Upstream Loans and Dispositions of Foreign Affiliate Shares

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The upstream loan rules in subsections 90(6) through (15) of the *Income Tax Act* (Canada) (the "ITA")[1] were originally proposed on August 19, 2011 and have now been in force for several years. Yet there remain several anomalies in the application of these rules, particularly where the Canadian parent company sells or restructures the foreign affiliate group from which an outstanding upstream loan has previously been made.

This article summarizes the upstream loan rules, and explores the impact of the upstream loan rules in several situations involving dispositions of the shares of the creditor foreign affiliate. In general, under the current rules anomalous results can be avoided with certainty only by causing the parent Canadian company to actually repay its outstanding upstream loans borrowed from any creditor foreign affiliates. This may not always be possible or practical. The repayment requirement is arguably too strict and warrants reconsideration.

Overview of the Upstream Loan Rules – Policy and Practice

A foreign affiliate of a Canadian corporation may have surplus cash, from earnings or otherwise, that is to be distributed up the chain to the Canadian parent. An actual dividend distribution could give rise to foreign withholding taxes, income taxes payable by any intermediate entities, and potentially Canadian taxes if the dividend is payable out of anything other than exempt surplus. In contrast, prior to the upstream loan rules, the foreign affiliate could lend the surplus funds up to the Canadian parent and avoid the potential foreign and Canadian taxes that might otherwise be payable due to a dividend distribution.

The Department of Finance explanatory notes indicate that the upstream loan rules were targeted at so-called "synthetic dividend distributions", *i.e.*, upstream loans that avoid income inclusions for the Canadian parent under subsection 90(1) that are not fully offset by the available foreign affiliate dividend deductions in subsection 113(1). The purpose of the rules is to effectively treat an upstream loan from a foreign affiliate in a manner equivalent to a dividend, so as to neutralize any Canadian tax incentive to lend funds upstream rather than distribute them as an actual dividend.

This is achieved by means of the income inclusion in subsection 90(6). If a "specified debtor"[2] in respect of a Canadian-resident taxpayer receives a loan from, or becomes indebted to, a

1 RSC 1985, as amended. All statutory references are to the ITA unless otherwise indicated.

2 "Specified debtor" is defined in subsection 90(15) and includes the Canadian taxpayer itself, and a non-arm's length person (other than a non-resident corporation that is a controlled foreign affiliate of the Canadian taxpayer for purposes of section 17). This has the effect of properly excluding inter-affiliate loans from the upstream loan rules.

creditor that is a foreign affiliate of the Canadian taxpayer, the "specified amount"[3] in respect of the loan or indebtedness is included in the Canadian taxpayer's income. (Certain upstream loans are excluded by subsection 90(8), including loans that are repaid within two years other than as part of a series of loans and repayments.) As a result, an upstream loan amount borrowed by a Canadian corporation from its wholly owned foreign affiliate (and that is not repaid within two years) would be included in income under subsection 90(6), just as a dividend paid to the Canadian corporation by its wholly owned foreign affiliate would be included in income under subsection 90(1).

But then, to replicate the surplus deductions available under subsections 113(1) and 91(5) for an actual foreign affiliate dividend, subsection 90(9) permits the parent Canadian corporation to potentially deduct an amount in respect of the subsection 90(6) upstream loan inclusion. For this purpose, the Canadian corporation must notionally assume that the loan amount had instead been paid up to the Canadian corporation as a dividend at the "lending time" when the loan was made or the indebtedness was incurred. The Canadian corporation must then demonstrate that it had sufficient surplus and basis attributes in respect of the creditor foreign affiliate[4] such that it could have deducted amounts in respect of exempt surplus, hybrid surplus and hybrid underlying tax, taxable surplus and underlying foreign tax, and pre-acquisition surplus and adjusted cost base, in respect of the notional assumed dividend. Any such amounts that the Canadian corporation can demonstrate as reasonably considered to have been deductible under subsection 113(1) (or 91(5)) in respect of the notional dividend can then be deducted under subsection 90(9), with the (temporary) effect of fully or partially offsetting the subsection 90(6) upstream loan income inclusion as if it were an actual foreign affiliate dividend.

