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New Foreign Affiliate 'Dumping' Rules Constitute Major Canadian Tax Policy Change

by Steve Suarez

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SPECIAL REPORTS

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by Steve Suarez

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If there is only one Canadian tax development for 2012 that foreign readers should be aware of, it is certainly the pending enactment of sweeping new rules directed at foreign-controlled Canadian resident corporations known colloquially as the ''foreign affiliate dumping'' rules (the FAD rules). While motivated by legitimate tax policy concerns, the FAD rules cast an overly broad net that goes far beyond the original mischief motivating their creation, and encompass many transactions that simply should not be caught. As such, the FAD rules are likely to create unpleasant surprises for taxpayers who are unaware of these rules, are unable or unwilling to spend the resources required to carefully work through them, or ignore them on the mistaken (but understandable) premise that these rules won't apply to taxpayers who are neither seeking nor obtaining any Canadian tax advantage or benefit.

For some years the Department of Finance has been troubled by transactions that, in their simplest form, involve a Canadian subsidiary of a foreign multinational group incurring intragroup debt to purchase shares (often fixed-value shares) of a foreign group member. Such ''debt dumping'' allowed the Canadian subsidiary to use the interest expense deduction on that debt to reduce Canadian tax payable, while creating little or no income that would be taxable in Canada, given that Canada's foreign affiliate rules largely exempt from Canadian taxation distributions received by a Canadian corporation from a corporation resident (and carrying on an active business) in a jurisdiction with which Canada has a tax treaty or tax information exchange agreement.[1] Effectively Canada perceived its foreign affiliate regime and interest deductibility rules as being misused when interest expense arising from investments in foreign affiliates that had been ''dumped'' into Canada by their foreign parent reduced Canadian tax on Canadian-source income.[2]

The FAD rules go far beyond this relatively narrow (and legitimate) concern. Rather than simply limiting interest expense deductions, these rules effectively treat almost any transfer of property (or incurrence of a liability) by a foreign-controlled Canadian corporation as prima facie surplus stripping designed to sidestep dividend withholding tax, to the extent that it relates to a foreign affiliate of the Canadian corporation. As such, when applicable, the FAD rules often produce a deemed dividend subject to Canadian withholding tax, either immediately or in the future, even when the transaction in question is a value-for-value exchange resulting in no net extraction of assets from Canada.

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[1]Foreign affiliate status causes distributions from Foreignco to come within Canada's exemption and credit system of dealing with distributions received by a Canadian corporation from a foreign corporation. *See* http://miningtaxcanada.com/investment-outside-of-canada/.

[2]That debt might arise directly as balance-of-sale owing for the purchase price of the shares of the foreign affiliate or debt incurred to fund the purchase price, or indirectly through an increase in the paid-up capital of the shares of the Canadian corporation (which allows increased cross-border intragroup financing into Canada under Canada's thin capitalization rules).

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Figure 1. Summary of Concerns With FAD Rules

Overreaching: charging provision far too broad; limited exceptions and relieving provisions too narrow and/or impractical:

- rules apply even if no Canadian tax deductions created and even if Foreignco investment generates taxable income in Canada
- value-for-value transactions (that is, no net value is being extracted from Canada) treated as distributions
- no exclusion of transactions undertaken for legitimate business reasons with no tax motive, impeding bona fide business investment
- anti-surplus-stripping rule applies whether or not Canco has any corporate surplus
- transactions with arm's-length parties treated no differently than intragroup transactions
- public corporations treated no differently than wholly owned subsidiaries
- treating the conferral of benefits on foreign affiliates as ''investments'' is impractical
- ''series of transactions'' extensions of charging provision unjustified

Numerous possible instances of double taxation.

No grandfathering for pre-existing structures already under Canada.

Unclear policy objectives (stated objectives vs. what is actually caught).

Needless planning/compliance costs created for taxpayers without corresponding benefits to Canada.

Treating investments ''down'' the chain as equivalent to distributions ''up'' and out of Canada contrary to existing tax policy and resulting in double taxation.

Will reduce the attractiveness of Canadian corporations to foreign buyers (particularly negative impact on mining sector, where is Canada commonly used as a base for foreign projects), and by extension to foreign investors choosing where to locate new holding/headquarters companies, since eventual takeover is exit strategy.

Foreign multinationals discouraged from holding/managing foreign subsidiaries through Canadian corporations.

Those responsible for designing and implementing tax policy at the Department of Finance do not have an easy job, and this relatively small group of dedicated public servants does a huge amount of work. It is difficult to achieve the right balance among the goals of raising the revenue that Canada needs, protecting the tax base from erosion, ensuring that compliance costs for taxpayers are kept to the minimum necessary for the proper functioning of the tax system, and encouraging (or at least not impeding) economic activity from which Canada benefits. Reasonable people can differ as to the choices that are made among these goals. That said, the FAD rules simply put too much emphasis on preventing base erosion, and all or substantially all of that objective could have been achieved with a more focused rule that would not create the undue tax costs and compliance/planning burden generated by the FAD rules or cause foreign groups and investors to reduce the economic activity they undertake in Canada, which is already occurring. The concerns with the FAD rules are summarized in Figure 1.

Originally announced in the federal budget of March 29, 2012,[3] the FAD rules target Canadian resident corporations that are controlled by a foreign corporation and make ''investments'' in non-Canadian corporations (including the mere conferral of ''benefits'' on those foreign entities). When applicable, the FAD rules deem the Canadian resident corporation to have paid a dividend to the foreign parent corporation (triggering nonresident dividend withholding tax) or reduce the Canadian resident corporation's tax attributes, adversely affecting it in various ways. While the FAD rules include provisions that exclude or mitigate the effect of their application in some circumstances, these provisions are too narrowly drafted, too complicated in their operation, and insufficiently workable in practice to offset the adverse effects of the overbroad charging provision.

[3]For prior coverage, see Steve Suarez, ''Canadian 2012 Federal Budget: Tightening the Screws,'' *Tax Notes Int'l*, Apr. 16, 2012, p. 247, *Doc 2012-6875*, or *2012 WTD 73-17*.

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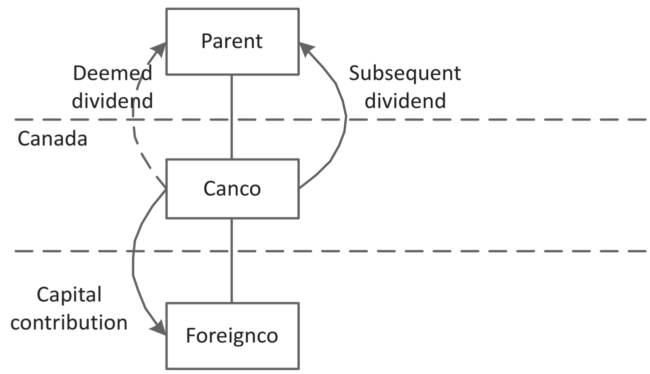
Figure 2. Canco Capital Contribution



- Canco deemed to pay dividend to Parent upon Canco capital contribution to Foreignco.
- Canadian withholding tax applies again when Canco later pays dividend to Parent.

