Foreign Tax Credit Generator Proposals – An Inadvertent Attack on Hybrids?

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The March 4, 2010 Canadian federal Budget included proposed legislation aimed at schemes referred to as “foreign tax credit generators”.¹ The proposed amendments would restrict the entitlement to deductions and credits for foreign taxes in respect of foreign-source income, and deductions on account of foreign accrual tax and underlying foreign tax in respect of foreign affiliates. These rules are proposed to be effective for taxation years that end after March 4, 2010.

Although the proposed rules are described in the budget materials as targeting very specific types of transactions, they are broadly drafted and will adversely affect many common investment structures involving the use of hybrid instruments and hybrid entities. At the May 19, 2010 IFA Roundtable in Montreal (the “IFA Roundtable”), representatives of the Department of Finance (“Finance”) acknowledged the proposals are overbroad and that amendments will be considered to better focus their effect on foreign tax credit generator schemes involving hybrid instruments that are the intended target of the proposals.

This article discusses the proposed legislation and provides some examples of typical foreign investment structures by Canadian taxpayers that will be affected by the proposed rules.

Foreign Tax Credit Generators

The proposed legislation targets transactions (referred to in the budget materials as “foreign tax credit generators”) that generally result in
the Canadian taxpayer receiving tax credits in respect of foreign taxes paid on an amount of income where there is no net tax paid in the foreign jurisdiction in respect of the income because of an offsetting deduction or credit. As noted in the budget materials, “[t]he main thrust of all these schemes is to exploit asymmetry, as between the tax laws of Canada and those of a foreign country, in the characterization of the Canadian corporation’s direct or indirect investment in a foreign entity earning the income that is subject to the foreign tax”. Finance indicated at the IFA Roundtable that the target of the proposals is transactions using hybrid instruments, not hybrid entities themselves.

The budget materials further describe foreign tax credit generators as follows:

These foreign tax credit generator schemes generally involve a complex series of transactions that, in substance, amount to a Canadian corporation making a loan to a corporation resident in a foreign jurisdiction that taxes on the basis of the substantive effect of the transaction, while relying on Canadian tax law looking only to the form of the transaction. The form is that of an investment by the Canadian corporation in a foreign special purpose entity which pays full foreign tax on an amount of income that is, in part, the return derived on the Canadian taxpayer’s investment. However, an offsetting tax reduction is generated in respect of that return within the foreign corporation’s group. If the Canadian corporation had instead made a simple loan to the foreign corporation, the interest income on that loan would generally not be subject to any foreign tax.

At the IFA Roundtable, Finance provided the following specific example of a targeted foreign tax credit generator (shown below in Example 1). An arm’s length U.S. corporation (“USco”) capitalizes two U.S. subsidiaries (“USub1” and “USub2”), which in turn form and capitalize a partnership (“US Partnership”). US Partnership lends the capitalization funds back to USco. US Partnership checks the box to elect to be treated as a U.S. corporation for purposes of the U.S. Internal Revenue Code (the “U.S. Code”) and is not part of the USco consolidated group. A Canadian corporation (“Canco”) pays cash to USub1 to purchase a share of USub1’s partnership interest (a 39% share, in the Finance example). USub1 directly or indirectly lends the cash back to Canco. Canco and USub1 enter into a “repo” arrangement in which USub1 is obligated to repurchase the 39% interest in US Partnership from Canco at a fixed time in the future.

![Example 1 Diagram](image)

From a U.S. tax perspective, the “repo” arrangement is intended to permit the cash purchase price paid by Canco to be treated as a loan to USub1, and consequently USub1 is considered the owner of the full 99% interest in US Partnership. The interest paid by USco to US Partnership is deductible by USco and included in the income of US Partnership (which is treated as a corporation for U.S. tax purposes), and US Partnership pays U.S. tax in respect of that interest income. USub1 earns interest income from Canco, but is also entitled to deduct, as interest on the deemed loan from Canco, the share of US Partnership income that is allocated and paid to Canco in respect of its 39% interest. As a result, USub1 pays no net U.S. tax, and while US Partnership pays U.S. tax on the interest income received from USco, USco benefits from the offsetting interest deduction. Thus, no net tax is paid from a U.S. perspective.

However, from a Canadian tax perspective, Canco would be considered to own the 39% interest in US Part-
nership and would be taxed on its share of the income of US Partnership – namely, the interest income earned from USco. The pro rata amount of U.S. tax paid (by US Partnership as a deemed corporation) in respect of the interest income from USco would be allocated to Canco, giving rise to a foreign tax credit under section 126. Canco would also be entitled to deduct the interest paid to USsub1. Effectively the deduction of the interest paid to USsub1 offsets the income allocated to Canco from the 39% partnership interest, so the foreign tax credit claimed by Canco could be viewed as “free”. Hence, the term “foreign tax credit generator”.

