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Sommer of Love?

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In the last few months, a number of court decisions have put taxpayers on a high; for some examples, see "Taxpayer Victories: Coincidence or Trend?" in the June issue of *Tax Notes*. In mid-July, the *Sommerer* appeal confirmed that a sale at fair market value to a trust did not trigger the so-called reversionary trust rules, per subsection 75(2) of the Act (see last month's *Tax Notes*). On August 1st, the love-in continued, with the release of the Supreme Court of Canada's long-awaited verdict on farming losses, *Craig* (2012 SCC 43). It overrode the Supreme Court's own verdict in the *Moldowan* case which had required that, to obtain unrestricted tax losses, other sources of income had to be subordinate to the farming source of income. The top court held instead that, per section 31 of the Act, a taxpayer's income will be "a combination of farming and some other source of income" - and thus restricted farm losses do not apply - if both sources are significant endeavours for the taxpayer, but farming need not be the predominant one. In this case, the taxpayer's horse-racing operation was a business, not a sideline, and it was a significant endeavour, so that restricted farm loss rules were inapplicable.

But elsewhere in Ottawa, it was not incense and peppermint. On August 14th, the Department of Finance released draft legislation pertaining to several key proposals in the March federal Budget. If you are getting a sense of *déjà vu*, much of the same federal budget was the subject of Bill c-38 which was passed in late June. But we are talking about some of the Budget's harder stuff here, such as in the international taxation area.

Magical Mystery Tour - Foreign Affiliate Debt Dumping

Particularly in view of their surprising breadth, I found the provisions relating to the controversial "foreign affiliate debt dumping" proposals particularly interesting. These are designed to deter Canadian subsidiaries of foreign-based multi-national groups from making investments in foreign affiliate non-resident corporations in situations where these investments can result in the "inappropriate" erosion of the Canadian tax base. (Notably, dividends from foreign affiliates can be tax-free, with Canadian interest deductions available on debt incurred to make such investments.)

In general terms, the new rules which (subject to grandfathering provisions) apply to transactions occurring after March 28, 2012, result in deemed dividends subject to non-resident withholding tax with respect to the value of investments in foreign affiliates, or reductions of paid-up capital of shares relating to such investments. These proposals are particularly controversial because of the wide variety of situations to which the rules potentially apply: to corporations resident in Canada ("CRICs"), where the subject corporation, i.e., the investee, is (or becomes) a foreign affiliate[i] of the CRIC, and the CRIC is (or becomes) controlled by a non-resident corporation. Investments are very broadly defined, including the acquisition of shares or contribution of capital (now including "benefits" conferred by the CRIC), transactions where the subject corporation becomes indebted to the CRIC or related company, and acquisitions of options in respect to shares or debt. In fact, the revised proposals would be expanded further by the August 14 draft legislation: to cover shares of another corporation resident in Canada which in turn derives more than 50% of the fair market value of its assets (subject to certain adjustments) from underlying shares of foreign affiliates; as well as the extension of maturity/redemption dates of debts/shares owned by the CRIC.

Purple Haze – Strategic Business Expansions

A key exception may apply in the context of a "strategic business expansion" according to stated criteria. Tax practitioners had already criticized these criteria as being uncertain in application, particularly in view of the broad swath of the proposal. It is unlikely that the criteria brought forth in the August 14th legislation will be perceived to be an overall improvement: the CRIC must "demonstrate" that <u>all</u> of the required conditions are met. Notably, the investment must remain *more closely connected* with the business activities carried on in Canada by a CRIC than to other non-residents of the group. Officers of the CRIC must exercise principal decision making authority in respect of the making of the investment and a majority of those officers must be resident and work principally in Canada at the investment time. Similar expectations in respect to ongoing activities must be met, including in respect to the majority of ongoing executive compensation and performance evaluation of the CRIC's Canadian-based executives *vis-à-vis* the subject corporation.[ii]

Apart from the strategic business expansion exemption, under the August 14th draft legislation, the proposals would be restricted in two other ways. First, they would not apply to foreign affiliates acquired by virtue of certain corporate reorganizations (but exceptions apply to the indebtedness assumed by the CRIC). Second, the proposals would not apply to investments in the form of foreign affiliate indebtedness to a CRIC incurred after March 28, 2012, if an election was made under new section 17.1, relating to so-called "pertinent loan indebtedness" (PLI) provided the CRIC includes in income an interest factor at the prescribed rate plus 4% (i.e., currently 5%) during the period the PLI is outstanding (or the rate applicable to debt obligation to fund the PLI, if higher).

A corresponding amendment would be made to subsection 15(2) permitting loans to a CRIC's foreign parent (or a foreign sister company, for example) without triggering the deemed dividend and withholding tax that can otherwise arise. These elections would be made on a borrower-by-borrower basis, not a loan-by-loan basis. But note the minimum rate on loans which is eligible annually, and compare that with the applicable withholding rate.

I suspect that advisors to multi-nationals will be less than pleased with the proposals, particularly "demonstrating" the requirements for the "strategic business expansion" exemption.**iii** This task will be difficult enough in the case of large multinationals, let alone smaller foreign owned businesses. Interestingly, however, the draft legislation now includes new rules that may allow the reduction of a CRIC's paid-up capital in its shares to avoid the consequences of the deemed dividend. The conditions for making such an election vary, e.g., depending on whether there is more than one class of shares outstanding; in addition, all shares of the CRIC not owned by the foreign parent must be owned by persons dealing at arm's length with the CRIC**iv**. The election can have other tax implications (e.g., thin capitalization limits, exceeding which may trigger its own withholding tax under other proposals).

Thus, the anti-dumping proposals will presumably take their place as convoluted international provisions, with varying tax impact. By the way, the time frame for providing comments on the draft legislation is less than a month after their release – September 13th. By now, international tax practitioners must be hard at work preparing submissions, probably leading to even more convolutions to the already-complex proposals.

Although the August 14th draft legislation was particularly interesting, shortly before this, the government released other rather notable documents. Actually, the date of the CRA's release on tax shelters (July 30th) may be at least as interesting as the actual content of the release itself, which echoed about a dozen similar releases over the years. These CRA releases have tended to be in the fall, and are often focused on charitable donation schemes, so this more general release about the perils of tax shelters was somewhat out of the norm.

Shortly afterward, other releases were focused on consultations regarding the impact that contingency fees on the SR&ED tax incentive program. Ostensibly, the consultations seek input on several issues, such as why firms hire tax preparers on a contingency fee basis, why these tax preparers charge contingency fees, the impacts of this practice on the effectiveness of the SR&ED program, etc. One suspects, however, that the consultations are more about process than answers to such questions, which are rather obvious. As readers may remember, proposed section 237.3 would enact a reportable transaction regime, applicable to tax avoidance entered into after 2010 (or that are part of a series of transactions that began before 2011 and are completed after 2010). Contingency fees are one of three "hallmarks" of a reportable transaction (to be reportable, a transaction must contain two out of three such hallmarks). Anyone remember Altamont?

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i Either immediately after the investment is made, or as a result of the series that include making the investment.

ii The strategic business expansion exemption and some of the corporate reorganization exemptions do not apply to investments in preferred shares and the like, except in wholly-owned situations

iii Although one might envision the "demonstration" process taking place before a tribunal or similar body, rather than ultimately taking place in court pursuant to reassessment, no such procedure is specifically mentioned in the proposals. Because the issue is largely dependent on applicable facts, it is uncertain whether the CRA will consider the granting of a ruling on the issues.

iv For example, the election will not be available where a holding company is interposed.