In August 2012 the government released draft legislation setting out the FAD rules, which was followed by a further version in October 2012.[4] While the later versions include some very meaningful improvements over the initial proposals, they also take a significant step backwards in some areas. In particular, the FAD rules are overly broad and capture many situations and produce many results that they should not, even after taking into account their relieving provisions. The combination of their breadth, their complexity, and the nonintuitive results they can produce make them particularly easy to run afoul of inadvertently. They constitute a dramatic shift in tax policy in the Income Tax Act (Canada), indeed going beyond the objectives stated by the government in enacting them.

By way of a simple example, when a foreign-controlled Canadian corporation contributes money to the capital of a wholly owned foreign subsidiary, the FAD rules treat this as prima facie equivalent to a dividend paid by the Canadian corporation to its foreign parent, and Canadian dividend withholding tax at a rate of 5 to 25 percent (depending on the facts) applies. (See Figure 2.) Moreover, there is no offsetting increase in the Canadian corporation's tax attributes, meaning that if the same money (or other property) is subsequently distributed by the Canadian corporation as an actual dividend, Canadian withholding tax will apply again, resulting in double taxation. An observer can be forgiven for finding this result to be something less than intuitive. While in some instances the FAD rules may allow such a deemed dividend to instead be treated as a reduction of the Canadian corporation's existing tax attributes (which also has adverse implications) to the extent such attributes exist, and in some circumstances a reduction of tax attributes occurring under the FAD rules may be reversed for limited purposes, the point is that this type of innocuous transaction is caught within the FAD rules, and the taxpayer is then left searching for an exception to their application (of which there are few) or a relieving provision that mitigates their effect.

Treating a payment ''down'' the chain to a wholly owned subsidiary ''below'' Canada (and hence completely within Canada's system for taxing foreign affiliates of Canadian corporations) as the equivalent of a distribution ''up'' the chain to a shareholder ''above'' Canada (that is, outside the Canadian tax system) is simply unprecedented and constitutes a major shift in Canada's international tax policy. The ITA recognizes that a Canadian corporation's foreign affiliates (or controlled foreign affiliates) remain within the Canadian tax system and accordingly it differentiates between the Canadian corporation's transactions with such foreign entities and its transactions with other nonresidents of Canada.[5] However, the FAD rules ignore this principle

[4]For prior coverage, see Patrick Marley, ''Canada Revises Proposed Foreign Affiliate Dumping Rules,'' *Tax Notes Int'l*, Aug. 27, 2012, p. 805, *Doc 2012-17369*, or *2012 WTD 160-1*; and Marley and Firoz Ahmed, ''Canada Approves New Foreign Affiliate Dumping Rules,'' *Tax Notes Int'l*, Nov. 12, 2012, p. 607, *Doc 2012-22330*, or *2012 WTD 213-2*. In fact, an earlier version of the present article was a few days away from publication when the October 15 draft legislation was released.

[5]For example, the income imputation regime for amounts owing by nonresidents includes an exemption for many controlled foreign affiliates of the taxpayer (section 17(8) of the ITA), the shareholder loan rules for amounts owing to a corporation from a person ''connected'' to a shareholder exclude foreign affiliates of the corporation (section 15(2.1) of the ITA), and Canada's transfer pricing rules have special exclusions for loans to (and guarantees of the debt of) most controlled foreign affiliates of the taxpayer (sections 247(7) and 247(7.1) of the ITA).

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for Canadian corporations that are foreign-controlled, effectively treating them as prima facie eroding the Canadian tax base by recharacterizing their transactions ''down'' the chain with foreign affiliates as distributions ''up'' the chain and out of Canada unless they fall within a narrow list of permitted exclusions or relieving provisions. This is a sub-optimal tax policy choice.

While the FAD rules are quite complex, at a very high level the process for working through them can be summarized as follows:

- determine whether the charging provision applies to the transaction;
- if so, consider whether the ''investment'' is excluded by virtue of one of the limited exceptions provided for in the FAD rules; and
- if no exception applies, determine the consequences of the rules' application.

I. Scope of the FAD Rules

The FAD rules set out a charging provision that is fairly simple to express, although not necessarily to interpret. It applies when a corporation that is resident in Canada (Canco) and that is controlled by a nonresident corporation (Parent)[6] makes an investment in a corporation not resident in Canada (Foreignco) that is a foreign affiliate of Canco.[7] For this purpose, an investment includes an acquisition of *debt* of Foreignco[8] and *shares* of Foreignco. The range of transactions caught by these rules is then broadened as follows:

- *Benefit Conferred on Foreignco*: A contribution by Canco to the capital of Foreignco is treated as an ''investment,'' which for this purpose is deemed to include any benefit conferred by Canco on Foreignco.
- *Options or Interests*: The acquisition by Canco of an option regarding, or an interest in, any Foreignco shares or debt[9] is deemed to be an investment.
- *Maturity/Redemption Date Extensions*: If the maturity date of a debt owing by Foreignco to Canco (other than a ''pertinent debt'' described in Section III below) or the redemption date of Foreignco shares owned by Canco is extended, the extension is treated as an acquisition of such debt or shares.
- *Indirect Acquisitions*: If Canco acquires shares of another Canadian corporation more than 75 percent of the value of whose assets is attributable to shares the other Canadian corporation owns (directly or indirectly) in its foreign affiliates, this too is caught as an indirect acquisition of the shares of those foreign affiliates (herein, an ''indirect acquisition''; see Figure 3). Another rule further extends the net to cases in which property of the acquired Canadian corporation is later sold as part of the series of transactions that includes Canco's investment (the relevant series) and such sale results in the ''>75 percent attributable'' threshold being met at any time during the relevant series.
- *Relevant Series of Transactions*: The charging rule extends to situations in which it would otherwise not apply because Foreignco is not a foreign affiliate of Canco or Canco is not controlled by Parent at the time of the Canco's investment, but at some other time during the relevant series, Foreignco *becomes* a foreign affiliate of Canco or Canco *becomes* controlled by Parent.
- *Acquisitions by Partnerships*: Look-through rules attribute acquisitions made by a partnership to its partners.

A few narrowly drafted exceptions are carved out of the FAD rules. As discussed in Section III below, in the case of an acquisition of *Foreignco debt* by Canco, there are exclusions for:

- debt incurred in the ordinary course of business (for example, trade debt) and repaid within 180 days; and
- debt arising after March 28, 2012, that Canco elects to make subject to a new rule requiring the inclusion in its income of at least a minimum amount of interest.