In both the budget materials and at the IFA Roundtable, Finance expressed its view that these types of foreign tax credit generator schemes can be successfully challenged under the existing general anti-avoidance rule. However, Finance indicated that because the Canadian tax at risk is in the “billions”, it is taking no chances and is introducing the new rules to specifically target these transactions. The expressed objective of the new rules is to put the taxpayer in the same tax position as if it had made a loan to the foreign corporation.

The Proposed Legislation

The proposed legislation is included in new subsections 91(4.1) and 126(4.11) and new Regulation 5907(1.03), and is generally effective for taxation years that end after March 4, 2010. In other words, its application is immediate and indeed retroactive with respect to taxation years already in progress on budget day.

All three rules are punitive in that, where the necessary conditions for application are satisfied, deductions or credits for all foreign taxes in respect of the investment for the relevant period are prohibited – i.e., the rules do not provide only for partial or pro rata non-recognition of foreign taxes. These provisions, in addition to examples of their application, are discussed below.

Subsection 126(4.11)

Income or profits taxes paid by a Canadian taxpayer to a foreign government is generally considered either “non-business income tax” or “business income tax”, as those terms are defined in subsection 126(7). The taxpayer can claim tax credits for non-business income taxes under subsection 126(1) and for business income taxes under subsection 126(2), and may deduct non-business income taxes from income under subsection 20(12). Where proposed subsection 126(4.11) applies, the foreign taxes will not be considered business income taxes or non-business income taxes for the purposes of these provisions.

Proposed subsection 126(4.11) is relevant only to a taxpayer that is a member of a partnership. It prohibits the inclusion in computing the taxpayer's business income taxes or non-business income taxes of any foreign taxes paid in respect of income of the partnership for a period where (i) the taxpayer's share of income of the partnership under any foreign tax law under which the income of the partnership is subject to taxation, is less than (ii) the taxpayer's share of the income for the purposes of the Act.

While this provision would indeed neutralize the foreign tax credit benefits available to Canco in the transaction described above in Example 1, it is also inappropriately applicable to many investment structures that are not foreign tax credit generators. For example, subsection 126(4.11) will apply to any equity investment by a Canadian taxpayer in a partnership that is treated as a partnership for the purposes of the Act and a corporation for foreign tax purposes (commonly referred to as a “reverse hybrid” partnership). Consider the following example:

Example 2

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+---------------------+  +---------------------+
| Canco 1             |  | Canco 2             |
|                    +  |                    |
|                     |  |                    |
| Partnership         |  | U.S. Business       |
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In this example, Partnership has checked the box to be treated as a corporation for purposes of the U.S. Code to eliminate the need for Canco 1 and Canco 2 to file U.S. tax returns. Accordingly, Partnership is a U.S. taxpayer and will pay tax under the U.S. Code in respect of income from the U.S. business.

For Canadian tax purposes, the income of Partnership from the U.S. business will be allocated to Canco 1 and Canco 2. The CRA accepts that partners of a partnership that are resident in Canada may claim a deduction under section 126 for foreign taxes paid by the partnership. However, under U.S. tax law, Canco 1 and Canco 2’s share of the Partnership income will be nil given that Partnership is the taxpayer for the purposes of the U.S. Code. It therefore appears that proposed subsection 126(4.11) will deny the tax credit for the U.S. taxes paid by Partnership. This will
result in double taxation as both Canadian and U.S. taxes will have to be paid on the same amount of income.

At the IFA Roundtable, a similar example was discussed. Finance indicated its view that the words of proposed subsection 126(4.11) are capable of being interpreted so that the provision would not apply to this type of investment structure. However, Finance stated it did not intend to target reverse hybrid structures, and is considering clarifications to the language that would make it clear that proposed subsection 126(4.11) would not apply in this situation.

Subsection 91(4.1) and Regulation 5907(1.03)

Subsection 91(1) generally includes in a Canadian taxpayer’s income its participating percentage of foreign accrual property income (“FAPI”) of any controlled foreign affiliate (“CFA”) of the taxpayer. Relief for foreign taxes is provided in subsection 91(4) by entitling a taxpayer to deduct from income an amount equal to the foreign accrual tax (“FAT”) applicable to the FAPI, multiplied by the relevant tax factor. Where proposed subsection 91(4.1) applies, foreign taxes paid by a foreign affiliate (“FA”) will not be considered FAT.

