Tax Policy

On October 24, 2012, Finance released a huge package of technical amendments to the Income Tax Act (Canada), many of which have been outstanding for years. The package also included an updated set of rules pertaining to “upstream loans” made by foreign affiliates of Canadian companies.

Finance has described the new upstream loan rules as “protecting the integrity” of the existing taxable surplus and the new hybrid surplus regimes, as well as ensuring that pre-acquisition surplus capital gains similarly cannot be avoided. In this respect, Finance says these rules are designed to prevent a foreign affiliate of a Canadian company from “making synthetic dividend distributions” in the form of loans or other indebtedness. The avoidance concern arises in those cases where the distributions would otherwise be taxable dividends paid to Canco, which in turn could not be fully offset by deductions in respect of exempt and other tax-free surplus balances. Accordingly, the new rules are designed to reflect this avoidance element.

Transition for Existing Loans

This latest release includes an extended transition period to August 19, 2016 for loans and indebtedness existing on August 19, 2011 (the date the draft rules were first released). Specifically, any loans or indebtedness incurred on or before August 19, 2011 are subject to a rule that deems the amounts thereof that remain outstanding on August 19, 2014 to be separate loans or indebtedness issued on August 20, 2014. This then triggers the further two-year repayment rule under the general scheme, giving rise to an extended repayment date of August 19, 2016 (see clause 66(3)(a) of the NWMM). Finance said this new transitional rule is intended to ensure that all pre-August 20, 2011 loans or indebtedness are entitled to a five-year repayment window. In short, Canadian companies have until August 19, 2016 to ensure that any pre-August 20, 2011 loans or indebtedness are repaid (or are otherwise covered by an exemption or other deduction, as explained below).

In addition, a new transitional rule sets-off foreign exchange gains (or losses) of a Canadian taxpayer on the repayment of a debt obligation owing to a foreign affiliate against the related losses (or gains) of the foreign affiliate from that repayment (s. 39(2.1)). The new rule will only apply where the taxpayer’s gain is equal to the foreign affiliate’s loss, or the taxpayer’s loss is equal to the foreign affiliate’s gain. A companion rule is provided that will deem the foreign affiliate’s gain or loss to be nil (s. 95(2)(g.04)). The application dates for these transitional foreign exchange set-off rules correspond with the transitional rule above. Accordingly, the provisions apply only to a foreign exchange gain (or loss) of a taxpayer on the repayment of the portion of a debt obligation outstanding on August 19, 2011 where that repayment occurs on or before August 19, 2016.
Summary of Rules

A. Income Inclusion

Section 90(6) provides for an inclusion of a "specified amount" in the income of a taxpayer resident in Canada where a loan is made by a foreign affiliate of the taxpayer to a "specified debtor". "Specified amount" and "specified debtor" are defined in s. 90(15).

"Specified amount" is determined by multiplying the amount of the upstream loan (or other indebtedness) by the difference between the taxpayer's equity interest in the creditor affiliate and its equity interest in the specified debtor, if any. The latter factor is relevant only where the specified debtor is a foreign affiliate of the taxpayer. A "specified debtor" includes the taxpayer and certain non-arm's length persons. An exception is made for controlled foreign affiliates of the taxpayer, where the control is effectively held by Canadian corporations.

B. Exceptions

Section 90(8) provides important exceptions. Specifically, s. 90(6) will generally not apply to loans or indebtedness that are repaid within two years, nor to (i) indebtedness that arises in the ordinary course of any business or (ii) loans made in the ordinary course of a money lending business, provided certain conditions are met. The two-year repayment rule does not apply if the repayment is "part of a series of loans or other transactions and repayments".

C. Deductions

Section 90(9) and s. 90(12) provides for a deduction and inclusion, respectively, on an annual basis for the period during which the loan or indebtedness is outstanding. Essentially the deduction is intended to allow taxpayers to make loans instead of paying dividends, where there is no intention to achieve a Canadian tax benefit.

Deduction. The deduction under s. 90(9) is for a particular amount in respect of the specified amount included in income under s. 90(6) (or in respect of an amount included under s. 90(12)) where the particular amount is the total of certain deductions (described below) that could have been claimed had the specified amount in respect of the upstream loan been instead distributed as dividends, provided these same deductions have not been claimed in respect of other loans or distributions (i.e., no double-count).

Locked In. It is not necessary that the full amount of the upstream loan be "covered" by these hypothetical deductions. Partial deductions under s. 90(9) are permitted. However, the deductible amount is "locked in" at the time the loan is made. There is no ability to increase the s. 90(9) amount based on future earnings of the foreign affiliate, for example.