The problem is that once an upstream loan arises (unless it is repaid within two years), the upstream loan rules will continue to apply each year until the amount of the loan or indebtedness is fully repaid. Unlike a one-off subsection 113(1) deduction in respect of an actual foreign affiliate dividend, the subsection 90(9) deduction is effectively a reserve, since the amount of the subsection 90(9) deduction in one year is carried forward and included in the Canadian corporation's income the following year under subsection 90(12). The Canadian corporation must then attempt to claim, in that following year, another subsection 90(9) deduction in respect of the surplus and basis attributes in existence at the "lending time" (when the upstream loan or indebtedness was initially incurred) that it can demonstrate would still have given rise to a subsection 113(1) (or 91(5)) deduction as at the lending time. Anti-double-counting rules in paragraphs 90(9)(b) and (c) preclude a continued subsection 90(9) reserve deduction if the particular surplus or basis attributes in existence at the "lending time" have been relevant in claiming a subsection 90(9) deduction for any other upstream loan or indebtedness, or any subsection 113(1) or 91(5) deduction in respect of any actual dividend paid during the period while the upstream loan or indebtedness is outstanding, or if the top-tier adjusted cost base is

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[3] "Specified amount" is defined in subsection 90(15) and effectively reduces the income inclusion for the Canadian taxpayer to the extent that the Canadian taxpayer's surplus entitlement percentage in respect of the creditor affiliate is less than 100%.

[4] This can include "downstream surplus" that pursuant to subsection 90(11) is considered to have been distributed up the chain to the creditor foreign affiliate at the lending time.

relevant to the taxation of any other distribution made during the period while the upstream loan or indebtedness is outstanding.[5]

If and when the Canadian taxpayer (or the "specified debtor") finally repays the upstream loan or indebtedness (but not as part of a series of loans and repayments), the repayment amount may be deducted from income under subsection 90(14). Consequently, each year while the upstream loan or indebtedness is outstanding, the prior year subsection 90(9) reserve is added back to the Canadian corporation's income, and a new subsection 90(9) reserve may be claimed only if and to the extent that the "lending time" surplus and basis attributes have not subsequently been utilized to shelter any foreign affiliate dividend or other distribution, and have not subsequently been "earmarked" to shelter any other upstream loan with a subsection 90(9) deduction. The only way the Canadian corporation can put a stop to this perennial reserve and inclusion mechanism is to actually repay the upstream loan or indebtedness and claim a terminal subsection 90(14) deduction.

What Happens When the Creditor Foreign Affiliate Shares are Sold or Restructured?

To illustrate some of the complexities and policy issues arising from this ongoing reserve and inclusion mechanism, it is instructive to review several simple examples that have been the subject of commentary from the Canada Revenue Agency ("CRA") and others. In each case, for simplicity, assume that a Canadian corporation ("Canco") directly owns 100% of the shares of its foreign affiliate ("FA1") with an adjusted cost base of $100, that FA1 has nil surplus balances in respect of Canco, and that in year 1 FA1 makes an upstream loan of $100 to Canco that is not repaid within two years.

Subsection 90(6) requires Canco to include the $100 upstream loan amount in income in year 1. However, subsection 90(9) permits Canco to deduct $100 in year 1 as a reserve, because if the $100 loan amount had been paid as a notional pre-acquisition surplus dividend to Canco, Canco would have been able to able to claim a paragraph 113(1)(d) deduction of $100 to fully shelter the notional dividend with its $100 adjusted cost base in existence as at the "lending time". In year 2, Canco must include the $100 year 1 reserve back in income under subsection 90(12), but is then potentially able to claim an offsetting subsection 90(9) reserve in year 2 if the $100 adjusted cost base attribute as at the "lending time" remains available under the anti-double-counting rules (*i.e.*, if the $100 of adjusted cost base has not been utilized to shelter another upstream loan or dividend or other distribution).

<u>Example 1: Canco sells the FA1 shares to an arm's length person</u>

Suppose in year 2 Canco sells its FA1 shares to a third party, so that it no longer owns the FA1 shares at the end of year 2 but still owes FA1 the $100 previously borrowed.[6] Canco has a

[5] Presumably this anti-double-counting requirement in paragraph 90(9)(c) is intended to prevent a subsection 90(9) deduction where the top-tier adjusted cost base has subsequently been utilized in respect of any capital distribution treated as a subsection 90(3) qualifying return of capital.

[6] It is acknowledged this may be a somewhat less common situation, since most third party purchasers would generally insist on a pre-closing "clean-up" of intercompany payables and receivables to sever ongoing links between the target (FA1) and the vendor group (Canco).

subsection 90(12) income inclusion of its year 1 reserve, but can it still claim a year 2 reserve even though it has sold the FA1 shares and no longer has the $100 of adjusted cost base attribute?