An exception is also provided for Canco acquisitions of *Foreignco shares* as part of some (but not all) intragroup corporate reorganizations (discussed in Section IV below). A smaller number of corporate reorganization exemptions apply to indirect acquisitions, that is, acquisitions of shares of another Canadian corporation passing the ''>75 percent attributable'' threshold. A further exception meant to allow for investments in foreign affiliates made as part of a strategic business expansion (discussed in Section V below) is so narrowly drafted and unclear in scope as to be of little practical use in all but a handful of cases. Figure 4 summarizes the analysis for assessing whether the FAD rules apply.

A. Consequences of Application

When the FAD rules apply to Canco's investment, they potentially have two effects:

[6] The rule does not apply when Parent is itself controlled by a Canadian resident person that is not controlled by a nonresident corporation. If there are multiple nonresident corporations in the corporate chain ''above'' Canco, the rules essentially deem the lowest-tier such nonresident corporation to be the one that ''controls'' Canco, and to be the sole ''Parent.''

[7] Generally, Foreignco will be a foreign affiliate of Canco if Canco has direct or indirect ownership of 10 percent or more of any class of shares of Foreignco.

[8] Subject to two exceptions discussed in Section III below.

[9] Other than debt, the direct acquisition of which is excluded from these rules under the exceptions discussed in Section III.

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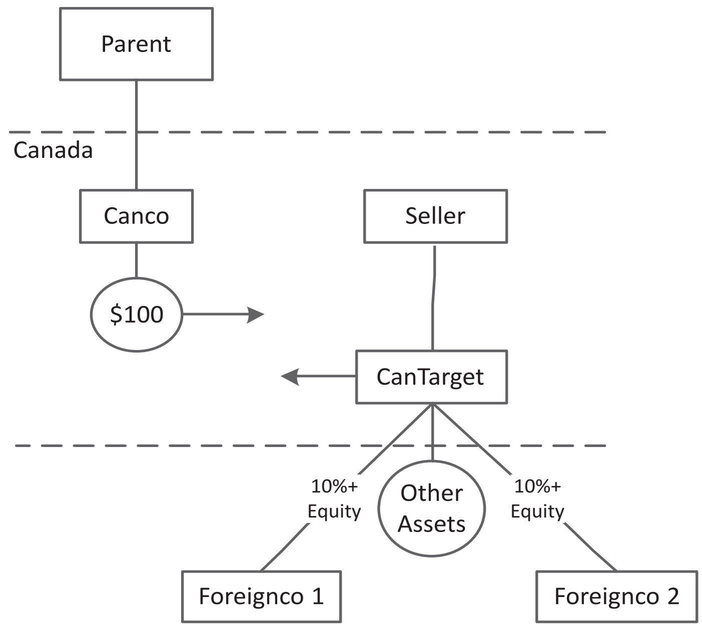
Figure 3. Indirect Acquisition Rule (Takeover)



Canco acquisition of CanTarget shares deemed to constitute an investment in Foreignco 1 and 2 if they collectively represent >75 percent of value of CanTarget property.

- To the extent that in relation to its investment Canco has transferred any property (other than Canco shares), incurred any obligation or received any property reducing an amount owing to it, the value thereof is treated as a dividend paid by Canco to Parent, triggering Canadian dividend withholding tax at a rate of 25 percent (subject to treaty reduction). Thus, for example, Canco making a loan to Foreignco or paying the purchase price for Foreignco shares in cash or a promissory note is treated as a dividend, even when Canco is acquiring property of equal value and even if the seller is an arm's-length party.
- To the extent that Canco has increased the paid-up capital (PUC) of its shares in relation to the investment (such as by issuing new Canco shares), that increase is reversed. This suppression of PUC reduces the amount Canco can distribute to nonresident shareholders as a return of invested capital without those shareholders incurring nonresident dividend withholding tax,[10] and so effectively amounts to a deferral of the deemed dividend rather than its elimination (subject to the potential PUC reinstatement described below). Moreover, suppressing Canco's PUC limits Canco's ability to deduct interest expense on intragroup debt owing to nonresidents of Canada under Canada's thin capitalization rules.[11]

There are then three further rules that may or may not mitigate the adverse effects of the FAD rules applying (depending on the facts), as discussed in Section VI:

- In some cases, an election may be made to treat a dividend that would otherwise be deemed to have

[10]A Canadian corporation can generally make non-dividend distributions on its shares as a tax-free return of capital to the extent of the PUC of those shares. PUC is meant to represent amounts invested in Canco as share capital by persons purchasing newly issued shares from Canco, and so PUC returns constitute a distribution of previously invested capital, not profits.

[11]Canada's thin capitalization rules apply to restrict the amount of interest-deductible debt owing by a Canadian resident corporation (Canco) to ''specified non-residents'': nonresidents of Canada who either are 25-plus percent shareholders of Canco (by votes or value) or do not deal at arm's length with those 25-plus percent shareholders. Currently, these rules prevent Canco from deducting interest expense on debt owing to specified nonresidents that exceeds twice the sum of (1) Canco's unconsolidated retained earnings at the start of the taxation year, and (2) PUC attributable to Canco shares owned by (and contributed surplus received from) a nonresident 25-plus percent shareholder of Canco. This 2-1 ratio is being changed to 1.5 to 1, effective 2013. *See* Steve Suarez and Stephanie Wong, ''Canadian Year-End Tax Planning Deadlines for 2012,'' *Tax Notes Int'l*, Nov. 19, 2012, p. 747, *Doc 2012-22478*, or *2012 WTD 223-18*.

