

ACB Adjustments for Foreign Affiliate Shares Held Through Partnerships

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Recent CRA comments at the May 2014 IFA international tax seminar¹ and a subsequently released CRA technical interpretation² highlight anomalies in the application of subsections 92(4) and (5) of the *Income Tax Act* (Canada) (the "**Act**").³

These provisions address the situation where shares of a foreign affiliate are held by a partnership of which a corporation resident in Canada is a partner.⁴ If the foreign affiliate has previously paid a pre-acquisition surplus dividend to the partnership, and the partnership then disposes of the shares of the foreign affiliate or the Canadian corporation disposes of its partnership interest, a deemed gain will arise. The problem is that this deemed gain will arise even where the disposition occurs under a rollover provision that is otherwise intended to provide a tax-deferred result.

This article first briefly compares the treatment of dividends and capital distributions paid by foreign affiliates directly to a Canadian corporate shareholder and those indirectly paid through a partnership holding structure. Where a pre-acquisition surplus dividend is paid on foreign affiliate shares held through a partnership, there is no reduction in the relevant adjusted cost base ("**ACB**"), and consequently subsections 92(4) and (5) will apply to subsequent dispositions of the partnership interest or the underlying foreign affiliate shares. The article then considers several possible ways in which the Department of Finance might address the anomalies.

Foreign Affiliate Distributions Paid Through Partnerships

Dividends (other than pre-acquisition surplus dividends)

Where shares of a foreign affiliate are held directly by a Canadian corporation, a dividend received by the Canadian corporation from the foreign affiliate is included in income of the Canadian corporation under subsection 90(1). The dividend amount is then potentially deductible by the Canadian corporation under subsection 113(1). The dividend will be deductible in its entirety if it is prescribed to have been paid out of the exempt surplus of the foreign affiliate, or in full or in part (to the extent of the grossed-up underlying foreign tax) if the

¹ CRA document 2014-0526751C6 dated May 22, 2014.

² CRA document 2012-0433731I7 dated May 7, 2014.

³ R.S.C. 1985, as amended. All statutory references are to the Act unless indicated otherwise.

⁴ Subsections 92(4) and (5) also apply where the partner is a foreign affiliate of the Canadian corporation, rather than the Canadian corporation itself. In that case, paragraph 95(2)(j) and Regulation 5908(10) would also be relevant. For simplicity, the discussion in this article is confined to the base case where the Canadian corporation is the direct partner of the partnership that owns the foreign affiliate shares.

dividend is paid out of taxable surplus⁵ or hybrid surplus. No adjustment is made to the Canadian corporation's ACB of the foreign affiliate shares, assuming the dividend is not a pre-acquisition surplus dividend.⁶

This result is effectively replicated where a partnership is interposed, such that the foreign affiliate shares are held by a partnership of which the Canadian corporation is a partner. In this case, subsection 93.1(1) applies (for purposes of determining foreign affiliate status and certain other specified provisions) to deem the Canadian corporation (and each other partner of the partnership) to own its proportionate number of the underlying shares of the non-resident corporation, based on the fair market value of the partnership interests held by each particular partner. This deemed direct ownership allows the non-resident corporation to be characterized as a foreign affiliate of the Canadian corporation.

When the foreign affiliate pays a dividend to the partnership, paragraph 96(1)(f) flows the dividend source through to the corporate partner and results in a subsection 90(1) income inclusion. Subsection 93.1(2) then applies for the purposes of section 113 to deem each partner to have received its proportionate share of the dividend, thus entitling each such corporate partner to a potentially offsetting subsection 113(1) deduction to the same extent as if the foreign affiliate dividend had been received directly.

No adjustment is made to the partnership's ACB of the foreign affiliate shares on which the dividend is paid.⁷ Moreover, if the full amount of the dividend is flowed through the partnership and distributed to the respective partners, there should be no net adjustment to any partner's ACB of its partnership interest – subparagraph 53(1)(e)(i) adds the dividend income allocation amount to ACB, while paragraph 53(2)(c)(v) subtracts the distributed amount from ACB.

In this way, the rules of the Act provide equivalent treatment for foreign affiliate dividends paid to a Canadian corporation either directly or through a partnership.

Qualifying Return of Capital

While *pro rata* distributions on foreign affiliate shares are generally deemed to be dividends under subsection 90(2), the shareholder may elect out of this treatment under subsection 90(3), and instead treat the distribution as a qualifying return of capital (a "QROC"), if the foreign affiliate distribution is a reduction in the foreign affiliate's paid-up capital under the applicable foreign corporate law.