Subsection 90(9) is clear that a year 2 deduction is still available in this case. There is no requirement that the creditor foreign affiliate continues to be a foreign affiliate of Canco in the year for which the deduction is sought. Moreover, the tax attributes of Canco in respect of FA1 are measured as at the "lending time", which locks in the measurement of the $100 adjusted cost base in the FA1 shares in year 1 when the upstream loan was made. That $100 adjusted cost base has not been used by Canco to shelter any other upstream loan or distribution, and consequently the anti-double-counting rules in paragraphs 90(9)(b) and (c) do not preclude a continued subsection 90(9) deduction. It is true that the $100 adjusted cost base in the FA1 shares has been relevant in computing Canco's capital gain or loss from its disposition of the FA1 shares, but this is permitted by, and not offside, paragraph 90(9)(c) (which precludes a subsection 90(9) deduction if the "lending time" adjusted cost base has been relevant in determining the taxability of any other distribution).

To make the example more compelling, suppose Canco realized a loss from its sale of FA1. Because the disposition was by assumption to an arm's length person, the subsection 40(3.4) loss suspension rules do not apply, with the effect that Canco now has a new tax attribute (an allowable capital loss) which is immediately available to it.[7] The $100 adjusted cost base has sheltered the $100 subsection 90(12) upstream loan inclusion, and has also contributed to Canco's capital loss. Is this double counting?

It is not double counting. Canco still owes $100 to FA1, which is now owned by the arm's length purchaser. FA1 has its $100 receivable from Canco, contributing to the value of the FA1 shares, so presumably the loss hypothetically realized on the FA1 shares was attributable to factors other than the synthetic dividend distribution to Canco (i.e., it is a "real" loss unaffected by the upstream loan). At some point, if and when Canco's debt is repaid to FA1, Canco will claim a terminal subsection 90(14) deduction instead of a continued subsection 90(9) reserve, and the $100 adjusted cost base attribute will no longer be relevant in sheltering Canco's upstream loan inclusion, such that the $100 adjusted cost base attribute will then have been relevant only in determining Canco's capital loss.

In the meantime, while the upstream loan remains outstanding, the tax result is the same as if Canco's borrowing had been from a third party lender rather than FA1, in which case Canco would still have realized a capital loss from selling the FA1 shares and would still have a $100 liability that would ultimately have to be repaid.[8] Consequently, it is appropriate and correct (although cumbersome) for Canco to be permitted an ongoing subsection 90(9) deduction as a

[7] Note that the loss denial rule in subsection 93(2.01) would not apply to reduce the loss by any exempt dividend because no actual dividend was paid by FA1 to Canco with respect to the upstream loan.

[8] Moreover, if Canco's $100 liability is not repaid but is instead forgiven, Canco will suffer the required consequences under the debt forgiveness rules.

reserve in respect of its $100 adjusted cost base in its FA1 shares as at the lending time, even after Canco has sold the FA1 shares to a third party.[9]

The more fundamental policy question is whether it is appropriate for the upstream loan rules to continue to apply to Canco on an ongoing basis (by virtue of the repeated subsection 90(12) inclusion of the prior year reserve) after the creditor ceases to be a foreign affiliate by virtue of the sale of the FA1 shares.[10] Arguably the change in relationship between FA1 and Canco should render the upstream loan rules inapplicable to Canco with respect to the historic upstream loan and terminate the ongoing inclusion and reserve mechanism, rather than deferring that desirable result until the loan is eventually repaid.

<u>Example 2: Canco liquidates FA1 to extinguish the upstream loan</u>

This is the example discussed at the November 24, 2015 CRA roundtable at the 2015 Annual Conference of the Canadian Tax Foundation in Montreal. Suppose in year 2, FA1 is liquidated, and the $100 receivable is effectively distributed up to Canco and extinguished by operation of law (since Canco becomes both creditor and debtor).

The top-tier liquidation of FA1 into Canco would be governed by subsection 88(3). If Canco elects under subsection 88(3.1) to treat the liquidation as a qualifying liquidation and dissolution (a "QLAD"), FA1's assets can be distributed up to Canco on a rollover basis but any capital loss realized by Canco on its disposition of the FA1 shares would be deemed to be nil. If Canco does not elect to treat the liquidation as a QLAD, a capital loss realized by Canco in respect of its disposition of the FA1 shares would be allowed (subject to subsection 93(2.01) if FA1 had previously paid any exempt dividends).[11]