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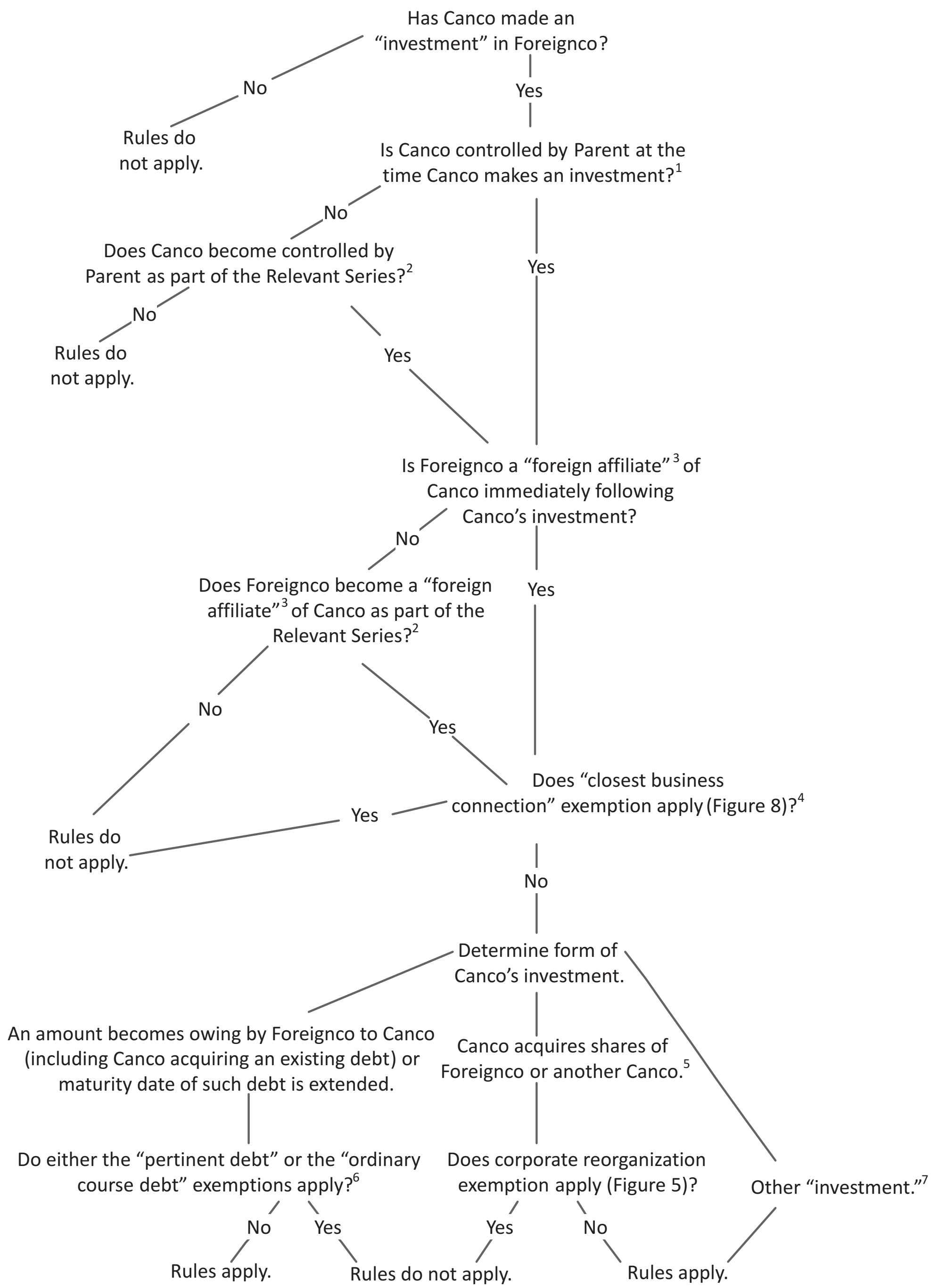
Figure 4. Foreign Affiliate Dumping Rules: Application



1. Other than where Parent is itself controlled by a Canadian-resident corporation that is not controlled by a nonresident person.
2. The "Relevant Series" is the series of transactions that includes Canco's investment in Foreignco.
3. Foreignco will be a foreign affiliate of Canco if Canco has direct or indirect ownership of 10 percent or more of any class of Foreignco's shares.
4. Or where Foreignco uses property received from Canco to make a loan to a controlled foreign affiliate of Canco, such exemption would have applied had Canco made such loan directly.
5. Canco aquires shares of another Canadian resident corporation >75 percent of whose property consists of (or subsequently becomes, as part of the Relevant Series) foreign affiliate shares.
6. "Pertinent debt" is a debt arising (or the maturity date of which is extended) after March 28, 2012, that Canco elects to be deemed to earn no less than a minimum amount of interest on; "ordinary course debt" is debt arising in the ordinary course of Canco's business that is paid within 180 days or acquired from an arm's-length person.
7. Canco makes a capital contribution to or confers a benefit on Foreignco, or acquires an option in respect of or an interest in Foreignco shares or debt, or the redemption date of Foreignco shares owned by Canco is extended. The only potential exception in these circumstances is an investment occurring on a windup or amalgamation of a wholly owned Canadian subsidiary into its Canadian parent.

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been paid by Canco to instead be paid by another related Canadian resident corporation (a qualifying substitute corporation, or QSC), if this would produce a less disadvantageous result (for example, a treaty-reduced dividend withholding tax rate lower than the rate applicable to a dividend deemed to be paid by Canco to Parent).

- In some cases, some or all of a deemed dividend (including one resulting from a QSC election) is replaced with a reduction in the PUC of the shares of Canco (or a QSC). While typically preferable to an immediate deemed dividend, such a PUC reduction has both immediate and future adverse effects and so constitutes only partial relief.
- When PUC has been reduced under the FAD rules, in some circumstances the PUC so reduced can be reinstated solely for the purpose of distributing out of Canco (or the QSC) any Foreignco shares Canco's investment in respect of which triggered the application of the FAD rules, any shares of another foreign affiliate substituted for those Foreignco shares, or sale proceeds from or distributions received on such shares.[12]

Effectively, the FAD rules treat any investment by a foreign-controlled Canadian corporation relating to a foreign affiliate as either:

- an immediate deemed dividend (requiring prepayment of dividend withholding tax and likely resulting in eventual double taxation); or
- a deemed return of capital distribution (causing future Canco distributions to trigger dividend withholding tax and reducing Canco's ability to debt-finance from foreign group members in the interim), unless:
  - — the investment is a debt owing by Foreignco that either bears a sufficiently high rate of interest or is a short-term trade payable;
  - — the investment occurs on a permitted intragroup corporate reorganization that does not amount to an incremental investment outside of Canada by Canco; or
  - — the investment occurs within the narrow confines of a complex and unworkable exception requiring that:
    - the business activities of Foreignco and its subsidiaries be ''more closely connected'' with the business activities in Canada of Canco (or related Cancos) than with the business activities of other non-Canadian group members; and
    - Canco officers (a majority of whom are resident and working in Canada or certain other countries) have and maintain principal control over the investment in Foreignco.[13]

If the investment is one to which the FAD rules apply initially to reduce Canco's PUC (as opposed to deeming a dividend to occur), and if subsequent events cause such PUC reduction to be reversed under the PUC reinstatement rule described in Section VI solely for the purpose of allowing Canco to emigrate from Canada or make certain distributions out of Canada, the initial PUC reduction should not result in double taxation.

II. Problems With the General Rule

As described earlier, the main problem with the FAD rules is that the charging provision is simply too broad and captures far more than it should. While a few exceptions and alleviating mechanisms are provided in the rules, they are narrowly drafted and substantively inadequate to fix a charging provision that needs to be more precise and more focused on what the policy concern is. There simply is not an appropriate degree of linkage between when the rules apply and the tax results they seek to prevent. The government's objective in enacting the FAD rules is stated to be countering erosion of the Canadian tax base arising from:

- the exemption from Canadian taxation of most foreign affiliate dividends in combination with the deductibility of interest expense incurred to make investments in foreign affiliates; and
- the extraction of corporate surplus from Canada free of dividend withholding tax.[14]

The following are significant ways in which the charging provision as drafted (and even after taking the exceptions and alleviating provisions into account) overreaches this objective:

- It applies regardless of whether Canco's investment produces any deductions from income (interest expense or otherwise) in Canada.
- It can apply even when Canco's investment produces (or could produce) income that would be taxable in Canada (that is, something other than

[12]A largely comparable PUC reinstatement also applies for purposes of computing the departure tax applicable upon Canco emigrating from Canada.