A dividend received from a non-resident corporation is included in a taxpayer’s income under section 90. Where the non-resident corporation is an FA of the taxpayer and the taxpayer is a corporation, the taxpayer is generally entitled to a deduction in respect of the dividend under section 113. In the case of a dividend prescribed by the regulations to be paid out of taxable surplus, a deduction is provided under paragraph 113(1)(b) in an amount equal to the underlying foreign tax (“UFT”) applicable to the dividend, multiplied by the relevant tax factor less one. Where proposed Regulation 5907(1.03) applies, foreign taxes paid by an FA will not be considered UFT.

Proposed subsection 91(4.1) and Regulation 5907(1.03) are relevant to both FAs held through a partnership of which the taxpayer is a member and FAs not held through a partnership.

In the case of an FA held through a partnership, foreign taxes paid by the FA on an amount will not be FAT or UFT where during the period the amount is earned, the taxpayer is considered under the foreign tax law to own less than all of the shares of the FA, of another FA of the taxpayer in which the particular FA has an equity percentage (e.g., a subsidiary of the particular FA), or of another FA of the taxpayer that has an equity percentage in the particular FA (e.g., a parent of the particular FA), that are considered to be owned by the taxpayer for the purposes of the Act.

Provided below are some examples that demonstrate the application of these rules.

Reverse Hybrid Partnership Example

Consider the facts in Example 3 below.

Example 3

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Canco 1

Partnership

CFA

Canco 2
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Similar to Example 2, Partnership has checked the box to be treated as a corporation for purposes of the U.S. Code. Accordingly, Partnership is a U.S. taxpayer and Canco 1 and Canco 2 will not have a share of the Partnership income for U.S. tax purposes. However, Partnership will be treated as a partnership for purposes of the Act and Canco 1 and Canco 2 will be allocated a share of the Partnership income for the purposes of the Act. Thus, if CFA earns any FAPI and pays U.S. tax in respect of that FAPI, Canco 1 and Canco 2 will be taxed on such FAPI under the Act but, by virtue of proposed subsection 91(4.1), it appears that no deduction will be available in respect of the U.S. taxes paid by CFA.

Based on its response at the IFA Roundtable to Example 2, Finance should not be targeting holding structures that use reverse hybrids. It is therefore hoped that the modifications Finance is considering would restore the pre-budget treatment of the U.S. taxes paid by CFA as FAT and UFT.
LLC Example

In Example 4 below, assume that CFA 1 is a U.S. limited liability company ("LLC") and is a disregarded entity for purposes of the U.S. Code. Further, assume that CFA 2 is a C corporation (i.e., a corporate taxpayer) for the purposes of the U.S. Code and realizes FAPI in respect of which it pays U.S. tax. Also, assume that CFA 3 is a corporation that earns active business income (as opposed to FAPI) but is resident in a country that does not have either a tax treaty or a TIEA with Canada and, accordingly, its income is included in taxable surplus.7

Example 4

For purposes of the Act, Canco owns all of the shares of CFA 1. However, it is unclear whether this is also the case for U.S. federal income tax purposes given that for these purposes CFA 1 is disregarded as an entity separate from Canco. Accordingly, it could be argued that Canco does not own all the shares of CFA 1 for U.S. tax purposes. The contrary argument is that CFA 1 is only disregarded for U.S. tax purposes because CFA 1 is wholly owned by Canco and, as such, Canco must own all the shares of CFA 1 for U.S. tax purposes in spite of the fact that CFA 1 is a disregarded entity.

If it was determined that Canco does not own the shares of CFA 1 for purposes of the U.S. Code, no deduction will be available for the U.S. taxes paid by CFA 2 in respect of the FAPI, by virtue of proposed subsection 91(4.1). In addition, by virtue of proposed Regulation 5907(1.03), the foreign taxes paid by CFA 3 will not qualify as UFT and, as such, no relief will be available under paragraph 113(1)(b) when the active business income is ultimately distributed to Canco. Moreover, if CFA 2 disposed of the excluded property shares of CFA 3 at a gain and paid U.S. tax on the gain, one-half of the gain would be included in taxable surplus but the U.S. tax would not qualify as UFT (and again no relief will be available under paragraph 113(1)(b) upon a distribution of the amount to Canco).

At the IFA Roundtable, in the context of a similar U.S. LLC holding structure example, Finance stated that the broad wording of subsection 91(4.1) and Regulation 5907(1.03) does appear to apply. Finance indicated that the proposals are not intended to attack hybrid entity holding structures such as this, and that it is considering modifications to the proposals that would fix the problem.

Repo Example

Example 5 below was discussed at the IFA Roundtable.

Example 5

Canco acquires preferred shares of US 2, and enters into a forward sale agreement with US 1 that provides for the purchase of those preferred shares by US 1 at a fixed time in the future. For U.S. tax purposes, US 1 is considered the owner of the preferred shares. However, for Canadian tax purposes, Canco is considered to own the preferred shares. Accordingly, proposed subsection 91(4.1) and Regulation 5907(1.03) apply to deny any FAT and UFT in respect of any FAPI or taxable earnings of US 1, US 2 or US 3.