Available Surplus Accounts. The deduction under s. 90(9)(a) is computed, in all cases, by reference to the exempt surplus and taxable surplus amounts and, in some cases, the hybrid surplus, pre-acquisition surplus and/or previously-taxed FAPI amounts, in respect of all affiliates in the chain of ownership extending from the taxpayer down to the creditor affiliate. This is meant to replicate the tax attributes

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1 This is a brief summary of the principal new rules. A description of the rules for partnerships is intentionally omitted.
that would be available if an actual dividend had been paid by the creditor affiliate, followed by
dividends from any other affiliates between the taxpayer and the creditor affiliate. In such cases the
surplus (and deficit) balances of those intervening affiliates would also be relevant. Also, the surplus
amounts of the creditor affiliate are based on a notional aggregation of surplus amounts from any
foreign affiliates that are "downstream" from the creditor affiliate (s. 90(11)).

**Underlying Foreign Tax.** In respect of taxable surplus, only taxable surplus amounts equal to the
grossed-up balance of underlying foreign tax may be considered distributed for the purposes of the
determination of these hypothetical deductions. In respect of hybrid surplus, the hybrid surplus
amounts will be included in this determination only where the grossed-up hybrid underlying tax is
greater than or equal to the hybrid surplus balance. In other words, the deduction may be taken only
where the hybrid surplus amounts are "fully covered" by hybrid underlying tax.

**Pre-Acquisition Surplus.** Section s. 90(9) also provides a deduction in respect of the pre-acquisition
surplus balance, but only to the extent of the taxpayer's ACB in the shares of a relevant directly held
foreign affiliate (which could be the creditor affiliate or another foreign affiliate that is higher up in the
chain). In other words, taxpayers can also claim deductions under s. 90(9) to the extent they have ACB
in the shares of the top-tier foreign affiliate in the chain. However, this deduction is not available where
the debtor under the loan is a non-arm's length non-resident person. This exclusion is meant to counter
certain tax planning strategies used by foreign multinationals to synthetically repatriate surplus of their
Canadian subsidiaries free of Canadian withholding tax.

**Previously-Taxed FAPI.** Finally, previously-taxed FAPI is also an element of the s. 90(9) deduction, but
only where the pre-acquisition surplus deduction is not available. In other words, it is only relevant
where the specified debtor is a non-arm's length non-resident person. This arises because previously-
taxed FAPI should also be reflected in the ACB of the top-tier foreign affiliate’s shares. Accordingly,
where the pre-acquisition surplus deduction is available, there is no need to also allow for previously-
taxed FAPI.

**No Double Count – Zero Tolerance.** Section 90(12) adds back, in computing income for the immediately
following taxation year, any amounts claimed under s. 90(9) as a deduction in computing income for a
taxation year. Accordingly, new deductions must be claimed under s. 90(9) every year, subject to
compliance with these conditions. If in any taxation year these conditions are not met, the taxpayer
loses the ability to claim deductions under s. 90(9) for that and future taxation years. Essentially the
rules in s. 90(9) are anti-double-counting rules. Taxpayers cannot use the same amounts of surplus or
ACB during the period in which the upstream loan is outstanding for any other loan or indebtedness
templated by these rules, nor for any actual (or deemed) dividends paid. This is an all or nothing
condition – any amount used twice, no matter how small, will result in the denial of future deductions
under s. 90(9).

**D. GAAR Warning**

Finance expressly states that any attempts to (a) circumvent s. 90(6), (b) fit into one of the exceptions in
s. 90(8), or (c) qualify for the deduction in s. 90(9) in a manner that is “not within the scope of the
intended application of these rules” will be subject to review under the general anti-avoidance rule in s.
245 (the GAAR). Among other things, the use of debt-like equity interests, such as preferred shares, or
other synthetic lending arrangements – such as the factoring of receivables or the sale of securities at a
discount – in order to avoid the application of s. 90(6) would be considered an abuse justifying the application of the GAAR.

E. **Downstream Surplus**

Section 90(11) allows the creditor affiliate to aggregate so-called "downstream surplus" for the purposes of the hypothetical deductions determination in s. 90(9). The rule is intended to eliminate the need for taxpayers to force the payment of actual dividends from lower-tier affiliates in order to move surplus balances up to the creditor affiliate with a view to increasing the amounts deductible under s. 90(9).

Section 90(12) provides for the inclusion in computing the income of a taxpayer for the current taxation year any amount deducted under s. 90(9) in computing the taxpayer's income for the immediately preceding taxation year. This inclusion can then be offset by a new deduction under s. 90(9) if the conditions of that section continue to be met.

F. **No Double Deduction**

Section 90(13) is a rule to prevent a double deduction in respect of the same loan or indebtedness, or portion thereof. This section "turns off" the s. 90(9) deduction for the year in which the relevant portion of a loan or indebtedness is repaid, and for all future years, as that repayment should give rise to a deduction under s. 90(14).

G. **Repayment of Loan**

Section 90(14) provides for a deduction from a taxpayer's income to the extent that a loan that was subject to s. 90(6) is repaid in a subsequent taxation year.

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