[13]A further requirement exists regarding the compensation and evaluation of such Canco officers.

[14]*See* the explanatory notes to section 212.3 of the ITA produced by the Department of Finance. These explanatory notes do not constitute part of the legislation but rather are an interpretational aid that a court may choose to consider in interpreting it.

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distributions from a foreign affiliate that benefit from a 100 percent dividends-received deduction).[15]

- It deems Canco to have made distributions even when no net assets have been extracted from Canada, for example, when Canco has participated in a value-for-value transaction, which is difficult to reconcile with the stated objective of preventing the extraction of corporate surplus. In fact, its application does not depend on the existence of *any* Canco corporate surplus, an odd feature of rules stated to be directed at preventing the tax-free extraction of such.
- It applies without regard to whether the investment has any Canadian tax purpose (or achieves any Canadian tax advantage), which is particularly troubling since the business purpose test in the original proposed version of the FAD rules was the primary filter for preventing that version of these rules from applying to transactions that should not be caught. The result is that the FAD rules may impede, for example, the legitimate diversification of the business activities of Canco's foreign affiliates.
- It can clearly apply in many instances to create double taxation, as is discussed further below. For example, double taxation will frequently occur whenever the FAD rules apply to deem a dividend to have been paid or deem a PUC reduction to occur that is not subsequently reversed under the rule allowing PUC reinstatement in limited circumstances.
- As noted earlier, it does not meaningfully differentiate between Canco investments made ''down'' the chain to closely controlled foreign affiliates (including those completely under Canadian ownership), and other investments made above Canco or outside the cone of Canco and its closely controlled foreign affiliates, contrary to established tax policy elsewhere in the ITA. In the context of preventing surplus stripping, these are simply not equivalent situations, since the former remain within Canada's system for taxing controlled foreign affiliates and any related corporate surplus remains in or below Canco.[16]
- It does not differentiate between investment transactions with arm's-length third parties (which are much less likely to involve base erosion) and intragroup transactions (which were the original source of the avoidance prompting the government to act).[17]
- A Canco that has arm's-length minority shareholders or that is a public corporation is treated the same as a Canco that is a wholly owned subsidiary of a multinational group, even though Canadian corporate law generally prevents Canco from unfairly favoring the controlling shareholder over minority shareholders, and a public corporation would be seriously constrained under Canadian corporate and securities laws from engaging in substantially all of the tax-motivated transactions that the FAD rules are directed at.
- Treating the conferral of benefits on a foreign affiliate (guaranteeing debts, providing management and related services, legal and accounting advice, and so forth) as an investment is quite impractical, and is something better left to transfer pricing rules rather than rules treating the conferral of such benefits as deemed dividends triggering immediate taxation.
- As is discussed below, the extension of the FAD rules to include indirect investments (acquisitions of shares of Canadian corporations more than 75 percent of whose property consists of shares of foreign affiliates) is especially unfortunate and will have a number of adverse effects.
- The use of the series of transactions concept to expand the reach of the charging rule is especially objectionable, given the broad and uncertain scope of that term, as is discussed below. There is no apparent justification for applying the FAD rules whenever Canco *becomes* controlled by Parent or Foreignco *becomes* a foreign affiliate of Canco as part of the same series of transactions as the investment (possibly occurring years apart), given how tenuous a connection is required between the two events in order for them to constitute part of the same series of transactions.
- The lack of any differentiation in the charging provision between investments in Foreigncos that were already Canco foreign affiliates on March 28, 2012, and investments in new foreign affiliates unfairly prejudices foreign groups that have inherited Canadian foreign affiliates following the acquisition of a Canco or that have made Canada a regional headquarters or product center for perfectly valid business reasons.

The approach taken in the FAD rules is to ensure that virtually every possible objectionable transaction is

[15]Such income might arise directly or as income earned by Foreignco that is imputed to Canco under Canada's anti-deferral (FAPI) rules, or when Foreignco uses funds from Canco to make certain intragroup loans.

[16]The ''closest business connection'' exemption discussed in Section V, which is intended to allow for business investments ''down'' the chain, is unworkable, complex, and uncertain to the point of being of very little practical value for most taxpayers.

[17]Indeed, in the case of shares issued by Canco to a third party in an arm's-length transaction, the adverse impact of the rules' application is borne wholly or partly by the third party, in terms of reduced PUC of the Canco shares they acquire.

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caught, and then rely on some very limited and inadequate relieving provisions to prevent inappropriate results, or simply assume that taxpayers will plan their arrangements so as to steer a very wide berth around the FAD rules. This is unfortunate, as there are significant detriments to having a charging provision that is too broad and captures more than it should:

- It clearly makes the FAD rules more complex than they need to be to achieve their objectives.
- It makes foreign investors more apprehensive about change of law risk in Canada, that is, the likelihood that there will be further adverse changes in Canadian tax law in the future affecting foreign investments made through Canada.
- It greatly increases the planning and compliance costs for taxpayers beyond what they should be, without generating any significant benefits. It is not appropriate to draft tax legislation on the assumption that all taxpayers will be aware of, and will have the time and resources to plan around, the overbreadth of the charging provision (to the limited extent such is possible).
- Ultimately, it makes Canada less attractive than it otherwise would be for foreign investors who have a choice between using Canada or another jurisdiction as a base for managing foreign operations, potentially diverting away economic activity that would otherwise occur in and benefit Canada.

A prime example of the last point is the Canadian mining industry. Canada possesses a world-leading infrastructure of geologists, lawyers, accountants, bankers, and financiers with mining sector expertise, well-known and accepted corporate law, stock exchanges (TSX and TSX-V) that have more mining listings than any other in the world,[18] and the world's most stable banking system.[19] These have contributed to make Canada the center of the world's mining industry, and Canadian corporations are frequently used as head office entities for mining projects in Latin America, Africa, Asia, or elsewhere in the world.

Investors deciding where to set up mining companies generally presume that using Canada in this way will be tax-neutral, since they have no material Canadian-source income, aren't seeking to generate any tax deductions or advantages in Canada, and typically view the sale of the Canadian company itself as the most likely exit strategy. As such, they start from the presumption that they will not have material Canadian tax issues when choosing to use a Canadian holding company for foreign investments, and to date they have generally been correct. The FAD rules change this paradigm, and the danger is that such investors will not be aware of how broad these rules are or (if they are) have any willingness to expend time and resources planning around them: They will simply go elsewhere.