At the IFA Roundtable, Finance indicated it is having difficulty justifying relieving modifications for repo structures such as this. Finance noted that normally there is no FAPI in the chain anyway because the repo financing is generally used to fund an active business that generates exempt surplus dividends on the preferred shares. Finance also expressed a concern that these repo structures could be used inappropriately to exploit the 0% withholding rate on interest under the Canada–U.S. tax treaty. However, it is
not clear why the Canadian rules should police U.S. withholding taxes or why overbroad anti-avoidance rules should be allowed to apply beyond their intended target.

**Hybrid Instrument Example**

Whenever a Canadian taxpayer holds preferred shares of an FA that are shares for purposes of the Act and treated as debt for foreign tax law purposes, the proposed rules will apply and foreign taxes paid by the FA (or a parent or subsidiary FA) will not qualify as FAT or UFT. Consider Example 6 below.

![Example 6 Diagram]

The preferred shares of CFA are equity for purposes of the Act and debt for foreign tax purposes. As a result, Canco will own fewer shares of CFA for foreign tax purposes than it does for purposes of the Act and the proposed rules will apply. The interest paid by Foreign Loanco will be FAPI to CFA. For foreign tax purposes, CFA will likely not have significant net income from the loan given that it will be able to treat dividends on the preferred shares as deductible interest. However, to the extent CFA does have any income for foreign tax purposes (including income from other sources) that is subject to foreign tax, such tax will not qualify as FAT or UFT under proposed subsection 91(4.01) and Regulation 5907(1.03).

At the IFA Roundtable, Finance reiterated that the target of the foreign tax credit generator proposals is investment structures using hybrid instruments, not hybrid entities. Example 6 illustrates a non-abusive investment structure using a hybrid instrument that is unfortunately caught as collateral damage by the proposals.

**Conclusion**

The foreign tax credit generator proposals are acknowledged by Finance to be overbroad. While they are expressly intended to target hybrid instrument structures, their broad wording will apply inappropriately to many common investment structures using hybrid entities, and also to investment structures using hybrid instruments that are not foreign tax credit generator transactions. Finance is urged to narrow the scope of the proposals so that they more specifically apply only to structures that Finance considers to be abusive. The integrity of the mechanisms in the Act preventing double taxation of foreign-source income, including foreign tax credits, FAT and UFT, must be restored.

**Notes:**

1. Unless otherwise noted, all statutory references herein are to the *Income Tax Act* (Canada) (the “Act”).

2. From a U.S. perspective, it appears the partnership distribution to Canco could potentially qualify for the 0% rate of U.S. withholding tax applicable to interest under the Canada–U.S. tax treaty.

3. The interest could potentially qualify for 0% Canadian withholding tax under the Canada–U.S. tax treaty.

4. See, for example, paragraphs 1 and 2 of Interpretation Bulletin IT-270R3, “Foreign Tax Credit”, dated November 25, 2004. Also, in CRA Document 9301815, dated April 6, 1993, the CRA commented that this position also applies to members of a partnership where the partnership has elected to be taxed as a corporation for the purposes of the U.S. Code.

5. Taxable surplus generally includes: (i) FAPI; (ii) earnings from an active business where the FA is not resident, or the active business is not carried on, in a country with which Canada has either a tax treaty or a tax information exchange agreement (“TIEA”); and (iii) the taxable portion of gains on excluded property that is partnership interests or shares of other FAS.

6. When the FAPI is paid as a dividend by CFA to Partnership, the partners (Canco 1 and Canco 2, by virtue of section 93.1) will not be entitled to a deduction under paragraph 113(1)(b) because proposed Regulation 5907(1.03) will prevent the U.S. tax on the FAPI from being added to UFT. However, the deduction under subsection 91(5) should be available and, as a result, no additional Canadian tax should be payable on the distribution of the FAPI.

7. Forming CFA 3 under CFA 2 (a U.S. resident) is not a structure a Canadian taxpayer would normally establish, but this could nonetheless result from a legacy structure.

