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A review of Canada's foreign affiliate dumping provisions – prevention of multinational surplus stripping

***Mark Woltersdorf** and **Larry Nevsky** consider the detail of the provisions found in Section 212.3 of the Income Tax Act, including their purpose and some application examples.*

Countries around the globe have increased their efforts to combat aggressive international tax planning arrangements. The Organisation for Economic Cooperation and Development (OECD) has led the charge with the Base Erosion and Profit Shifting (BEPS) project and its close companion, the multilateral instrument.

While the BEPS project and the multilateral instrument have focused on aggressive tax-planning strategies in an international environment, countries such as Canada have also adopted domestic provisions to target specific planning techniques designed to erode the Canadian tax base. One such example is the foreign affiliate dumping (FAD) provisions found in Section 212.3 of the Income Tax Act (ITA – Canada), which were enacted in 2012 and have been amended several times since.

The purpose of the FAD provisions is to curtail tax planning transactions that use foreign affiliates to erode the Canadian corporate tax base without providing any significant economic benefit to Canada. The erosion can occur because of the exempt treatment of certain dividends received from foreign affiliates in combination with increased interest expense deductions or, in certain cases, the ability to extract corporate surplus free from withholding taxes. Conceptually, the FAD provisions are relatively easy to understand but the legislation is detailed and complex and, as a result of its broad application, captures unintended structures. Consequently, great care is required when corporate structures involve non-residents owning a Canadian corporation that has a foreign affiliate.

Overview of the FAD provisions

Generally, the FAD provisions will apply where:

1. A corporation resident in Canada (CRIC);
2. is controlled by a non-resident corporation (or, if the current proposals to amend the ITA are enacted as proposed, controlled by any non-resident person or group of non-resident persons who do not deal at arm's length, herein referred to as the parent); and
3. makes an investment in a foreign corporation that is a foreign affiliate of the CRIC.

For the purposes of determining control of a CRIC, the proposed amendments have extended the meaning of various terms and could cause a CRIC to be found to be controlled by a non-resident parent in several surprising ways. The proposed amendments also introduce special rules for trusts. Specifically, a trust is assumed to be a corporation with a single class of voting shares. Each beneficiary is considered to own shares determined on the basis of their proportionate interest in the trust calculated as the fair market value of their interest in the trust over fair market value of all interests in the trust. For discretionary trusts, each discretionary beneficiary is deemed to own all of the shares of the corporation. At time of writing, it is uncertain if these proposed amendments will apply as drafted. The proposed revisions to the FAD provisions are applicable to investments made in a foreign affiliate after 18 March 2019.

The term "investment" for the purposes of the FAD provisions is defined to include several enumerated transactions. These include the acquisition of shares of the foreign affiliate, the contribution of capital to the foreign affiliate, the conferring of a benefit on the foreign affiliate, the causing of amounts to be owing to the CRIC by the foreign affiliate (other than where certain conditions are met and a pertinent loan or indebtedness (PLOI) election is filed, as discussed more fully below) and the indirect acquisition of the shares of the foreign affiliate through the acquisition of shares of another Canadian corporation, or any option in respect of any of the foregoing.

Consequences of the FAD provisions

Subject to certain exceptions, where the FAD provisions are applicable, the CRIC is deemed to have paid a dividend to the non-resident parent equal to the fair market value of the investment. The deemed dividend is subject to Canadian withholding taxes at the rate of 25% (subject to reduction by an applicable tax treaty). In certain circumstances the deemed dividend will automatically be reduced and treated as a reduction to the paid-up capital (PUC) of shares in the capital stock of the CRIC. PUC in a Canadian tax context is similar to stated capital (which is generally the fair-market value of the consideration received by a corporation for shares issued by it) but is subject to specific adjustments under the ITA. If shares in the capital stock of the CRIC are issued by it when making an investment in the foreign affiliate, an automatic reduction to PUC of the shares issued will apply.

In circumstances where the CRIC is deemed to have paid a dividend and the automatic reduction to PUC of the shares described above is not applicable, the non-resident parent and the CRIC can jointly elect to treat the deemed dividend as a reduction to the PUC of the CRIC's shares.

A PUC reduction will reduce the ability to return capital to the CRIC's shareholders on a tax-free basis and it could also reduce the amount of interest expense deductible by the CRIC under Canadian thin-capitalisation provisions, which use PUC in determining the amount of interest expense that is deductible. The thin-capitalisation rules restrict interest to certain non-resident shareholders, by restricting the capitalisation of the CRIC beyond a debt-to-equity ratio of 1.5:1. Any non-deductible interest amounts are deemed to be a dividend paid by the CRIC to the non-resident creditor subject to withholding tax of 25% (subject to reduction by an applicable tax treaty).

Subsequently, if the investment is reversed (for instance if the foreign affiliate returns funds to the CRIC), the PUC reduction can be reinstated.

Practical structuring considerations

Where the FAD provisions would be applicable, the following rules of thumb can be used to avoid a deemed dividend from arising from the CRIC making an investment in the foreign affiliate:

- If possible, attempts should be made to remove the foreign affiliate from under the CRIC. This may require some prospective planning at the time of acquisition.
- Where the structure cannot be avoided, consider arranging financing in a manner that does not flow through Canada unnecessarily. Instead determine if financing can flow directly from the non-resident parent to the foreign affiliate.
- Where financing is required to flow through Canada, care should be taken to arrange the financing in a way that ensures there is sufficient PUC in the shares issued by the CRIC, or in a manner that permits the PLOI election to be made.