The risk to Canada is the erosion of its dominant position in the mining sector, through the unintended creation of a tax issue that causes foreign investors to locate elsewhere high-value economic activity that:

- would otherwise occur in Canada; and
- does not constitute the kind of inappropriate tax planning that the FAD rules are directed at.

Most foreign investors undertaking projects that could be, but need not be, headquartered in Canada (especially junior mining companies with very limited management and financial resources) simply will not spend time or money to deal with complicated rules that do or may apply but possibly can be managed around in the right circumstances.

The government's view appears to be that potentially affected taxpayers will be aware of the scope of these rules, and either expend the resources required to plan their way through them or simply steer far wide of them by not involving Canadian corporations in foreign activities. In many cases the latter will be the more likely result, with a significant loss of economic activity (in mining and other sectors) that would otherwise be of benefit to Canada. This will potentially manifest itself in numerous ways:

- As noted above, foreign investors looking for a suitable holding company jurisdiction as a base for foreign projects (as often occurs in the natural resources sector) may choose a country that does not involve any risk of double taxation or require any significant tax planning or compliance to be tax-neutral, and that is perceived as having less change-of-law risk.
- Multinationals choosing a country as a headquarters for particular geographic regions or business functions (thereby creating many significant high-value jobs) are far less likely to choose Canada, since doing so creates tax risks and compliance costs due to the FAD rules that simply don't exist in other jurisdictions. Canada thereby risks becoming a ''branch plant'' economy except to the extent of Canadian-controlled enterprises, instead of a group hub for particular geographic regions or business functions within a multinational group.
- Foreign companies considering the purchase of a Canadian corporation that owns significant foreign affiliates (even less than the 75 percent threshold necessary to make the acquisition itself an investment) may be willing to pay less than would otherwise be the case, since they will essentially be incurring a risk of double taxation and acquiring an ongoing Canadian tax problem after making the acquisition due to the FAD rules.

[18]*See* http://www.tmx.com/en/listings/sector_profiles/mining.html.

[19]*See* World Economic Forum, http://www.cba.ca/en/media-room/50-backgrounders-on-banking-issues/626-canadas-banks-made-of-canada.

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- As discussed below, foreign companies that *do* acquire Canadian corporations will now have a strong tax bias to strip all foreign subsidiaries out of the Canadian target to the greatest degree possible, again reducing the Canadian operations to branch plant status.

A. Inadequate Grandfathering Treatment

The fact that the charging provision does not differentiate between investments in Foreigncos that were already Canco foreign affiliates on March 28, 2012, and investments in new foreign affiliates is a further example of its overreach. The result is to penalize foreign multinationals that have chosen to locate foreign group members under Canada for business reasons or that inherited a ''below Canada'' foreign affiliate structure following the direct or indirect acquisition of a Canadian corporation that had foreign affiliates. It will now be dramatically more difficult to manage the funding of these foreign affiliates going forward, and there are no special accommodations offered for removing from under Canada foreign affiliates that would not have been placed (or left) under Canada had the FAD rules existed at that earlier time.

Transitional relief under the charging provision is very limited. It applies to all transactions occurring after March 28, 2012, except transactions between *arm's-length* parties that were the subject of a binding written agreement on or before that date and that are completed by the end of 2012. Given the magnitude of the FAD rules and the absence of any relief for existing Canco foreign affiliates, it would certainly have been desirable to allow multinational groups more time to consider the implications of these rules and (when appropriate) restructure foreign affiliates out from under Canadian group members. Indeed, the Canadian Bar Association-Canadian Institute of Chartered Accountants Joint Committee on Taxation (CBA-CICA Joint Committee) has noted that there is no obvious reason for the 2012 completion deadline for a transaction that is the subject of an otherwise legally binding agreement, and further suggested that transitional relief be extended to non-arm's-length transactions made to consummate an arm's-length agreement that meets the transitional relief rule.[20]

B. Arm's-Length Acquisitions of Canadian Corps.

Under the charging provision there is no business purpose test, and arm's-length transactions are treated no differently than intragroup investments. While these facts contribute to the overbreadth of the charging provision in many ways, one of the most serious is in the acquisition by foreign investors of Canadian resident corporations owning foreign affiliates. While only the acquisition of Canadian resident corporations whose assets are more than 75 percent attributable to shares of foreign affiliates constitutes an investment under the indirect acquisition element of the investment definition, a broader problem exists on *all* foreign acquisitions of Canadian corporations with foreign affiliates, *whether or not reaching the 75 percent threshold.*

At present, foreign purchasers of Canadian resident corporations owning foreign affiliates essentially have three options for dealing with those foreign affiliates post-acquisition:

1. Leave them in place under Canada.
2. Extract them from Canada by disposing of them to a foreign group member (the potential for this generally depends on the Canadian and foreign tax cost of disposing of the shares of the relevant foreign affiliate).
3. Move Canco's fiscal residence out of Canada to a foreign jurisdiction (that is, emigrate).

Before the enactment of the FAD rules, many foreign acquirers were content to choose option 1. Indeed, in some cases the government requested (or insisted) that foreign acquirers make Canada a regional or global headquarters for particular business lines as a condition for approval of the acquisition, which would typically involve leaving the Canadian target's relevant foreign affiliates beneath it.[21] Following the introduction of the FAD rules, however, it will generally be much more costly and inconvenient to leave existing foreign affiliates ''beneath'' Canada, since the FAD rules will apply to any subsequent investments made by the Canadian entity in its foreign affiliates, even if occurring for perfectly legitimate business reasons.[22] This is so *whether or not the initial acquisition of the Canadian target was itself an investment under the FAD rules*, that is, whether foreign affiliate shares exceeded 75 percent of the Canadian target's assets. As a result, foreign acquirers will now have a much greater Canadian tax incentive to pursue options 2 or 3 whenever possible, thereby reducing the amount of activity in Canada relating to the management, financing, and support of foreign affiliates. This would not seem to be to Canada's economic benefit.

There is more, however. While options 2 and 3 will be available as an alternative to option 1 in some circumstances (and indeed the PUC reinstatement rule

[20]*See* submission of the CBA-CICA Joint Committee on the Draft Legislation dated September 13, 2012, pp. 24-25, at *Doc 2012-19263* or *2012 WTD 180-26* (the ''Joint Committee submission'').

[21]In Vale's acquisition of Inco Limited, for example, the Brazilian purchaser agreed to make Canada its worldwide nickel headquarters; *see* http://www.sec.gov/Archives/edgar/data/917851/000095012306012775/y25717pe6vk.htm.

[22]As discussed in Section V, while there is an exception to the charging provision intended to allow for certain strategic investments in Canco's foreign affiliates, this exception is flawed to the point of being of very little practical use.