8. This example is similar to the cash repatriation strategy that the CRA recently ruled was not abusive (CRA Ruling 2010-035314IR3). In the facts of the ruling, Canco had excess cash, which Parentco wished to redepot in its non-Canadian group. The payment of dividends by Canco to Parentco would trigger Canadian withholding tax and adverse foreign tax consequences, and a loan by Canco to Parentco would trigger a deemed dividend under the Act by virtue of subsection 15(2) and paragraph 214(3)(a). The transactions described in the ruling were intended to repatriate the cash to the Parentco group without paying a dividend or triggering a deemed dividend under the Act. It appears the ruling was granted on the basis that the Loan is interest-bearing and the interest is FAPI of CFA 3 included in income of Canco.
Non-Resident Commercial Trusts: Exemption Under the Latest Proposals To Amend the Non-Resident Trust Rules

By: Ron Richler, Blake, Cassels & Graydon LLP

In a continuing saga that began with the February 16, 1999 federal Budget announcement of changes to the non-resident trust rules ("NRT Rules") of the Income Tax Act (Canada) (the "Act") and lingered through numerous versions of draft legislation, the Department of Finance (the "Department") announced in the federal Budget of March 4, 2010 that the proposed NRT Rules will be revised again. Amended draft legislation has not been released but the Department stated that the scope of the former proposals would be simplified and better targeted, and it set out the points of departure from the former proposals.

The Department reiterated that it is not intended that bona fide commercial trusts be caught by the NRT Rules. This article focuses on the conditions that will have to be met for a non-resident commercial trust to be exempt under the proposed NRT Rules.

Former Proposals

The most recent iteration of the proposals to amend the NRT Rules was contained in Bill C-10, which was passed by the House of Commons in 2007, became stalled in the Senate, and died on the Order Paper when Parliament was dissolved because of the calling of an election in the fall of 2008.

The former proposals were complex and far-reaching. Essentially, they would have deemed non-resident trusts, other than "exempt foreign trusts", to be resident in Canada if there was either a "resident contributor" to the trust or a "resident beneficiary" under the trust. Both of the latter two terms were widely defined. For example, a Canadian resident that acquired a unit of a typical commercial trust from another holder would have been deemed to be a "resident contributor" (and apparently this will not be changed under the new proposals).

Under the former proposals, a deemed resident trust would have been taxed on all its income, regardless of who contributed the property that generated the income or the source of the income. Those proposals would have generally made both "resident contributors" and "resident beneficiaries" jointly and severally liable for tax payable by the deemed resident trust. After objections were raised before the Senate Banking, Trade and Commerce Com-
mittee, the Department agreed in comfort letters issued in April 2008 to provide an exemption to "qualifying pension entities", including registered pension plans and certain Canadian intermediaries such as pooled fund trusts, in which qualifying pension entities were the only holders of equity or participating debt.

For a foreign commercial trust that had or wished to have Canadian investors, the focus was on qualifying as an "exempt foreign trust" so that it would not be exposed to Canadian tax liability as a deemed resident of Canada. There were numerous conditions that had to be met to be an "exempt foreign trust", and it was difficult in many cases to opine that a particular foreign trust would be exempt.

Admittedly, the Department has a difficult task in providing practical rules that exempt bona fide commercial foreign trusts while at the same time preventing improper tax avoidance through the use of offshore trusts structured to look like commercial trusts. Still, I and other Canadian tax advisors were met with incredulity when forced to advise legitimate foreign commercial trusts that all of their income might be subject to Canadian tax because of a few Canadian investors.

New Proposals

The new proposals are to apply for the 2007 and subsequent taxation years, except that the attribution rule mentioned below is to apply for taxation years that end after March 4, 2010.

Under the new proposals, a foreign trust other than an "exempt foreign trust" will still be deemed to be resident in Canada if there is a "resident beneficiary" or a "resident contributor". However, the amount of income of a deemed resident trust subject to Canadian tax will be significantly limited. It is proposed that the trust property be divided into a resident portion and a non-resident portion. The resident portion will consist of property acquired by the trust by way of contributions from residents and certain former residents, and any property substituted for such property. The non-resident portion will consist of all other property. Income from the non-resident portion will be excluded from the trust income subject to Canadian tax. Income from the resident portion will be attributed to resident contributors so that the trust will not be subject to tax thereon. As a result, the trust will ordinarily pay tax in Canada only on income derived from contributions of certain former resident contributors.

Additional rules will allocate accumulating income to the resident portion or the non-resident portion, establish ordering rules for distributions, and provide better foreign
tax credits for taxes paid to another country that treats the trust as a resident.

Also, tax-exempt entities such as registered pension plans and charities will be deemed not to be “resident beneficiaries” or “resident contributors”. Unlike the comfort letters of April 2008, the new proposals do not mention pooled funds used exclusively by tax-exempt entities. These should be accorded the same treatment.

While the amount that may be taxed in Canada as a deemed foreign trust will be limited, a foreign commercial trust will still be looking for an exemption. If the exemption is available, the trust would not be required to file a Canadian tax return as a deemed resident of Canada. Canadian tax responsibilities would fall on the Canadian resident investors rather than on the trust. Canadian resident investors in an exempt foreign trust would, among other things, need to be concerned with the offshore investment fund rules of existing section 94.1 of the Act, as modified by the March 4, 2010 federal Budget, rather than the fondly remembered proposals for foreign investment entities abandoned in that budget.