What is a foreign affiliate for Canadian tax purposes?

The determination of a corporation as a foreign affiliate is subject to complex statutory provisions contained in the ITA. These provisions can be summarised for the purposes of this article. First, the corporation must be a non-resident corporation. Generally, this would mean a corporation that was incorporated outside of Canada with central management and control in a foreign jurisdiction. The Canadian shareholder must own, directly or indirectly, 10% or more of the equity shares issued by the non-resident corporation. At least 1% must be held directly by the CRIC and the other 9% can be held indirectly by other persons. For example, assume a Canadian corporation (CanCo) owns 5% of the common shares of a non-resident corporation (ForCo) and a related corporation owns 15% of the common shares of ForCo. The remaining shares are held by third parties. The 1% direct ownership requirement is met and the additional 9% (or more) of equity shares are held by a related person. The 10% or more requirement is met and ForCo is a foreign affiliate of CanCo.

Exceptions to FAD provisions

More closely connected business activities

This exception applies where the foreign affiliate's business is "more closely connected" to the CRIC's business than the non-resident parent's business. Very generally, to take advantage of this exception it must be demonstrated that:

1. The investment in the foreign affiliate is a strategic acquisition that is more closely connected to the activities carried on by the CRIC than to a non-arms length non-resident member of the multinational group;
2. Officers (including directors) of the CRIC have and exercise the principal decision-making authority in respect of the making of the investment in the foreign affiliate and a majority of those officers were, at the time of making the investment, persons who were resident in Canada and working principally in Canada or in the country where the foreign affiliate is resident; and
3. At the time of making the investment it is reasonably expected that such officers will continue to have and exercise the ongoing principal decision-making authority in respect of the investment, the majority of the officers will be resident in and working principally

in Canada or in a country where the foreign affiliate is resident, and the officers' evaluation and compensation will be based on the performance of the foreign affiliate to a greater extent than the compensation of other officers within the multinational group.

Corporate reorganisations

Certain corporate reorganisations are exempt from the FAD provisions. Generally, these include transactions to acquire shares or debt from a related corporation in a transaction or as the result of an amalgamation or certain tax-deferred transactions. These provisions will not be discussed in detail.

Pertinent loan or indebtedness

An investment in a foreign affiliate does not include a debt that is treated as a PLOI. The PLOI is a debt between the CRIC and a non-resident person where the CRIC and its non-resident parent have filed a joint election under the ITA for the debt to be considered a PLOI. Once the election is made, there is a deemed interest benefit that accrues to the CRIC calculated at the Canadian prescribed rate applicable to these kind of loan transactions (currently 5.67%). The deemed interest benefit is reduced by the amount of interest actually paid by the non-resident person to the CRIC.

Case study: How the FAD provisions apply

The following example illustrates the basic operation of the FAD provisions. Assume the following:

1. A corporation resident in the US (the US parent) owns sufficient equity shares to control a CRIC.
2. The US parent owns equity shares of a corporation (ForCo) resident in Germany.
3. A CRIC carries on a profitable business in Canada earning $1 million annually. It pays income taxes of $270,000 each year on its profits.
4. The US parent makes a loan of $10 million to the CRIC bearing interest at the rate of 10% annually.
5. At the US parent's direction, the CRIC uses the loan proceeds to purchase the equity shares of ForCo from the US parent.
6. As a consequence of the purchase, ForCo is a foreign affiliate of CRIC.
7. ForCo carries on a profitable business in Germany.
8. ForCo will distribute after-tax profits to its shareholders (including a CRIC) annually by way of dividend.

In the absence of the FAD provisions, the above transaction will erode the Canadian tax base significantly. Interest on the loan from the US parent will reduce the CRIC's profits to nil each year (assume CRIC has sufficient equity so that the Canadian thin-capitalisation rules are not applicable). The CRIC's share of the dividend received from ForCo is subject to German withholding tax of 5% but is exempt from tax in Canada because the dividend is paid from the exempt surplus of a ForCo. Under the Canada-US Treaty, the interest on the loan payable by CRIC to the US parent is not subject to Canadian withholding tax. The non-taxable dividend received from ForCo can be used to repay the loan payments (principal and interest) to the US parent without withholding tax. Canada has gone from collecting corporate tax of $270,000 to nil while the profits from the German foreign affiliate flow through Canada on a tax-free basis to pay the loan payments.

Assuming the FAD provisions are applicable to the above transaction, the $10 million purchase price for the ForCo investment will automatically reduce the PUC of the shares of the CRIC to nil and any excess of the investment over the PUC reduction is deemed to be a dividend paid by the CRIC to the US parent, which will be subject to Canadian withholding taxes of 5% (as provided in the Canada-US Treaty). Moreover, this may reduce the amount of interest expense that is deductible by the CRIC and the non-deductible amount is deemed to be a dividend paid to the US parent which is subject to withholding taxes of 5% (as provided in the Canada-US Treaty). This ensures that the Canadian source income will be subject to the appropriate amount of Canadian corporate tax and may also subject the US parent to Canadian withholding tax.

Concluding comments

The above is a generous simplification of some very complex provisions contained in the ITA. Practitioners should be careful when dealing with corporate structures involving Canada that could trigger application of the FAD provisions. It is important to determine whether the structure can be adjusted to avoid the rules altogether or if the more closely connected business activities exception will be applicable.

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