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facilitates their use),[23] the fact is that in many cases they will not be. Option 2 is possible in some circumstances without incurring unmanageable tax costs, when (1) there is little or no Canadian tax on the accrued gains on the foreign affiliate shares,[24] and (2) the foreign affiliate's home jurisdiction does not (or under an applicable tax treaty cannot) tax those accrued gains. However, in a significant number of cases this will not be the case; for example:

- the section 88(1)(d) ITA cost basis ''bump'' used to eliminate accrued gains on the Canadian target's foreign affiliate shares (and thereby Canadian tax on the disposition of those shares) will generally not be available when, for example, the foreign purchaser uses consideration other than cash to pay the Canadian target's shareholders, or when some other technical requirement of the cost basis bump is not met, as often occurs; or
- when the foreign affiliate shares derive their value primarily from local real property (as will typically be the case in the real estate, mining, and oil and gas sectors), the foreign affiliate's home country will usually tax any accrued gain on the disposition of the foreign affiliate's shares.

Similarly, because a corporate emigration involves a deemed fair market value disposition of *all* of the Canadian resident corporation's property and a notional dividend of its corporate surplus, it generally is viable as an alternative to option 1 only when the section 88(1)(d) cost basis bump is available, where its property consists entirely of shares of foreign affiliates and other ''bump-eligible'' property, and where the home countries of its foreign affiliates do not treat the merger or wind-up required to produce the ''bump'' as a taxable transaction. As such, the practical result of including bona fide business investments in foreign affiliates that have been acquired on a previous arm's-length acquisition of a Canadian resident corporation within the scope of the charging provision is that foreign purchasers of Canadian corporations will generally either (1) strip out of Canada as many foreign affiliates as they can to the extent possible without significant tax costs, and (2) discount the purchase price they are willing to pay to reflect the costs of (1) and the costs of the Canadian tax problem they are thereby inheriting under the FAD rules for all other foreign affiliates. Both of these results seem adverse to Canada's interest, and it is not apparent what offsetting benefit Canada is enjoying by not excluding from the FAD rules transactions that are sourced from arm's-length acquisitions and/or have no Canadian tax avoidance motive.

C. Indirect Investments

The extension of the charging provision to include indirect acquisitions (that is, acquisitions of Canadian corporations more than 75 percent of whose property is shares of foreign affiliates) is especially problematic. It is doubtful that such transactions produce any material surplus stripping that the FAD rules are stated to be directed at. Arm's-length acquisitions of Canadian corporations owning foreign affiliates are invariably transactions undertaken by the purchaser for business reasons, not to engage in surplus stripping.[25] As such, the benefits of including an indirect acquisition element in the investment definition are hard to see.

Including such indirect acquisitions as an investment greatly increases the scope of the FAD rules, often (as noted by the CBA-CICA Joint Committee) in completely inappropriate situations when the transaction has no tax motivation and is simply a capital markets or an ordinary-course business transaction.[26] Foreign acquirers of a Canadian corporation that owns shares of foreign affiliates representing more than 75 percent of the Canadian corporation's assets (as often occurs in the natural resources sector) will generally fall within this element of the charging provision simply by following the standard (and completely benign) practice of using a Canadian corporation (that is, a Canco) to make the acquisition.

When the indirect acquisition rule may apply, one would expect the foreign acquirer to price the transaction accordingly, potentially discounting the price that it would otherwise be willing to pay to reflect:

- the risk of double taxation arising from the initial acquisition, to the extent that the FAD rules produce either a deemed dividend or a reduction of PUC that is not later reinstated under the PUC reinstatement rule;
- the same costs (Canadian and foreign) of extracting the Canadian target's foreign affiliates out from under the Canadian tax system, and ongoing costs of financing any Canadian target foreign affiliates that do remain under Canada as apply to *all* foreign acquirers of Canadian corporations with foreign affiliates (described above in Section II.B); and
- further adverse change-of-law risk.

Foreign investors choosing where to locate a headquarters or holding company for foreign operations (in particular junior mining companies) will often view an eventual takeover as a likely exit strategy. As such, a Canadian tax issue that causes a potential acquirer to pay less for the Canadian corporation will in turn

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[23]Both options generally require that the Canadian corporation's PUC be as high as possible.

[24]In particular, when a foreign acquirer is able to use the section 88(1)(d) cost basis bump described in Section IV, it may be possible to eliminate accrued gains for Canadian tax purposes on the shares of the Canadian target's top-tier foreign affiliates.

[25]Existing cross-border surplus stripping rules already apply to certain non-arm's-length transactions; *see* section 212.1 of the ITA.

[26]Joint Committee submission, pp. 16-18.

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make it less likely that the initial investors choose to use a Canadian corporation at the outset.

D. 'Series of Transactions'

The liberal use of the term ''series of transactions'' to further broaden the charging provision is particularly troubling. The result is that the general rule can apply when as part of the relevant series Canco *becomes* controlled by Parent or Foreignco *becomes* a foreign affiliate of Canco, or when shares of a Canadian corporation have been acquired and as part of the same series of transactions some of its property is subsequently sold such that its remaining property is more than 75 percent attributable to shares of foreign affiliates. In other contexts in the ITA, the term ''series of transactions'' has been interpreted by Canadian courts quite broadly, to include within a series of transactions a transaction that occurred either *before or after* the other elements of the series, if the parties ''knew of the . . . series, such that it could be said that they took it into account when deciding to complete the transaction.''[27] The degree of linkage required between two events to make them both part of the same series of transactions is surprisingly low.[28]

As a result, it will be necessary for Canco to employ some degree of clairvoyance when making its investment, if the basis for concluding that the FAD rules do not apply is that Canco is not controlled by a nonresident corporation or that Foreignco is not at that time a foreign affiliate of Canco. If either of those events occurs subsequent to the investment, the fact that such subsequent event was not anticipated at the time of the investment is *not* by itself enough to conclude that the subsequent event is not part of the relevant series.[29] As such, the use of the ''series'' concept to expand the charging provision to capture later events creates a significant degree of uncertainty for taxpayers.[30] No justification has been put forward to explain why the government's policy objectives require such a tenuous connection between the ''investment'' and the related event. If an antiavoidance measure is required to prevent multi-step transactions from circumventing the FAD rules when they should apply, a much more focused rule should be employed (as occurs elsewhere in the ITA and the FAD rules).[31]

III. Foreignco Debt Exceptions

Two exceptions to the general rule apply specifically to investments that constitute an acquisition by Canco of debt of Foreignco. The first of these is relatively straightforward, being applicable to debts arising in the ordinary course of Canco's business and which are paid within 180 days.[32] This exception would appear to be directed at trade debt (for example, inventory purchases) and the like. It is, however, complicated by the exclusion of debts that are repaid within 180 days but that are part of a ''series of loans or other transactions and repayments.'' The vagaries of the ''series'' concept have been noted earlier; one can only hope that the Canada Revenue Agency does not apply the exclusion to running balances that are incurred, repaid, and incurred on an ongoing basis in the ordinary course.

