North American Free Trade & Investment Report

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Biweekly report on legal & financial issues affecting direct investment and cross-border trade in Mexico, the U.S., and Canada

Canada: M&As

Canadian M&A: New Tax Landscape Requires Innovative Planning

By Elinore Richardson and Larissa Tkachenko
(Borden Ladner Gervais LLP)

The past year has seen significant developments in Canada's international tax rules affecting both inbound and outbound investment, with the promise of more to come.

Canadians now have greater access to international capital markets. Effective January 1, 2008, Canada repealed its withholding tax on interest paid by Canadian borrowers to arm's length foreign lenders. The relief is broad covering debt of all maturities and related financing costs. All foreign arm's length lenders benefit from the exemption regardless of

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Mexico: Budget

Mexico's 2009 Proposed Revenue Law and Budget

By Oscar Castañeda and John Salerno
(PricewaterhouseCoopers LLP)

On September 8, 2008, the Executive Branch of the Mexican government submitted the proposed 2009 Revenue Law and Budget to the Mexican Congress.

Breaking with long-standing tradition, this proposal excludes major changes to the tax laws, and emphasizes that the Mexican economy, business community and revenue system are all engaged in a process of adaptation to and implementation of the major tax reforms introduced in recent years (e.g., the Flat Tax, the cost of goods sold concept, and the Tax on Cash Deposits). Nonetheless, the 2009 Revenue Law does contain some tax-related provisions, which are summarized below.

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HIGHLIGHTS

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that withholding procedures and documentation are reviewed, updated, implemented, and accurate. Withholding agents participating in the section 1441 Voluntary Compliance Program ("VCP") are not exempt from these new audit standards and should expect the Service to impose penalties if the expectations of IRM provision 4.10.21 are not met.[13]

Recommendation

Any taxpayer subject to withholding obligations under sections 1441 and 1442 should review its withholding procedures and documentation to ensure that they are accurate and up to date.

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[1]According to the IRM, this provision was finalized on July 29, 2008.
[2]Section 1442 applies section 1441 to foreign corporations.
[3]IRM 4.10.21.1.1.
[4]IRM 4.10.21.8.
[5]IRM 4.10.21.9.
[6]IRM 4.10.21.8.3 (for financial institutions) and IRM 4.10.21.9.3 (for multinational companies).
[7]*See* IRM 4.10.21.8.3 and IRM 4.10.21.8.4.
[8]IRC § 1461.
[9]IRM 4.10.21.8 and 4.10.21.9.
[10]IRM 4.10.21.8.2.
[11]IRM 4.10.21.8.7.
[12]IRM 4.10.21.8.6.
[13]*See* Rev. Proc. 2004-59, IRM 4.10.21.7, and IRM 4.10.21.11.

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CANADA

Competition

Conservatives Promise Important Amendments to Canada's Competition Act

By Mark Katz (Davies Ward Phillips & Vineberg, LLP)

Much has been made of the potential impact of the November presidential election on the enforcement of U.S. antitrust law.

Somewhat surprisingly, competition law has emerged as an issue in Canada's upcoming federal election as well, which is scheduled to take place on October 14, 2008.

It is unusual for competition law issues to form part of an electoral campaign in Canada, much less to assume a prominent role in a party's platform. Yet, on September 25, 2008, the Conservative Party of Canada announced that if re-elected, it would introduce several far reaching changes to Canada's *Competition Act* as part of a broader effort to protect Canadian consumers from anti-competitive practices.

Specifically, the Conservatives said that they would amend the *Competition Act* by:

- introducing a new criminal conspiracy offence focussed on "hard core" cartel conduct such as price fixing and bid-rigging, with other types of potentially anti-competitive agreements to be dealt with on a separate non-criminal track;
- decriminalizing the *Competition Act*'s price discrimination, promotional allowances and predatory pricing offences;
- raising the maximum penalties for cartels and bid-rigging to a $25 million fine and 14 years in prison from the current $10 million fine and five years imprisonment;
- introducing fines for abuses of dominance (up to $10 million for first time and $15 million for repeat offenders);
- increasing the maximum penalties for obstructing Competition Bureau investigations to $100,000 on summary conviction (up from $5,000) and 10 years imprisonment for an indictable offence (up from two years); and
- increasing the existing penalties for deceptive marketing.

The above proposals are not entirely new. They have been suggested before, including in large part in draft legislation that was introduced by the former Liberal government, which then fell by the wayside when the Liberals were defeated by the Conservatives in Canada's last federal election.

Following that election, the Conservatives indicated very clearly that they were not interested in these - or any other - amendments to the *Competition Act*. This view was met with approval by most of Canada's business community, which was particularly opposed to the idea of introducing a *per se* criminal offence for "hard core" cartels and fines for abuses of a dominant position (although there was support for decriminalization of the pricing offences).

