Deloitte.

Canada
International Tax

Contacts

National leader - International Tax
Olivier Labelle
403-267-1790

Quebec
François Champoux
514-393-5019

Eastern
Tony Maddalena
905-315-5734

Patrick Bilodeau
613-751-5447

Toronto
David Bunn
416-601-5890

Prairies
Andrew McBride
403-503-1497

British Columbia
Brad Gordica
604-640-3344

Related links
International Tax services
Deloitte Tax services

International tax alert
New international tax legislation

September 20, 2016

The Department of Finance (Finance) released a package of draft legislation on September 16, 2016 that may require taxpayers to amend tax returns filed in prior years or evaluate whether to file certain elections before the end of the year. The most important international tax proposals are discussed below.

Stub period FAPI

Foreign accrual property income (FAPI) earned by a foreign corporation must be reported in a taxpayer's income if the foreign corporation is a controlled foreign affiliate (CFA) of the taxpayer at the end of its taxation year. If the taxpayer has sold the CFA or the entity has ceased to be a CFA during the year, no FAPI is required to be reported. Finance released draft legislation on July 12, 2013 that would have deemed the CFA's taxation year to have ended at the time the CFA is disposed of or the taxpayer's interest (surplus entitlement percentage or SEP) in the CFA declines, requiring the taxpayer to report the FAPI earned by the CFA as of that point in time during the year.

The July 12, 2013 proposals were subject to criticism due to technical issues and were not subsequently introduced in the House of Commons. In the 2015 budget, the government indicated its intention to introduce such proposals in the future. Now those proposals have been released again in draft form, and are proposed to be applicable retroactive to July 12, 2013. Taxpayers may be required to refile their returns in order to report FAPI or to take into account changes in the draft legislation.

There are numerous technical differences between the former proposed rules and the rules that were released on September 16, 2016. Most importantly, there are three exceptions to the application of the rules and two elections for taxpayers to consider.

The rules generally apply if a particular foreign affiliate (FA) earns FAPI and the taxpayer's SEP in the particular FA subsequently increases or decreases as a result of the acquisition or disposition of shares in a FA of the taxpayer. The taxpayer need not acquire or dispose of the shares itself

and the FA need not be the particular FA that has earned the FAPI in order for the rules to apply. The result may be a deemed year end for the particular FA immediately before the time of the acquisition or disposition.

Exceptions are generally available if:

1. The taxpayer's SEP in the particular FA has decreased and the SEP in the FA of taxable Canadian corporations that do not deal at arm's-length with the taxpayer has increased by the same amount;

2. The acquisition or disposition results from an amalgamation under section 87 of the Income Tax Act; or

3. Throughout the taxation year of the particular FA, decreases in the taxpayer's SEP in the FA do not exceed increases in the taxpayer's SEP in the FA by more than 5%. Therefore, the rules will not apply if the taxpayer's SEP in the particular FA decreases in the year by 5% or less.

The rules are complex, and in some instances may result in more than 100% of a particular FA's FAPI being reported by Canadian taxpayers, taking into account stub period FAPI and FAPI reported by taxpayers in respect of whom the corporation is a CFA at the end of the year. In certain circumstances, it can be beneficial for a taxpayer to opt into the rules, and elections are provided for this purpose. There is an extended period for filing those elections in respect of prior taxation years.

Upstream loan rules

The upstream loan rules were introduced in 2011, and apply to loans made by or debts owing to an FA of a taxpayer by certain specified debtors such as the taxpayer and other non-arm's length persons. If such loans or debts (loans) are outstanding for 24 months, they may result in an income inclusion to the taxpayer. The income inclusion can be offset by a reserve to the extent that there were sufficient tax attributes (such as exempt surplus) available at the time, such that a dividend paid at the time the loan was made would not have been taxable. An offsetting deduction also applies when the loan is ultimately repaid.

Many issues have arisen with respect to the application of the rules, and taxpayers have been expecting technical amendments for years. Those amendments were released on September 16, 2016. While they are generally relieving, the proposals do not address many of the problems with the rules.

