividend or a capital distribution), taxpayers can either (i) choose to treat the particular distribution as a dividend that accessed the relevant surplus balances of the distributing foreign affiliate (by not further electing to apply Regulation 5901(2)(*b*) to that particular dividend or deemed dividend), or (ii) choose to treat the particular distribution as a pre-acquisition surplus dividend that accessed the basis of the foreign affiliate before potentially dipping into the relevant surplus balances of the distributing foreign affiliate (by further electing to apply Regulation 5901(2)(*b*) to that particular dividend or deemed dividend).[6]

For example, consider an historic foreign affiliate distribution paid for foreign corporate law purposes out of share premium, contributed surplus, or similar equity-type account where the Canadian tax treatment (as a dividend or capital distribution) might have been unclear. Or consider an historic dividend where the surplus balances might have been uncertain and there was a risk of elevating taxable surplus with insufficient underlying foreign tax. Alternatively, consider an historic capital distribution paid by a foreign affiliate with exempt surplus that might have subsequently been eroded by exempt losses. In each of these cases, the Canadian parent now has the time-limited opportunity to reconsider the originally intended surplus and basis consequences of the distribution. By strategically electing under Regulation 5901(2)(*b*) taxpayers may either preserve, clarify, or improve those consequences.

Paragraph 95(2)(d.1) — Foreign Affiliate Mergers

The former foreign affiliate merger rollover in paragraph 95(2)(*d*.1) has now been replaced by a broader (and generally more taxpayer-friendly) foreign affiliate merger rollover in new paragraph 95(2)(*d*.1), effective for foreign affiliate mergers after August 19, 2011.

The former paragraph 95(2)(*d*.1) rollover suffered from several limitations. In particular, it applied to a foreign merger (as defined in subsection 87(8.1)) only if the Canadian taxpayer had a strict 90% or greater surplus entitlement percentage in each predecessor foreign affiliate and in the merged foreign affiliate. The foreign merger had to satisfy a "foreign non-recognition" condition requiring that no gain or loss was realized by each predecessor foreign affiliate under its local tax law in respect of any of its capital property that became capital property of the merged foreign affiliate in the course of the merger. In addition, the rollover applied only to capital property of the predecessor foreign affiliates.

The new foreign affiliate merger rollover in paragraph 95(2)(*d*.1) has been amended, among other things, to eliminate the "90% surplus entitlement percentage" and "foreign non-recognition" conditions, and to broaden the deemed rollover disposition so that it applies to all property of the predecessor foreign affiliates, not just capital property.

Paragraph 95(2)(*d*.1) now applies where there has been a foreign merger, where one or more of the predecessor foreign corporations was a foreign affiliate of the taxpayer, and where the merged foreign corporation is a foreign affiliate of the taxpayer. Where it applies, each property of a predecessor foreign affiliate is deemed to have been disposed for proceeds of disposition equal to its relevant cost base and to have been acquired by the new foreign corporation at a cost equal to the same amount. In addition, a continuity rule deems the new foreign corporation to be the same corporation as, and a continuation of, each foreign affiliate predecessor corporation for various purposes.

Bill C-48 permits a taxpayer to elect to retroactively apply new paragraph 95(2)(*d*.1) to all of its foreign affiliate mergers occurring after December 20, 2002.[7] Consequently, taxpayers now have the one-time opportunity to elect to generally apply the broader rollover rule in paragraph 95(2)(*d*.1) retroactively to all post-December 20, 2002 foreign affiliate mergers. Where those mergers were originally intended to qualify for the narrower rollover under former paragraph 95(2)(*d*.1), the election to apply new paragraph 95(2)(*d*.1) retroactively could be considered "protective" since the effect would be to provide the same rollover relief but now under a provision that applies in a broader range of circumstances with fewer restrictions.