More recently, however, a panel appointed by the Conservative government to review Canadian competition (and foreign investment) law included the same types of proposals in its list of recommendations. With their recent promise, the Conservatives are now committed (insofar as a political party can ever be "committed") to implementing these changes. Given that the Conservatives are now comfortably ahead in the polls, this promise may shortly become legislative reality.

The Conservatives are surely aware of the Canadian business community's past opposition to many of these proposals. Indeed, in their announcement, the Conservatives took pains to reaffirm their devotion to "free enterprise, free markets and free trade". However, the Conservatives are also trying to position themselves as advocates of "regular people" and have obviously drawn the conclusion that there are votes to be won as the champion of Canadian consumers. All of which means that, if the Conservatives are indeed re-elected, the Canadian business community will have to once again work to prevent the enactment of amendments that run contrary to its interests, but this time without the support of their natural allies in government.

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whether their home jurisdictions provide reciprocity to Canadian lenders. However, the exemption does not apply to participating debt interest linked to factors such as revenues, profits, commodity prices or dividends.

On October 31, 2006, the Minister of Finance announced the intention of the Government of Canada to tax existing specified investment flow–through (SIFT) entities, (subject to certain grandfathering requirements) beginning in 2012, at the entity level as if they were corporations. Implementing legislation was enacted in 2007. SIFTs, which included, publicly traded trusts (income trusts) and partnerships had previously not been subject to tax and had been preferred investments for foreign investors.

Despite the tax benefits they offered, at least in the short term, there were also disadvantages to the income trust structure. Many SIFTs, therefore, began to consider conversion to corporations but were hampered by the fact that Canada's tax rules did not facilitate such conversions. The Canadian government promised to address these uncertainties and on July 14, 2008 released draft amendments to facilitate conversion of SIFT trusts and partnerships into corporations. The draft legislation addresses the different ownership structures used by income trusts and provides tax deferred conversions:

- through an exchange of units of a publicly traded SIFT for shares of a newly created and publicly traded Canadian corporation, followed by a liquidation of the trust (and other subject entities), or
- through a redemption or cancellation of units of a SIFT followed by a distribution of shares of a taxable Canadian corporation.

The principal benefit of the proposals is that, in addition to deferral and some carry-over of attributes, they will minimize the administrative burden attendant on such planning. While the proposals will not directly have application where a foreign investor acquires a SIFT from its unitholders, they will, however, facilitate the process, either "pre" or "post" acquisition, of conversion to corporate form.

Frustrations for Foreign Investors

Against these positive developments, others, among them Canada's disappointing proposals to amend its reporting rules for foreign arm's length sellers of Canadian-based investments, its continued adherence to overly complex rules relating to the write-up of inside asset cost for acquirors on non-depreciable capital assets and the absence of any action to redress the rules which leave many Canadian subsidiaries exposed to huge currency gains on repayment of foreign denominated debt with no recognition for offsetting real economic losses on underlying investments, remain ongoing sources of frustration for foreign investors.

Where a Canadian company issues debt convertible into its own shares or exchangeable into shares or other assets to a lender, the recent decision of the Federal Court of Appeal in *Tembec Inc. v. The Queen* establishes that, in the former case, no deduction will be available to the issuer for the difference between the fair market value of the shares issued on conversion and the issue price of the debt. While this result might well have been expected given the decision of the Supreme Court in *Imperial Oil v. The Queen*, the decision of the Federal Court of Appeal also casts doubt on the long standing administrative practice of the Canadian tax authorities to permit the issuer a deduction for this difference in the case of commodity-based or exchangeable debt. If this decision was to result in a disallowance of such deductions to issuers, there would be no offset, in future, for the portion of the taxable gain recognized by the issuer on delivery of the shares or commodity into the conversion. *Tembec* has filed for leave to appeal the decision to the Supreme Court of Canada.

Foreign investors, and in particular those from the U.S. with profitable Canadian subsidiaries that prefer not to repatriate those profits but to redeploy them elsewhere in their corporate group from Canada, have long been the focus of review by Canada's revenue authorities. In addition, the Canadian and the U.S. tax administrations have had cross-border planning involving hybrid entities, both inbound and outbound, high on their agendas.

Tax Haven Subsidiaries and Tower Structures Targeted

In 2007, Canada passed legislation to deny, after 2011, interest deductibility to Canadian corporations in respect of so-called double dip structures. The rules will apply only to outbound double dip financing arrangements (Canadian corporations financing foreign subsidiaries). Two particular types of cross-border financings were targeted in the legislative background material released by the Department of Finance. The first is a structure, which utilizes an intermediary subsidiary located in a low tax jurisdiction. The second is known as a "tower structure", and takes advantage of hybrid entities, which are treated differently for tax purposes, specifically with reference to Canada and the U.S. Such structures are commonly used by Canadian corporations to finance foreign acquisitions with the tax benefit of allowing, in effect, the same interest deduction to reduce both Canadian and foreign taxes, without an offsetting income inclusion.