In year 2, Canco has a subsection 90(12) income inclusion in respect of the prior year subsection 90(9) reserve. However, it appears that a renewed year 2 reserve under subsection 90(9) may no longer be available, by virtue of paragraph 90(9)(c). Canco's $100 adjusted cost base in its formerly owned FA1 shares (which by the end of year 2 have been cancelled upon the dissolution of FA1) has been relevant in determining the taxability of the year 2 liquidating distribution of FA1's assets, *i.e.*, the adjusted cost base is relevant in determining Canco's capital

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9 In CRA document 2013-0483791C6, response 5(b), the CRA addresses a similar situation of a sale of the shares of the creditor foreign affiliate, although in the different context of the grandfathering rules for upstream loans made before August 19, 2011 that are deemed made on August 19, 2014. CRA did not discuss the availability of the ongoing subsection 90(9) reserve, but did indicate that the terminal subsection 90(14) deduction would be available if and when the loan is repaid after the sale of the creditor foreign affiliate shares. The CRA also questioned the appropriateness of applying the upstream loan rules in circumstances where the lending corporation is no longer a foreign affiliate at the subsequent time when the grandfathered loan is deemed to be made.

10 Bradley, Thompson and Buttenham, "Recommended Amendments to the Upstream Loan Rules", *Canadian Tax Journal* (2015) 63:1, 245-67, have helpfully suggested that a transaction that caused the creditor foreign affiliate to no longer be a foreign affiliate of the Canadian taxpayer should be one of several triggering events that would terminate application of the upstream loan rules.

11 Paragraph 88(3)(e) would not deem the loss to be nil provided the liquidation is not a QLAD, and since the FA1 shares disappear on the liquidation and no subsection 40(3.5) identical property is acquired by an affiliated person, the loss suspension rules in subsection 40(3.4) would not apply.

gain or capital loss from its disposition of the FA1 shares, which by paragraph 88(3)(d) are deemed disposed of for proceeds of disposition equal to the net distribution amount.[12]

If no ongoing subsection 90(9) reserve is available, may Canco claim a terminal deduction under subsection 90(14) in year 2, to offset the subsection 90(12) inclusion of the prior year reserve claimed under subsection 90(9)?. Under the current overly strict version of subsection 90(14), the terminal deduction is available only to the extent the upstream loan was "repaid" in year 2. CRA expressed the unfavourable position at the 2015 Annual Conference of the Canadian Tax Foundation that the upstream loan would not be considered "repaid" where it is cancelled or extinguished in this manner on the liquidation of the creditor foreign affiliate into the Canadian parent, such that no subsection 90(14) deduction would be available.[13]

As a result, under the current law as administered by CRA, an upstream loan must actually be repaid in order for Canco to claim a terminal subsection 90(14) deduction. This can include repayment effected by legal set-off,[14] but will not include a cancellation of the upstream loan by operation of law upon the liquidation of FA1 into Canco. In this example, the year 1 upstream loan results in a permanent $100 income inclusion for Canco in year 2, which is not an appropriate result – the correct result should arguably be governed by the paragraph 88(3)(d) determination of Canco's proceeds of disposition of the FA1 shares based in turn on the net distribution amount in respect of the liquidation. This result could be restored with an appropriately broadened scope of the terminal deduction in subsection 90(14).

<u>Example 3: Canco sells the FA1 shares to another foreign affiliate and liquidates FA1</u>

This example combines elements of the previous two examples. Suppose in year 2 Canco sells the FA1 shares to FA2, another wholly owned foreign affiliate of Canco, for cash consideration, and then in year 3 FA1 liquidates into FA2. The $100 loan receivable of FA1 would be distributed to FA2 on the year 3 liquidation.

May Canco claim a subsection 90(9) deduction in year 2 to offset its subsection 90(12) inclusion in respect of the prior year reserve?. As in example 1, the deduction should be available and not precluded by the anti-double counting rules in paragraphs 90(9)(b) and (c). In particular, while Canco has sold the FA1 shares and no longer has the $100 adjusted cost base attribute available, the subsection 90(9) deduction is based on the attributes available to Canco at the "lending time" in year 1. Moreover, that $100 adjusted cost base has not been used by Canco to shelter any other upstream loan or distribution to Canco. That $100 adjusted cost base has been relevant in

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12 The link is somewhat tenuous, as the subsection 88(3.2) net distribution amount is used only indirectly, to determine the paragraph 88(3)(d) proceeds of disposition of the shares. It could instead be argued that even though FA1's assets are transferred on its liquidation for a particular "net distribution amount", this does not result in a "distribution" for purposes of paragraph 90(9)(c) because the scheme of subsection 88(3) is to give Canco capital gain or loss treatment upon its disposition of the cancelled FA1 shares as a result of the liquidation, in the absence of an elective subsection 93(1) deemed dividend.