Paragraph 95(2)(e) — Lower-Tier Foreign Affiliate Liquidations

The former lower-tier foreign affiliate liquidation rollover in paragraph 95(2)(*e.1*) has been replaced by a broader (and generally more taxpayer-friendly) foreign affiliate liquidation rollover in new paragraph 95(2)(*e*). Like the new foreign affiliate merger rollover in paragraph 95(2)(*d*.1), new paragraph 95(2)(*e*) is effective by default for foreign affiliate liquidations after August 19, 2011, but can be electively applied retroactively to foreign affiliate liquidations after December 20, 2002.

The former paragraph 95(2)(*e.1*) rollover applied in relatively narrow circumstances. In particular, it applied only if the Canadian taxpayer had a strict 90% or greater surplus entitlement percentage in the liquidating foreign affiliate. The liquidation had to satisfy a "foreign non-recognition" condition requiring that no gain or loss was realized by the liquidating foreign affiliate under its local tax law in respect of any capital property distributed by it. In addition, the rollover applied only to capital property distributed by the liquidating foreign affiliate.

New paragraph 95(2)(*e*) replaces the "90% surplus entitlement percentage" and "foreign non-recognition" conditions with a "designated liquidation and dissolution" ("DLAD") requirement based on a broader range of 90% ownership tests (and without any foreign non-recognition requirement), and expands the scope of the rollover to all distributed property (not just capital property). A DLAD is defined in subsection 95(1) by reference to a foreign affiliate liquidation that meets one of three alternative "90% ownership" tests. The DLAD requirement is satisfied if either (i) the Canadian taxpayer had a 90% surplus entitlement percentage in respect of the liquidating foreign affiliate, (ii) one foreign affiliate shareholder holds shares of the liquidating foreign affiliate representing at least 90% of "votes and value", or (iii) one foreign affiliate shareholder owns at least 90% of each class of shares of the liquidating foreign affiliate.

If a foreign affiliate liquidation qualifies as a DLAD the distributed properties are deemed by subparagraph 95(2)(*e*)(i) to be disposed of for proceeds equal to the relevant cost base as well as deemed by subparagraph 95(2)(*e*)(iii) to be acquired by the shareholder foreign affiliate at the same cost amount (and thus a full rollover is available). Furthermore, pursuant to subparagraph 95(2)(*e*)(iv) each share of the liquidating foreign affiliate is deemed disposed of by the shareholder foreign affiliate generally for proceeds of disposition equal to the adjusted cost base of the share (i.e., on a full rollover basis without gain or loss recognition) with one new exception: If the shares of the liquidating foreign affiliate are excluded property, and the total cost of the distributed property is less than the shareholder foreign affiliate's adjusted cost base of the liquidating foreign affiliate's shares (such that there would otherwise be a loss), the shares are deemed disposed of for proceeds equal to the cost of the distributed property – i.e., the loss on the excluded property shares is realized and there is no rollover (thus resulting in a grind to the shareholder foreign affiliate's hybrid surplus or creating a hybrid deficit, under the post-August 19, 2011, rules).

If the foreign affiliate liquidation qualifies as a DLAD, a continuity rule in subparagraph 95(2)(*e*)(v) deems the shareholder foreign affiliate to be the same corporation as, and a continuation of, the liquidating foreign affiliate for various purposes.

Taxpayers may elect to retroactively apply new paragraph 95(2)(*e*) to foreign affiliate liquidations beginning after December 20, 2002, with the same deadline as applies for paragraph 95(2)(d.1).[8] However, where this election is made, a modified version of the DLAD definition, and of paragraph 95(2)(*e*) itself, applies for liquidations beginning after December 20, 2002, but before August 19, 2011.[9] The main difference is there is no forced loss realization (and surplus grind) for excluded property shares of the liquidating foreign affiliate.