⁵ The dividend would also be deductible to the extent the dividend is paid out of taxable surplus that represents foreign accrual property income ("FAPI") that was previously included in the Canadian corporation's income.

⁶ The "no ACB adjustment" result also assumes the dividend is not paid out of taxable surplus that represents FAPI that was previously included in the Canadian corporation's income.

⁷ Again, this assumes the dividend is not paid out of taxable surplus that represents FAPI that was previously included in the Canadian corporation's income.

A QROC distributed by a foreign affiliate directly held by a Canadian corporation is neither included in the Canadian shareholder's income under subsection 90(1), nor is it potentially deductible by the Canadian corporate shareholder under subsection 113(1). Instead, the capital distribution reduces the shareholder's ACB of the foreign affiliate share pursuant to subclause 53(2)(b)(i)(B)(II).

The same result applies where the foreign affiliate shares are held indirectly through a partnership. The subsection 90(3) election may be made by the partnership as shareholder of the foreign affiliate to treat the capital distribution as a QROC⁸, and the partnership's ACB of the foreign affiliate share is reduced under subclause 53(2)(b)(i)(B)(II) in the same manner.

If the proportionate share of the capital distribution received by the partnership is distributed to the Canadian corporate partner, the partner's ACB of its partnership interest will be correspondingly reduced under subparagraph 53(2)(c)(v) as a distribution of the partnership's capital – there would be no offsetting increase to the ACB of the partnership interest because the QROC is not income of the partnership allocated to the partner under subparagraph 53(1)(e)(i). Consequently, from the partnership perspective both the inside ACB (in the foreign affiliate shares) and the outside ACB (in the partnership interest) are correspondingly reduced.

Pre-Acquisition Surplus Dividends

Pre-acquisition surplus dividends paid by a foreign affiliate to a corporate shareholder (whether a Canadian parent corporation or another foreign affiliate of the Canadian corporation) are conceptually treated under the Act in a manner similar to a tax-free return of capital – that is, similar to a QROC. This reflects that the foreign affiliate making the distribution is assumed to have no net surplus balances in respect of the corporate shareholder (as required for a foreign affiliate distribution to be treated as a pre-acquisition surplus dividend under Regulation 5901(1)(c)), so by default the distribution is treated as paid effectively out of its capital with respect to the shareholder.⁹

Where shares of a foreign affiliate are held directly by a Canadian corporation, the dividend paid out of pre-acquisition surplus is both included in the Canadian corporation's income under subsection 90(1), and fully deductible under paragraph 113(1)(d). The Canadian corporation's ACB of the foreign affiliate shares is then reduced under subsection 92(2) (and clause 53(2)(b)(i)(A)) by the amount of the pre-acquisition surplus dividend deductible under paragraph

⁸ See Regulation 5911(6)(a)(i)

⁹ However, the recently enacted election under Regulation 5901(2)(b) permits a dividend paid otherwise out of exempt surplus, hybrid surplus or taxable surplus to instead be treated as a pre-acquisition surplus dividend. Consequently it is no longer necessarily the case that a foreign affiliate paying a pre-acquisition surplus dividend has no net surplus in respect of the shareholder. In any event, the Regulation 5901(2)(b) election is not available to a partnership that is a shareholder of a foreign affiliate.

113(1)(d) (less any applicable amount of foreign withholding tax). This is effectively the same result (basis reduction, no income inclusion) as for a QROC.¹⁰

However, this general principle is applied differently where the foreign affiliate shares are instead directly held by a partnership of which the Canadian corporation is a partner. In that case, as with a regular (non-pre-acquisition surplus) foreign affiliate dividend out of a positive net surplus balance, paragraph 96(1)(f) flows the dividend source through to the Canadian corporate partner, resulting in a subsection 90(1) income inclusion. The offsetting deduction for the Canadian corporate partner under paragraph 113(1)(d) is permitted by virtue of subsection 93.1(2).

The difference is in the effect of the pre-acquisition surplus dividend on ACB. Unlike the situation where the foreign affiliate is directly held by the Canadian corporate shareholder, the subsection 92(2) ACB reduction for a pre-acquisition surplus dividend does not apply where the foreign affiliate shares are held through a partnership. None of the "look-through" rules in section 93.1 (and in particular subsection 93.1(2)) apply for purposes of the subsection 92(2) ACB reduction for pre-acquisition surplus dividends – the section 93.1 partnership look-through rules apply for specific purposes such as determining foreign affiliate status, the flow-through of foreign affiliate dividends for sections 90 and 113, and several other specific purposes, but not for purposes of any section 92 ACB adjustments.