The new rules are extremely complex. They are also broadly drafted and will have application beyond the scope of their expressed purpose, that is, where no double interest deduction actually occurs. The rules may apply not only when a Canadian corporation directly incurs interest and financing expenses, but also when it is a member of a partnership that incurs such expenses. In addition, if certain attribution rules apply, an inter-affiliate loan which benefits one corporation in a related group may result in a denied interest deduction to another corporation within the group.

As well, on September 21, 2007, Canada and the U.S. signed the Fifth Protocol to the Canada-U.S. Income Tax Convention that contains both (expected) relieving provisions and (unexpected) changes which eliminate treaty benefits. Treaty benefits will be extended to U.S. members of U.S. LLCs, a withholding tax exemption will apply to both guarantee fees and arm's length and, over a three-year phase-in, to related party interest payments and "look-through" provisions will permit corporate members of fiscally transparent entities the reduced 5 percent substantial interest dividend withholding rate.

Anti Hybrid Rules

The Protocol, however, adds highly complex "anti hybrid" rules intended to deny treaty benefits to entities, such as partnerships and companies, that are considered fiscally transparent (that is, not subject to tax at the entity level) in one country but not the other. These rules will have effect from the first day of the third calendar year that ends after the Protocol enters into force. If the rules apply, cross-border payments (such as interest and dividends) made by or through a fiscally transparent entity will be subject to the full domestic rate of non-resident withholding tax applicable in the country of source of the payment (25 percent in the case of payments made from Canada). In the Canadian inbound context, U.S. residents routinely use Canadian unlimited liability companies (ULCs), which they can elect to treat as fiscally transparent for U.S. tax purposes, as intermediaries to hold interests in Canadian corporations and to carry on business activities in Canada. Concerns have been raised by many tax professionals that the new rules, which will deny treaty benefits to dividend distributions from ULCs and taxed distributions from other entities should not generally be considered to be tax abusive. The U.S. Treasury Department Technical Explanation of the Protocol released on July 10, 2008, concurrent with the hearing on that date of the U.S. Senate Committee on Foreign Relations on pending income tax treaties with Canada, Iceland and Bulgaria, did not provide the hoped for resolution of these issues.

A significant change in the Protocol is Canada's buy-in to its first comprehensive "limitation on benefits" provision, intended to curtail tax treaty shopping. Treaty benefits will no longer be available simply because a taxpayer is a resident of the U.S. Only a U.S. resident that is a "qualifying person" will be entitled to treaty benefits. A U.S. resident that is not a "qualifying person" may obtain benefits for certain income if it meets an "active trade or business" test or a "derivative benefits" test. Any other U.S. resident will not obtain treaty benefits unless Canada grants discretionary relief.

Qualifying Persons

In the commercial sector, the following categories of Canadian and U.S. residents are "qualifying persons":

- An individual resident in one or other of the contracting states.
- Companies and trusts that satisfy a "publicly traded" test. The company's or the trust's principal class of shares or units and any "disproportionate" class must be primarily and regularly traded on one or more recognized stock exchanges. A company's "principal class" of shares is its ordinary or common shares or such other classes of shares that represent the majority of the votes and value in the company. A disproportionate class is one on which the return tracks the issuer's income, profit or gain from the other country.
- Subsidiaries of publicly traded companies and trusts of which more that 50 percent of the votes and value of their shares (and of each disproportionate class of shares) is owned, directly or indirectly, by five or fewer publicly traded qualifying persons.
- Companies and trusts that satisfy an "ownership/base erosion" test. For a company, 50 percent or more of the votes and value of its shares, (and of each disproportionate class of shares), must not be owned, directly or indirectly, by persons except qualifying persons. A similar ownership requirement applies to a trust. Also, the amount of tax-deductible expenses paid or payable by the company or trust, directly or indirectly, to non-qualifying persons in its preceding fiscal period must be less than 50 percent of gross income for that period.

Active Trade or Business Test

A U.S. or Canadian resident that is not a qualifying person may be entitled to treaty benefits for certain income pursuant to an "active trade or business" test or a "derivative benefits" test.

Under the "active trade or business" test, income that a resident earns from the other source country will benefit from treaty relief if the resident (or a related person) is engaged in the active conduct of a trade or business in its country of residence, the source country income is derived in connection with, or is incidental to, that trade or business, and that trade or business is substantial. The Technical Explanation indicates that income will be derived in connection with an active trade or business if the activity in one country is "upstream", "downstream" or "parallel" to that in the other. For example, the connected U.S. activity of a Canadian manufacturer can consist of selling the manufactured product, providing inputs to the manufacturing process, or manufacturing and selling the same kind of product in the U.S.