Where a taxpayer's post-December 20, 2002, lower-tier foreign affiliate liquidations were originally intended to qualify for the narrower rollover rule under former paragraph 95(2)(*e*.1), an election to apply new paragraph 95(2)(*e*) retroactively could be considered "protective" since the same rollover relief would apply under a provision with fewer restrictions (and consequently more certainty). Moreover, due to the broadened DLAD concept, the new paragraph 95(2)(*e*) rollover could now apply to situations where the prior rollover clearly would not have applied (e.g., where a foreign affiliate has liquidated into a parent foreign affiliate in which the Canadian parent has less than a 90% interest).

Subsection 88(3) — Top-Tier Foreign Affiliate Liquidations and Property Distributions

The top-tier foreign affiliate liquidation rollover in subsection 88(3) has been amended with mandatory effect for foreign affiliate liquidations and dissolutions that begin after February 27, 2004. In general, new subsection 88(3) provides a full rollover for all distributed property of the liquidating foreign affiliate (and potentially also for the disposition of the shares of the liquidating foreign affiliate), provided the liquidation is a "qualifying liquidation and dissolution" ("QLAD").

QLAD status under subsection 88(3.1) is elective (unlike DLAD status, which is automatic where one of the 90% ownership conditions is satisfied). QLAD eligibility requires that the Canadian taxpayer own either (i) 90% or more of each class of shares of the liquidating foreign affiliate, or (ii) shares meeting a 90% of "votes and value" test. The taxpayer must then elect to treat the liquidation as a QLAD in accordance with Regulation 5911(1). The normal deadline for filing a QLAD election is the filing due date for the Canadian taxpayer's taxation year which includes the foreign affiliate's year-end for the year in which it distributed the property. However, Bill C-48 provides that any QLAD election that would otherwise be late may be timely filed within one year after the day on which Bill C-48 received Royal Assent, namely June 26, 2014.[10]

If the Canadian taxpayer satisfies one of the 90% ownership tests in subsection 88(3.1) and makes the required QLAD election, the liquidating foreign affiliate is deemed by paragraph 88(3)(*a*) to dispose of all distributed property for proceeds of disposition equal to relevant cost base (i.e., on a fully tax-deferred basis). By contrast, in a non-QLAD, only excluded property foreign affiliate shares are distributed on a tax-deferred basis — other property is deemed disposed for fair market value proceeds under paragraph 88(3)(*b*), potentially recognizing FAPI.

In either event, for a QLAD or a non-QLAD, the Canadian taxpayer is deemed under paragraph 88(3)(*c*) to acquire the distributed property at a cost equal to the liquidating foreign affiliate's proceeds of disposition (either at relevant cost base or at fair market value, whatever the case may be).

The shares of the liquidating top-tier foreign affiliate held by the Canadian taxpayer are deemed disposed under paragraph 88(3)(*d*) for proceeds equal to the "net distribution amount" which is, effectively, the cost to it of the distributed property, less any debt of the liquidating foreign affiliate that is assumed or cancelled upon the liquidation. If this net distribution amount exceeds the Canadian taxpayer's adjusted cost base of the shares of the liquidating foreign affiliate (generally, if the inside basis of the liquidating foreign affiliate exceeds the outside basis), the Canadian taxpayer would realize a gain in respect of the shares of the liquidating foreign affiliate. On the other hand, if the net distribution amount is less than the Canadian taxpayer's adjusted cost base of the shares of the liquidating foreign affiliate, the Canadian taxpayer would realize a loss (subject to any applicable stop-loss rule). If the taxpayer elects into QLAD treatment, its loss is deemed by paragraph 88(3)(*e*) to be nil.