13 See CRA's response to question 8 at the November 24, 2015 CRA roundtable discussion at the 2015 Annual Conference of the Canadian Tax Foundation in Montreal. The CRA did however indicate its expectation that this issue may be addressed by the Department of Finance in future amendments to the upstream loan rules.

14 For example, see CRA document 2013-0499121E5.

determining Canco's capital gain or loss from its disposition of the FA1 shares, but that is appropriately not offside paragraph 90(9)(c).

If Canco realized a capital loss from its sale of FA1 to FA2, the capital loss would initially be suspended by subsection 40(3.4), because FA2 is affiliated with Canco and owns the transferred property (the FA1 shares) more than 30 days after the disposition. But regardless whether the disposition gives rise to a capital gain or capital loss or is to an affiliated person or an arm's length person, the use of Canco's $100 adjusted cost base attribute both to determine its capital gain or capital loss (whether suspended or not) and to claim a continued subsection 90(9) deduction in respect of the upstream loan inclusion, gives Canco the same result it would have if the $100 upstream loan had instead been borrowed from an unrelated party. Consequently, the continued subsection 90(9) deduction based on the $100 adjusted cost base attribute should not be viewed as inappropriately double-counting that $100 adjusted cost base attribute.

In year 3, FA1 is liquidated into FA2 and FA2 acquires the loan receivable. The lower-tier foreign affiliate liquidation of FA1 would be governed by paragraph 95(2)(e) as a designated liquidation and dissolution. The cancellation of the FA1 shares upon the dissolution would release Canco's suspended capital loss (if any) from the initial year 1 disposition of the FA1 shares to FA2.[15]

The liquidation of FA1 highlights an anomalous issue more generally applicable with respect to internal loan assignments. The issue is whether Canco would technically have a double income inclusion in year 3. First, Canco would be required by subsection 90(12) to include in income in year 3 its prior year 2 reserve claimed under subsection 90(9). However, in addition, subsection 90(6) could potentially apply again to Canco, because as a result of FA2 acquiring FA1's $100 receivable owing by Canco, Canco has become "indebted to" FA2 and meets the conditions of subsection 90(6). Fortunately, CRA has recognized this double income inclusion would be inappropriate and unintended, and has adopted a favourable administrative position consistent with paragraph 248(28)(a) to apply only a single income inclusion in this situation.[16]

Consequently, in year 3 Canco will have a single $100 income inclusion in respect of the upstream loan. Provided Canco's $100 adjusted cost base attribute available as at the lending time has not been used to shelter any other upstream loan or distribution to Canco, a continued subsection 90(9) deduction should be available to Canco to offset its perennial re-inclusion of the prior year reserve, until such time as Canco actually repays the upstream loan (to FA2) to claim the terminal subsection 90(14) deduction.

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15 Paragraph 40(3.5)(c) would not preclude the release of Canco's capital loss. FA1 is not merged or combined to form a new entity, FA1 was is not wound up under subsection 88(1), and Canco is the relevant transferor of the FA1 shares and is not a foreign affiliate. Moreover, the continuity rule in subclause 95(2)(e)(v)(A)(III) is not relevant because paragraph 40(3.5)(c) has not previously applied to FA1.

16 See CRA document 2013-048881E5 and the discussion of scenario 6. See also CRA document 2013-0499121E5.

Summary

The ongoing inclusion and reserve mechanics of the upstream loan rules are somewhat complex and cumbersome, particularly in the manner they continue to apply after the creditor foreign affiliate shares have been sold or restructured. Despite this, a (temporary) distribution from a foreign affiliate by means of an upstream loan may still be preferred to a (permanent) distribution from a foreign affiliate by means of an actual dividend, because the upstream loan may avoid foreign withholding and other taxes that would be incurred with an actual dividend.

However, under the current upstream loan rules, the only way the Canadian taxpayer can permanently escape the grip of the rules is to actually repay the loan, which may not be practical or cost-effective and which may ultimately give rise to the adverse foreign tax consequences initially sought to be deferred. A broadening of the scope of the terminal subsection 90(14) deduction is warranted, so that the terminal deduction is available not only when the loan is "repaid", as currently required, but also where the loan is cancelled or extinguished upon a liquidation and dissolution, or where the creditor foreign affiliate ceases to be a foreign affiliate of the Canadian taxpayer by virtue of a share disposition or reorganization, among other possible scenarios.