Consequently, where a foreign affiliate owned by a partnership pays a pre-acquisition surplus dividend, the ACB of the foreign affiliate shares remains unchanged. Moreover, if the partnership distributes the full amount of the pre-acquisition surplus dividend to its partners, there should be no net change to any partner's ACB of its partnership interest – subparagraph 53(1)(e)(i) adds the subsection 90(1) pre-acquisition surplus dividend income allocation amount to ACB, while paragraph 53(2)(c)(v) subtracts the distributed amount from ACB. As a result, from the perspective of the partnership there would be no change in either the inside ACB (in the foreign affiliate shares) or in the outside ACB (in the partner's partnership interest) resulting from the distribution of the pre-acquisition surplus dividend – a more favourable result than would arise if the foreign affiliate shares were held directly by the Canadian corporation, and a more favourable result than if the pre-acquisition surplus dividend were instead made as a QROC.

Deemed Proceeds/Gains Under Subsections 92(4) and 92(5)

This different treatment for pre-acquisition surplus dividends, and the absence of a subsection 92(2) ACB reduction where the foreign affiliate shares are held by a partnership, is addressed by the alternative treatment in subsections 92(4) and (5). These provisions effectively recognize the effect of prior pre-acquisition surplus dividends flowed through a partnership, by deeming

¹⁰ One small distinction is that the amount of the ACB reduction for a QROC is not reduced by any applicable amount of foreign withholding tax.

proceeds or gains to arise when there is a disposition of either the partnership interest or the underlying foreign affiliate shares.

Subsection 92(4) applies where the Canadian corporation (or a foreign affiliate of the Canadian corporation) has disposed of an interest in a partnership (*i.e.*, a partnership that owns shares of a foreign affiliate of the Canadian corporation). In computing the proceeds of disposition of the partnership interest, an amount is added equal to all prior paragraph 113(1)(d) deductible amounts in respect of pre-acquisition surplus dividends flowed through the partnership to the corporate partner (less any applicable foreign withholding tax amounts).

Subsection 92(5) applies where the partnership (*i.e.*, a partnership of which a Canadian corporation or a foreign affiliate of a Canadian corporation is a member) has disposed of a share of a corporation (*i.e.*, the underlying foreign affiliate of the Canadian corporation). The partnership's disposition of the foreign affiliate share is deemed to result in a gain for the partner in the amount determined by subsection 92(6), which is essentially the amount of prior paragraph 113(1)(d) deductions available to the corporate partner in respect of pre-acquisition surplus dividends paid on the foreign affiliate share (less any applicable foreign withholding tax amounts). To avoid double counting, the subsection 92(6) deemed gain amount is reduced by any proceeds of disposition previously deemed to arise under subsection 92(4) in respect of dispositions of the partnership interest.

Thus, instead of applying the regular ACB reduction rule in subsection 92(2) to pre-acquisition surplus dividends received on foreign affiliate shares held by a partnership, the Act defers the consequence of the pre-acquisition surplus dividend until such time as either the foreign affiliate shares or the partnership interest is disposed, and deems the Canadian corporate partner to have either a gain or increased proceeds of disposition in the same amount as the subsection 92(2) ACB reduction that would otherwise have applied.¹¹ From a policy perspective it is appropriate that the Canadian corporation should be required to account for amounts previously extracted tax-free from the foreign affiliate as pre-acquisition surplus dividends with no ACB reduction. The problem is that the subsection 92(4) or (5) deemed proceeds/gain consequences will arise on any disposition of the partnership interest or foreign affiliate shares, regardless whether the disposition occurs pursuant to a tax-deferred rollover.

In some cases, taxpayers holding foreign affiliate shares through a partnership may be able to use "self-help" to avoid the latent proceeds/gain recognition under subsections 92(4) and (5). In particular, a taxpayer may be able to avoid pre-acquisition surplus dividends and instead ensure that any such distributions are made by the foreign affiliate as a capital distribution to the partnership that can be electively treated as a QROC. However, this solution will not be available in all cases, since capital distributions are not possible under the corporate laws of all countries or may be subject to more onerous approval requirements.

¹¹ The distinction between the deemed proceeds of disposition in subsection 92(4) and the deemed gain in subsection 92(5) could, in certain circumstances, impact the resulting tax consequences from the disposition.