Importantly, new subsection 88(3.3) provides for a "suppression election" opportunity, if the liquidation is electively treated as a QLAD, so as to "suppress" the cost of the distributed capital properties received by the Canadian taxpayer to the elected amounts.[11] The effect of a suppression election is to reduce the net distribution amount and to thus reduce the Canadian taxpayer's proceeds of disposition of the shares of the liquidating foreign affiliate. Therefore, a QLAD election combined with a suppression election enables the taxpayer to minimize or avoid the capital gain on the shares of the liquidating foreign affiliate that would otherwise be realized if the "inside basis" exceeds the "outside basis". The subsection 88(3.3) suppression election must also be made in accordance with Regulation 5911(1), with a deadline of June 26, 2014, for historic foreign affiliate liquidations commencing after February 27, 2004.[12]

As a further alternative, although new subsection 88(3) mandatorily applies for top-tier foreign affiliate liquidations commencing after February 27, 2004, taxpayers may elect[13] instead to apply a transitional version of subsection 88(3) to property received after February 27, 2004 and before August 19, 2011. This transitional version of subsection 88(3) somewhat reflects the originally proposed version from the February 27, 2004, draft legislation, such that it applies more broadly where the Canadian taxpayer receives property from the top-tier foreign affiliate on a liquidation of the disposing affiliate, on a redemption, acquisition or cancellation of shares of the disposing affiliate, or on payment of a dividend by, or on a reduction of capital of, the disposing foreign affiliate.

Any taxpayer that received property from a top-tier foreign affiliate after February 27, 2004, should first consider whether to elect into the transitional version of subsection 88(3) and then, in the case of a top-tier foreign affiliate liquidation, whether to elect to treat the liquidation as a QLAD and whether to further elect to suppress the cost of any of the distributed properties received by the taxpayer. The retroactive QLAD and suppression elections in particular may now be necessary in order to achieve the originally intended outcome of a fully tax-deferred top-tier liquidation.

Summary

In Bill C-48 the Department of Finance provided very powerful one-time election opportunities. These elections allow taxpayers to flexibly choose which rules to retroactively apply to historic foreign affiliate transactions completed during the years when the foreign affiliate reorganization rules were in an uncertain state of flux.

Taxpayers with foreign affiliates should review their historic post-December 20, 2002, transactions, and consider the effect of the one-time transitional elections on any foreign affiliate mergers, liquidations, or distributions. Protective elections to retroactively apply the new, broader FAPI rollover rules for foreign affiliate mergers and lower-tier foreign affiliate liquidations in paragraphs 95(2)(*d*.1) and (*e*), respectively, may generally be advantageous. Top-tier foreign affiliate liquidations and other distributions after February 27, 2004 should be reviewed to determine if the transitional version of subsection 88(3) should be electively applied or if the QLAD election and any suppression elections should be made. Moreover, there may be circumstances where a general election to retroactively apply Regulation 5901(2)(*b*) (which also retroactively applies the deemed dividend rule in subsection 90(2)), potentially coupled with specific Regulation 5901(2)(*b*) elections in respect of particular distributions, can protectively confirm, or even strategically improve, the originally intended surplus and basis impacts of post-December 20, 2002, foreign affiliate distributions.

Notes:

[1] R.S.C. 1985, as amended. All statutory references are to the Act and regulations thereunder.

[2] S.C. 2013, c. 34. As discussed below, the top-tier foreign affiliate liquidation rules in subsection 88(3) are an exception, with the new rules applying retroactively to February 27, 2004.

[3] See 66(2) of Bill C-48 with respect to subsection 90(2) and 68(8) of Bill C-48 with respect to subsection 93(1.11). The versions of subsections 90(2) and 93(1.11) that would apply after December 20, 2002, but before August 20, 2011, are slightly modified by removing the references to a "qualifying return of capital" under subsection 90(3) that are relevant only after August 19, 2011.

[4] See paragraph 79(2)(*a*) of Bill C-48. The election for a general retroactive application of Regulation 5901(2)(*b*) must be made in writing jointly by all related Canadian corporations of which the paying foreign affiliate is a foreign affiliate on or before the later of (i) the earliest of the filing due dates for the tax returns of all electing Canadian corporations for their taxation years that include June 26, 2013 (the date Bill C-48 received Royal assent), and (ii) one year after Bill C-48 received Royal Assent, namely June 26, 2014. The version of Regulation 5901(2)(*b*) that would apply after December 20, 2002 but before August 20, 2011 is slightly modified, among other things, by removing references to hybrid surplus that are relevant only after August 19, 2011.