At the time that the upstream loan rules were introduced, a transitional rule provided additional time to repay certain loans that were outstanding when the rules came into force, and to allow foreign exchange gains and losses of the FA creditor and Canadian debtor to be offset in circumstances where the loans were denominated in a foreign currency. However, the rules were strictly drafted and provided that the foreign exchange gain and loss must be equal in order for the relief to be available. Finance listened to most of the suggestions for improvement to these rules. That requirement has been removed. In addition, the amount of the loss will no longer be determined after the application of a stop loss rule that could apply to deem the FA's loss on a non-interest-bearing loan to be nil. Relief has also been extended for loans to certain other Canadian resident borrowers and not only the taxpayer itself.

One of the most significant problems with the provisions has been a lack of rules to deal with reorganization transactions. There has been concern that many transactions result in the multiplication of the application of the rules as loans are transferred and become owned by or owed to new creditors and debtors, or such creditors and debtors cease to exist. Such transactions may also result in an inability to claim the reserve or a deduction when the loan is ultimately repaid.

The draft legislation contains rules to address changes to the creditor or debtor in the course of an amalgamation, merger, winding-up or liquidation and dissolution, as well as circumstances where the taxpayer has ceased to exist or been part of a merger transaction. The rules are intended to provide continuity by generally deeming the new creditor or debtor to be the same as the old creditor or debtor and the loan to be the same loan as the original loan. Where the taxpayer has been wound-up or part of a merger, the shareholders of the taxpayer or new corporation formed on the merger are deemed to be the same entity as and a continuation of the taxpayer.

The new rules are welcome but clearly will not provide relief in all situations. For example, there does not appear to be any relief in circumstances where an FA creditor is wound-up into a Canadian parent debtor and the loan ceases to exist. The CRA has stated that the loan is not considered to have been repaid in such circumstances. There is no relief provided against a double inclusion where the loan is distributed as a dividend or otherwise transferred to a related party or where relationships change and the FA creditor ceases to be a FA or the debtor ceases to be a specified debtor. Many such situations that were identified in submissions made to Finance were not addressed.

In addition, the reorganization rules are not proposed to be generally retroactive. If a taxpayer wishes the rules to apply retroactively to the introduction of the upstream loan rules on August 20, 2011, an election must be made and filed by the end of 2016.

In other respects, the proposals confirm that the reserve is available for previously taxed FAPI where, generally, the loan is made to Canadian resident borrowers; however, the reserve will no longer be available for loans made on or after August 16, 2016 if the debtor is a non-arm's length non-resident (unlike the current rule). According to the Explanatory Notes, Finance's concern is that the existing provision provides the ability to synthetically repatriate FAPI earned by an FA to a foreign multinational free of withholding tax.

Finally, Finance has introduced changes to the definition of "specified debtor" in accordance with a previously released comfort letter. The changes narrow the definition and may be helpful in joint venture situations.

Other miscellaneous proposals

The draft legislation contains numerous other changes relating to international taxation, including:

- Changes to the shareholder benefit rules to facilitate FA spin-off transactions;
- A rollover for shares that are taxable Canadian property (other than treaty-protected property) owned by a foreign corporation and disposed of on a foreign merger;
- An amendment to the foreign tax credit generator rules to properly allow for entities such as disregarded LLCs in an ownership chain of FAs without triggering the application of the rules;
- Changes to deem dispositions to have occurred, with related filing requirements, when the tax basis of certain properties that are taxable Canadian property is reduced to less than nil;
- An expansion of the FA dumping rules to catch investments in an FA made by Canadian companies that do not deal at arm's length with the FA's shareholder. This amendment is applicable to transactions and events occurring on or after August 16, 2016; however, certain debts of FAs may be deemed to have been entered into on January 1, 2017 if still outstanding at that date, requiring such debts to be repaid before the end of the year to avoid the application of the FA dumping rules.

- An election to have the FA dumping rules result in a deemed dividend rather than a paid-up capital (PUC) reduction during a transition period after March 28, 2012 and before August 16, 2013 (when the structure of the rules was changed to reduce available PUC prior to the generation of a deemed dividend).

Sandra Slaats, Toronto

We welcome you to download our mobile APP

Deloitte tax@hand

iOS

Android

BlackBerry

Bay Adelaide Centre, East Tower
22 Adelaide Street West, Suite 200
Toronto, ON M5H 0A9