With regard to the exemption under the proposed NRT Rules, the Department stated that a commercial trust will not be deemed to be resident in Canada if it satisfies all of the following conditions:

(a) each beneficiary is entitled to both the income and capital of the trust;

(b) any transfer of an interest by a beneficiary results in a disposition for the purposes of the Act and interests in the trust cannot cease to exist otherwise than as a consequence of a redemption or cancellation under which the beneficiary is entitled to receive the fair market value of the interests;

(c) the amount of income and capital payable to a beneficiary does not depend on the exercise of, or failure to exercise, discretion by any person (discretion only with respect to the timing of distributions will not prevent a trust from being an exempt foreign trust);

(d) interests in the trust: (i) are listed and regularly traded on a designated stock exchange, (ii) were issued by the trust for fair market value, or (iii) where the trust has at least 150 investors, are available to the public in an open market;

(e) the terms of the trust cannot be varied without the consent of all the beneficiaries or, in the case of a widely held trust, a majority of the beneficiaries; and

(f) the trust is not a “personal trust”.

We will have to wait for draft legislation to judge whether these conditions will provide a reasonable basis for exemption for bona fide commercial trusts. But, a number of issues are already apparent, and submissions have been made to the Department, including a submission by the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants that was made May 3, 2010. Some of these are continuing concerns raised in respect of the former proposals.

1. Transfers and Cessation of Interests

With regard to condition (b) above, the usual ways that an investor would transfer an interest in a commercial trust – namely, redemption or sale – would result in a disposition for the purposes of the Act. However, the condition further requires that, on a redemption, the proceeds equal fair market value. Where units are listed, the fair market value would likely be considered to equate to the listed value. If redemption proceeds are equal to net asset value and this differs from listed value, the condition would not be met. Often, redemption proceeds otherwise payable are reduced when units have been held less than a stated number of years. This is accepted in the market but would not pass muster under this condition. Condition (b) should be amended to permit redemption at fair market value, at net asset value, or pursuant to a commercially reasonable formula.

There should also be an exception for unitholders that are employees to accommodate redemptions for no consideration of units issued under an employee incentive plan, where a vesting requirement is not met.

Another concern is whether, on a reorganization or merger of the trust, units might cease to exist otherwise than as a consequence of a redemption or cancellation. For example, the foreign jurisdiction may permit a merger in which the units of the trust cease to exist and are transmogrified into units or shares of a surviving entity in a way that does not involve a redemption or cancellation. A foreign trust may have no intention to ever merge in this way. But the possibility that it might would deny the exemption. Condition (b) should be amended so as not to taint the trust if it may cease to exist on a reorganization or merger where unitholders would receive consideration on a commercially reasonable basis. Better still, it should be restricted to cessations of interest that may occur pursuant to the trust documents as opposed to the reorganization and merger law of the governing jurisdiction.
2. Discretion
The Department has added the helpful comment that discretion only with respect to timing of distributions will not prevent a trust from being an exempt foreign trust. This is consistent with prior positions of the Canada Revenue Agency with respect to the similar condition in existing paragraph 94(1)(c) of the Act.\(^1\) It is unclear, however, if a trust would be tainted where the discretion as to timing of distributions has an impact on the amount of distributions. Where the amount to be distributed depends on amounts earned or received by the trust up to the record date for distribution and the trustees have discretion in determining the record date, that discretion will govern not only the timing of the distribution, but also the amount of the distribution.\(^2\) Another concern is that the trustees may have discretion to determine the amount of income or distributable cash to be payable to investors. Also, the Joint Committee pointed out that some trusts provide for discretionary distributions so that the units of the trust are not classified as liabilities under International Financial Reporting Standards. As a policy matter, these types of discretion should not be problematic. In discussions regarding the former proposals, officials of the Department indicated that the purpose for the condition on discretionary distributions was to deny the exemption to trusts that permit discrimination among investors regarding distributions or permit the appointment of new beneficiaries. The Department should clarify that this condition is limited to those types of situations.

3. Issuance at Fair Market Value
Condition (d) provides for three alternatives. In the case of a commercial trust whose units are not listed or otherwise traded in an open market, it appears that all of the units must be issued by the trust for fair market value. But how does one determine fair market value in these circumstances? Most of these trusts would generally issue units at net asset value. Is net asset value to be considered the equivalent of fair market value in the absence of a market? If so, this should be stated in the rules. That would still leave a problem for these trusts that issue units at a discount to net asset value pursuant to rights offerings or on the reinvestment of distributions. As all unitholders are provided these opportunities, this should not result in denial of the exemption, and the Department should clarify that this is the case. There should also be an accommodation for units issued at less than fair market value pursuant to an employee option or incentive plan.