[5] See paragraph 79(2)(*b*) of Bill C-48, which provides that any election that otherwise must be filed before 120 days after Bill C-48 receives Royal Assent is deemed to have been filed on a timely basis if it is filed within 365 days after the day on which Bill C-48 received Royal Assent. Note that for calendar year corporations, the deadline to make a specific Regulation 5901(2)(*b*) election for a particular historic dividend (June 26, 2014) oddly occurs before the deadline to elect a general retroactive application of Regulation 5901(2)(*b*) (June 30, 2014).

[6] The Regulation 5901(2)(*b*) election also retroactively applies the new and broader automatic subsection 93(1) election for dispositions of foreign affiliate shares. Previously, there was an automatic election only if the foreign affiliate shares disposed of for a capital gain by another foreign affiliate were excluded property. Now, for dispositions after August 19, 2011, and for dispositions after December 20, 2002, if the taxpayer elects to have Regulation 5901(2)(*b*) apply retroactively, the automatic subsection 93(1) election occurs for all lower-tier dispositions of foreign affiliate shares that result in a capital gain for a foreign affiliate shareholder regardless of the excluded property status of the disposed foreign affiliate shares (and, in addition, the automatic subsection 93(1) election can now apply where the shareholder is the Canadian taxpayer itself if its foreign affiliate shares are deemed disposed by subsection 40(3) resulting from a Regulation 5901(2)(*b*) election or a subsection 90(3) qualifying return of capital election). Since any historic capital gain realized from non-excluded property foreign affiliate shares would have given rise to foreign accrual property income ("FAPI"), and the effect of the retroactive automatic subsection 93(1) election would reduce such a capital gain and thereby reduce FAPI, the consequences in many cases presumably would not be adverse.

[7] See paragraph 70(31)(*a*) of Bill C-48. This election must be made in writing by the later of (i) the date that is one year after Bill C-48 received Royal Assent (June 26, 2014), and (ii) the taxpayer's tax return filing due date for its taxation year that includes the date on which Bill C-48 received Royal Assent.

[8] See subsection 71(28) of Bill C-48. This election must be made in writing by the later of (i) the date that is one year after Bill C-48 received Royal Assent (June 26, 2014), and (ii) the taxpayer's tax return filing due date for its taxation year that includes the date on which Bill C-48 received Royal Assent.

[9] In particular, the "90% of votes and value" branch of the DLAD test is simplified to a "90% of value" test. The modified version of paragraph 95(2)(*e*) provides, for a DLAD, that the shares of the liquidating foreign affiliate are in all cases deemed disposed of on a full rollover basis for proceeds of disposition equal to the shareholder foreign affiliate's adjusted cost base of those shares.

[10] See subsection 88(2) of Bill C-48.

[11] Subsection 88(3.4) establishes the limits for the suppression election. Essentially, for each distributed capital property the claimed proceeds of disposition must be no greater than they otherwise would have been (cannot elect to increase proceeds), and the aggregate suppressed proceeds on all distributed properties must not exceed the taxpayer's capital gain amount on the shares of the liquidating foreign affiliate (cannot suppress to such an extent that the gain becomes a loss).

[12] See subsection 88(2) of Bill C-48.

[13] See subsection 65(2) of Bill C-48. This election to apply the transitional version of subsection 88(3) must be made in writing, in respect of all of the taxpayer's foreign affiliates, on or before the later of (i) the date that is one year after Bill C-48 received Royal Assent (i.e., June 26, 2014), and (ii) the taxpayer's tax return filing due date for its taxation year that includes June 26, 2013.