Derivative Benefits Test

The derivative benefits test permits a U.S. or Canadian resident company that is not a qualifying person to obtain treaty benefits for dividends, interest and royalties. The company must satisfy an ownership base erosion test intended, in essence, to provide benefits if the company is owned by a resident of a third country whose tax treaty with the source country is as favorable in its treatment of the relevant item of income, as that provided for in the Canada-U.S. Income Tax Convention. This will prove difficult in the case of related-party interest paid from Canada, as Canada's zero rate treaty with the U.S. is unique, among its agreements with its treaty partners.

The limitation on benefits provision will require Canadians paying amounts to the U.S., to satisfy themselves as to their recipient's entitlement to treaty reduced withholding tax rates.

The limitation on benefits provision will require Canadians paying amounts to the U.S., to satisfy themselves as to their recipient's entitlement to treaty reduced withholding tax rates. In most cases entitlement will require factual information not in the public domain. To make the system viable the Canadian tax administration has indicated that it will be issuing guidelines on an appropriate certification system; absent such a system contractual representations and indemnities will be essential. Withholding tax gross-up provisions in contracts with U.S. recipients should be reviewed, since Canadians who have agreed to gross-ups may incur additional costs if the

U.S. recipient is no longer entitled to treaty benefits. The limitation on benefits provision has no grandfathering or apportionment relief, so a person who ceases to be entitled to treaty benefits cannot claim relief for previously accrued gains or income. Companies that are not publicly traded will need to monitor the status of their shareholders to determine their eligibility for treaty benefits. A takeover of a publicly traded company or trust by private interests may result in loss of treaty benefits.

Canada's tax treaties have also been considered in three important Tax Court decisions, all decided in favor of the taxpayers. These cases address two concepts contained in most OECD-type tax treaties, "beneficial ownership" and "permanent establishment" and will be of considerable importance to foreign investors in structuring their investments into and their activities with and in Canada. The *Prevost Car* decision rejected the government's "conduit" attack on a Dutch holding company through which UK and Swedish shareholders owned their Canadian subsidiary. The Tax Court recognized the Dutch company as the 'beneficial owner' of dividends paid from Canada, because it maintained discretion and the right of independent action as to the use of those funds, and applied the reduced rate of withholding tax under the Canada-Netherlands treaty. In the *American Income Life Insurance Co.* and *Knights of Columbus* decisions, the Tax Court upheld two U.S. insurers' claims for the "business profits exemption" under the Canada-U.S. Income Tax Convention on the basis that the insurers did not have permanent establishments in Canada. The *Prevost* case has been appealed.

Canada has created an Advisory Panel to recommend further changes to Canada's international tax system. The Panel will address expansion of the exemption feature of Canada's CFC system, withholding tax exemptions, changes to Canada's thin capitalization rules, and measures to counteract treaty shopping and to simplify administration. The Panel is to provide its recommendations by December 1, 2008. Any changes based on the Panel's recommendations (given its areas of review) will most likely impact future planning for foreign investors in structuring their arrangements into Canada.

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Competition

Controversial Report Issued on Canadian Competition Bureau's Subpoena Powers

By George Addy, John Bodrug and Mark Katz
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On January 28, 2008, a judge of Canada's Federal Court set aside two subpoenas obtained by the Competition Bureau against two Canadian brewing companies (Labatt and Lakeport) as part of the Bureau's ongoing inquiry into their beer merger. The judge found that the Competition Bureau's original applications for the orders (which were filed and considered on an *ex parte* basis) were "misleading, inaccurate and incomplete". The judge's comments led the Federal Minister of Industry to call for an investigation into the Bureau's conduct. Subsequently, the Commissioner of Competition (who heads the Bureau) and the Deputy Minister of Justice appointed Brian Gover, a Toronto lawyer in private practice, to review and advise on the Competition Bureau's subpoena process, which is set out in Section 11 of the *Competition Act*.

Mr. Gover's report (the "Gover Report") was released on August 12, 2008 and is available on the Competition Bureau's website at http://www.competitionbureau.gc.ca/epic/site/cb-bc.nsf/en/02709e.html. While the report makes some helpful recommendations, it also includes some questionable conclusions and, overall, falls short of a much needed objective review of the Section 11 subpoena process.

The Section 11 Process

Section 11 of the *Competition Act* allows the Commissioner of Competition to apply *ex parte* to a court for an order that is similar to a subpoena. Section 11 orders can require the production of documents, attendance at an oral examination under oath, and responses to written interrogatories under oath, often within a very short time frame.

Responding to Section 11 orders can be an expensive and onerous proposition. It often requires production of massive volumes of documents and information, including extensive searches of computer records and electronic databases going back many years. These orders also frequently require the creation of new and costly types of reports or data streams.