CRA Guidance – No Administrative Relief for Tax-Deferred Dispositions

In technical interpretation 2012-0433731I7 (which is dated May 7, 2014 and was released after the May 2014 IFA international tax seminar), the CRA considered a situation in which a Canadian corporation ("**Canco**") was a partner of a limited partnership ("**LP**") which owned shares of a foreign affiliate of Canco ("**Forco**") by virtue of subsection 93.1(1)). Forco had paid pre-acquisition surplus dividends to LP and Canco had claimed the corresponding paragraph 113(1)(d) deductions. LP then formed ULC (a Canadian corporation) and transferred the Forco shares to ULC pursuant to an elective subsection 85(2) tax-deferred disposition. The disposition by LP triggered a subsection 92(5) gain for Canco, and the issue was whether the deemed gain could be taken into account in determining LP's proceeds of disposition of the Forco shares or the elected amount pursuant to subsection 85(2) and paragraph 85(1)(a). The CRA concluded no, with the adverse result that Canco's objective of effecting a tax-deferred disposition of the Forco shares by LP was thwarted by the subsection 92(5) gain included in Canco's income.

The same issue was raised with CRA at the May 2014 IFA international tax seminar, where the CRA was asked whether it would offer administrative relief from subsections 92(4) and (5) in analogous circumstances of internal tax-deferred reorganizations. In its written response (document 2014-0526751C6 dated May 22, 2014), the CRA declined to offer administrative relief from the deemed proceeds of disposition or deemed gain arising from the application of subsections 92(4) and (5) when the relevant disposition occurs pursuant to a tax-deferred rollover.

Possible Legislative Approaches

There are several possible ways the Department of Finance could amend the Act to address the anomaly arising when subsections 92(4) and (5) apply on otherwise tax-deferred dispositions of the partnership interest or underlying foreign affiliate shares.

One approach would be to defer or suppress the deemed proceeds realization or deemed gain under subsections 92(4) and (5) in any case where the disposition occurs pursuant to one of the tax-deferred rollovers in the Act.¹² This could perhaps be effected by a rule carving out the specified tax-deferred dispositions from subsections 92(4) and (5), with a triggering mechanism to unsuspend the deferred proceeds/gain recognition upon a subsequent (non-rollover) disposition.

However, the root of the issue is the absence of an ACB reduction when a pre-acquisition surplus dividend is paid on a foreign affiliate share held by a partnership, which from a policy perspective makes the deferred proceeds/gain recognition in subsections 92(4) and (5) necessary. This might be addressed by extending section 93.1 so that subsection 92(2) would apply to a pre-

¹² This is suggested by Barnicke and Huynh, "FA Shares Held in Partnership", Canadian Tax Highlights (June, 2014), vol. 22, No. 6, Canadian Tax Foundation.

acquisition surplus dividend where the foreign affiliate shares are held by a partnership. However, this alone would not be sufficient, because while it would reduce the inside ACB (of the foreign affiliate shares held by the partnership), it would not reduce the outside ACB (of the partnership interest held by the Canadian corporate partner).¹³

As described above, the conceptually correct result arises where the foreign affiliate distribution is a QROC. The existing provisions of the Act applicable to QROCs operate appropriately to reduce both the inside ACB of the foreign affiliate shares held by the partnership (under subclause 53(2)(b)(i)(B)(II)) and the outside ACB of the partnership interest held by the Canadian corporation (under subparagraph 53(2)(c)(v)), where the capital distribution from the foreign affiliate is further distributed by the partnership to the Canadian corporate partner. The scheme of the Act is similar for pre-acquisition surplus dividends and QROCs, in that both are taxed essentially as tax-free returns of capital that reduce ACB. But where the foreign affiliate shares are held in a partnership, the Act departs from this scheme for pre-acquisition surplus dividends, by substituting the deferred proceeds/gain recognition consequences of subsections 92(4) and (5) in lieu of an immediate ACB reduction. The solution may be to adopt the QROC ACB reduction mechanics for pre-acquisition surplus dividends. Perhaps, where a pre-acquisition surplus dividend is paid on a foreign affiliate share held by a partnership, the partnership and its partners should be permitted to elect to treat the pre-acquisition surplus dividend as a QROC, with the result that both the inside and outside partnership ACB would be immediately reduced, and no deferred proceeds/gain recognition under subsection 92(4) and (5) would be necessary.

¹³ There is no net reduction in the Canadian corporation's ACB of its partnership interest because the pre-acquisition surplus dividend is included in the Canadian corporation's income, resulting in an increase in ACB that is offset when the pre-acquisition surplus dividend is distributed by the partnership to the Canadian corporate partner. Perhaps this could be addressed by a rule that would "shut-off" the subparagraph 53(1)(e)(i) increase in ACB of a partnership interest where the income allocated to the partner is in the form of a pre-acquisition surplus dividend.