4. Variation of the Terms of the Trust
Most commercial trusts permit amendments to the terms of the trust without consent of the investors to cure ambiguities, fix defects, or, generally, when the change does not materially adversely affect the interests of the investors. The Department should change condition (e) so that this does not deny the exemption.

Conclusion
Clearly, the proposals are a welcome improvement. With relatively few clarifications and adjustments when the draft legislation is released, the stated policy objective of exempting bona fide commercial trusts would be achieved.

Notes:
1. See CRA Document Nos. 5-4117 (June 23, 1982), 5-8820 (March 2, 1990), 903515 (January 15, 1991) in which the CRA also took the position that discretion as to the amount to be distributed was not problematic if the trustees did not have discretion to distribute to one or more beneficiaries at the exclusion of others and 2008-0285961ES (September 16, 2008).

CRA Rules on Second-Tier Financing Structure

By: Drew Morier, Osler, Hoskin & Harcourt LLP

A recent advance ruling issued by the Canada Revenue Agency (the “CRA”) suggests that the use of a Canadian company’s cash to indirectly benefit its non-resident parent through a second-tier financing structure may not pose an avoidance risk, at least in certain circumstances, provided the relevant technical rules are complied with.

A number of rules in the Income Tax Act (Canada) (the “Act”) are aimed at preventing the appropriation of a Canadian company’s cash (and the income such cash could generate) by or for the benefit of a non-resident shareholder. The main provisions are subsection 15(2) and paragraph 214(3)(a), which treat a loan by a Canadian-resident corporation to a non-resident shareholder (or to a person connected with a non-resident shareholder) as a distribution subject to dividend withholding tax, unless the loan is a short-term loan that is not part of a series of loans and repayments. Subsection 80.4(2) deems the shareholder to have received a benefit to the extent that the lender does not receive interest that equals or exceeds the prescribed rate, and a combination of subsections 15(9), 15(1) and paragraph 214(3)(a), subjects the amount of the benefit to dividend withholding tax. There are related measures aimed at preventing the erosion of the Canadian tax base resulting from the expatriation of funds from Canada. Subsections 17(1) and (2) impute interest income on direct and indirect longer-term loans from a Canadian-resident corporation to non-residents that are outside of the “Canadian cone.” In the foreign affiliate context, the recent tightening of the “deemed
active business” rules in paragraph 95(2)(a) ensures that the beneficial “deemed active business income” rules apply only where the relevant Canadian taxpayer has a material equity interest in the underlying active business corporations. This framework is further supported by the anti-avoidance rule in subsection 95(6), by the deemed interest rule in subsection 258(3), and by the general-anti avoidance rule in section 245.

CRA Document No. 2010-0353141R3, published on May 5, 2010, is an advance income tax ruling (the “Ruling”) dealing with the Canadian subsidiary (“Canco”) of a U.S. public company (“Parentco”). Parentco holds all the shares of a Canadian holding company (“Can Holdco”), which in turn holds all of the shares of Canco. The Parentco group includes non-Canadian and non-U.S. operating companies, including a non-U.S. company (“Loanco”) that acts as a finance company in respect of the Parentco group’s non-U.S. and non-Canadian operations – i.e., it takes deposits of excess cash from group members and redeploy it within the group. Canco has excess cash that it has traditionally loaned to other Canadian members of the group; however, there is no longer any need for this cash in Canada and Canco has loaned a portion of it, on a short-term basis, to Parentco.

The “Proposed Transactions”, as described in the Ruling, involve Canco using the proceeds of repayment of the loan from Parentco, and its other excess cash on hand, to finance a wholly owned subsidiary formed by Canco in a foreign jurisdiction (“Financeco”). Canco will use its excess cash to subscribe for “mandatorily redeemable preference shares” (“MRPS”) of Financeco. The Ruling states that the MRPS have a hybrid nature for relevant foreign purposes, treated as equity for the relevant foreign corporate law purposes, but as debt for the relevant foreign tax law purposes.3

Financeco will use the funds obtained from Canco to make a loan to Loanco at a term longer than one year, and with a floating LIBOR-based interest rate. Loanco will then on-lend the funds to non-Canadian and non-U.S. members of the Parentco group. Neither Loanco nor any of the ultimate borrowers is a foreign affiliate of Canco or any other Canadian-resident member of the Parentco group. The Ruling indicates that Canco may subscribe for additional MRPS of Financeco as it generates excess cash.

Under the heading “Purpose of the Proposed Transaction”, the Ruling indicates that Canco “contemplated” distributing its excess cash to Parentco by way of dividend (i.e., dividend to Can Holdco followed by dividend from Can Holdco to Parentco), but that such dividends “would trigger adverse U.S. tax consequences”. In addition, the Ruling notes that the application of subsection 15(2) and paragraph 214(3)(a) to Canco’s loan to Parentco would trigger 15% dividend withholding tax under the Canada–U.S. Tax Treaty, and that Parentco would not be entitled to the lower 5% rate since it does not, directly, own any shares in Canco (whose shares are held by Can Holdco).4

The CRA’s rulings confirmed the following technical application of the provisions of the Act:

- Financeco will be a foreign affiliate and a controlled foreign affiliate of Canco.
- Financeco’s interest income will be foreign accrual property income (“FAPPI”) to Financeco.
- Subsection 17(2) will apply to deem Loanco or the ultimate Parentco group borrowers to owe amounts directly to Canco. However, in accordance with the terms of the provision, subsection 17(1) will not apply to require Canco to include any income amount in respect of attributed interest provided that the FAPI earned by Financeco (and included in Canco’s income under subsection 91(1)) exceeds the prescribed rate for subsection 17(1) set out in Regulation 4301(c).
- In accordance with its terms, subsection 80.4(2) will not apply to deem any benefit provided that the interest rate on the loan to Loanco exceeds the Regulation 4301(c) rate and the interest for a year is paid no later than 30 days after the end of the year.

More importantly, the CRA ruled that subsection 15(2) would not apply to the loan to Loanco, and that the GAAR would not apply to redetermine the consequences confirmed by the previous rulings.

In the “Reasons” section of the Ruling, the CRA indicates that subsection 15(2) would not apply by virtue of subsection 15(2.2), which states that subsection 15(2) does not apply to indebtedness between non-resident persons. The CRA also states that “GAAR will not apply because the interest on the loan is FAPI to the controlled foreign affiliate”.

Thus, it appears that the “toll charge” to be paid in order to use the Canadian company’s excess cash to fund operations of the Parentco group over a longer term period (without having to pay a dividend) is the FAPI generated by the loan to Loanco.5 The inference is that the transaction is not considered to constitute abusive tax avoidance where the income from the funds deployed from Canada remains in the Canadian tax net.

An advance income tax ruling applies, of course, only to the taxpayer to whom it is issued. While it is always prudent to exercise caution when relying on a CRA position expressed in a ruling, this is particularly the case in an area as sensitive as subsection 15(2) avoidance. The CRA’s traditional hostility to so-called “second-tier” financing structures (and the reliance on a subsection 15(2) avoidance argument to challenge them) calls for caution in this area. In addition to the GAAR, the CRA has, in the past, attempted to challenge transactions of the type set out in the Ruling using other provisions, such as subsection 95(6) in relation to the formation of a foreign finance company, and subsection 258(3) in respect of the characterization of
the dividends on foreign finance company shares, where the Canadian taxpayer is a specified financial institution. In addition, the substance and residence of the foreign finance company (and the characterization of its interests where they are of a hybrid nature) is open to review. It is notable that the CRA did not raise such concerns in the Ruling.

The Ruling may indicate a more general relaxation of the CRA’s position in this area, suggesting that the CRA is now satisfied with the statutory tools available to it in such circumstances (such as section 17 and the recent tightening of the paragraph 95(2)(a) requirements). On the other hand, the CRA may have been comfortable in the context of the Ruling on the basis of its particular facts, without intending to telegraph a more lenient position overall. Notwithstanding the Ruling, any taxpayer considering a similar transaction may consider seeking its own ruling. It will be interesting to see how the CRA responds to similar ruling requests and how its position in this area continues to evolve.

Notes:

1 Subsection 80.4(2) is broader than subsection 15(2) since it can (unlike subsection 15(2)) apply to debts between non-residents.


3 On the basis of the description of the MRPS it may be inferred that the relevant foreign jurisdiction is Luxembourg, although this is not stated in the Ruling.

4 Both of these issues could have been avoided if (a) Canco paid a dividend to Can Holdco, and (b) Can Holdco made a loan to which subsection 15(2) applied. Presumably Parentco would not be considered to receive a dividend for U.S. tax purposes, and the 3% rate of withholding would apply since the dividend would be deemed to be paid by Can Holdco, 100% owned by Parentco.

5 Of course, there may not necessarily be additional Canadian tax if the FAPI inclusion is sheltered by losses or other tax attributes. In the circumstances of the Ruling, where Canco appeared to have a material amount of excess cash, it may be reasonable to assume that it was taxable and that the FAPI inclusion would result in additional Canadian tax.