The second exception is somewhat more involved and is based on the new term ''pertinent loan or indebtedness'' (herein, ''pertinent debt''). Only amounts that became owing *after* March 28, 2012, are eligible to be pertinent debt. Essentially, Parent and Canco can choose to make a one-time *permanent* joint election for each such debt owing by Foreignco to Canco (that is, a debt-by-debt election) to cause it to be pertinent debt, the results of which are:

- the FAD rules will not apply to that debt; and

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[27] *Canada Trustco Mortgage Co. v. The Queen*, 2005 SCC 54, at para. 26, *available at* http://scc.lexum.org/en/2005/2005scc54/2005scc54.html. The Supreme Court went on as follows:

> Section 248(10) extends the meaning of ''series of transactions'' to include ''related transactions or events completed in contemplation of the series''. . . . We would elaborate that ''in contemplation'' is read not in the sense of actual knowledge but in the broader sense of ''because of'' or ''in relation to'' the series. The phrase can be applied to events either before or after the basic avoidance transaction found under s. 245(3).

[28] According to the Supreme Court of Canada in *Copthorne Holdings Ltd. v. The Queen*, 2011 SCC 63, at para. 46:

> a ''strong nexus'' is not necessary to meet the series test set out in *Trustco*. The court is only required to consider whether the series was taken into account when the decision was made to undertake the related transaction in the sense that it was done ''in relation to'' or ''because of'' the series.

See http://scc.lexum.org/en/2011/2011scc63/2011scc63.html.

[29] This was specifically decided by the Supreme Court of Canada in *Copthorne* at para. 56:

(Footnote continued in next column.)

> The fact that the language of s. 248(10) allows either prospective or retrospective connection of a related transaction to a common law series and that such an interpretation accords with the Parliamentary purpose, impels me to conclude that this interpretation should be preferred to the interpretation advanced by Copthorne.

[30] Indeed, the fact that the FAD rules rely heavily on the accompanying Explanatory Notes to explain what is meant and how the rules are intended to operate further increases the apprehension of taxpayers and their advisers.

[31] *See*, for example, section 212.3(21) of the ITA, which deems two persons not to be ''related'' to one another for purposes of the corporate reorganization exemption if one of the main purposes of a transaction or event is to cause them to be related.

[32] A separate exception exists if Canco acquired the Foreignco debt from another person, the acquisition is in the ordinary course of Canco's business and the seller is a person dealing at arm's length with Canco (there is no 180-day repayment requirement in these circumstances).

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- Canco will be required to report a minimum amount of income each year regarding that debt (effectively, imputed interest).

The minimum income inclusion under this regime is the amount of interest that would accrue on the debt for the portion of the year it remains outstanding if a 5 percent interest rate applied,[33] reduced by any interest on the debt actually included in Canco's income for the year (that is, if the debt actually accrues interest at 3 percent, the pertinent debt regime requires another 2 percent to be included in Canco's income). However, when Canco itself (or a related Canadian resident) owes interest on a debt it incurred as part of the relevant series and that can reasonably be considered to have funded (directly or indirectly, in whole or in part) Canco's loan to the nonresident debtor, the minimum income inclusion under the new regime will be the actual interest payable by that Canadian borrower for the year, if that amount is higher than the amount produced by applying the 5 percent rate to Canco's receivable from the nonresident debtor for the year. Where a nonresident corporation acquires control of a Canco that was not controlled by a nonresident corporation immediately before that time, a special rule provides a 180-day exemption from the minimum income inclusion regime on debt owed to Canco.

The pertinent debt exception is thus the only situation in which an investment is excluded from the FAD rules by virtue of generating a threshold amount of income each year for Canadian tax purposes. It represents an important potential source of relief from the FAD rules for debts that generate (or that the parties are willing to have deemed to produce) taxable income for Canco, and as such constitutes a logical and welcome exception. Indeed, in many situations when multinationals have significant foreign operations held under a Canadian subsidiary (either for historical reasons or as a result of having acquired a Canadian corporation in an arm's-length takeover) that need ongoing financing, the pertinent debt exception may be the only practical way of dealing with the FAD rules. It would not be surprising to see taxpayers cause capital contributions made to and benefits conferred on foreign affiliates structured as debts instead, so as to potentially allow them to come within the pertinent debt exception.

That being said, this exception could certainly be improved. The 5 percent rate currently provided for (which is more likely to increase than decrease in the future) could easily exceed an arm's-length rate of interest on the facts, which seems inappropriate; if an arm's-length rate of interest is being earned on Canco's receivable, the Canadian tax base is not being eroded. Requiring income recognition at the lesser of the 5 percent prescribed rate and an arm's-length rate is a simple fix that prevents either too much income being recognized in Canada or interest expense being denied recognition in the debtor's country because it exceeds an arm's-length amount. Moreover, the rule providing for a higher than 5 percent rate when Canco (or a related Canadian) has itself incurred debt as part of the relevant series that can be linked to the pertinent debt is overly broad, going beyond simple back-to-back loans and requiring seemingly little linkage between the debt incurred by Canco (or the related Canadian) and the pertinent debt owing by Foreignco.

IV. Corporate Reorganizations Exceptions

A major criticism of the original proposal was that it applied whether or not any new investment was being made in Foreignco from a Canadian perspective. In particular, share exchanges and restructurings that cause Foreignco shares or debt to be acquired by Canco but that simply replace an existing foreign affiliate investment came within the scope of the rule.

While the FAD rules still encompass situations in which no incremental investment is being made, they include an important exception for specific corporate reorganizations, which is definitely helpful. The exceptions for specific reorganizations contain various limitations that significantly restrict their scope, often without an obvious reason, and the result is that reorganizations that do not involve a new investment remain an uncertain exercise. The corporate reorganization exceptions are explained diagrammatically in Figure 5, which gives the reader some sense of how carefully they must be approached to ensure that they can safely be relied upon.

A. Canadian Parent/Subsidiary Mergers

The only form of corporate reorganization exception that applies to all forms of Foreignco investments without qualification is the amalgamation or winding up of one taxable Canadian corporation into another taxable Canadian corporation that owns all of its shares.[34] Such amalgamations or liquidations of a Canadian subsidiary into its Canadian parent are tax-deferred under the ITA at both the corporate and shareholder levels. For an amalgamation, the resulting corporation must own all of the property and bear all of the liabilities of the parent and subsidiary immediately before the amalgamation (other than amounts owing between the parent and subsidiary), and the shareholders of the parent must not receive any property on the transaction (the shares of the subsidiary are simply cancelled).

[33]This prescribed rate will be adjusted each quarter.

[34]In a liquidation or winding up of the subsidiary, the parent need only own 90 percent or more of each class of the subsidiary's shares (with the remainder being owned by persons dealing at arm's length with the parent), although in practice one rarely encounters this form of tax-deferred reorganization other than in 100 percent ownership cases.

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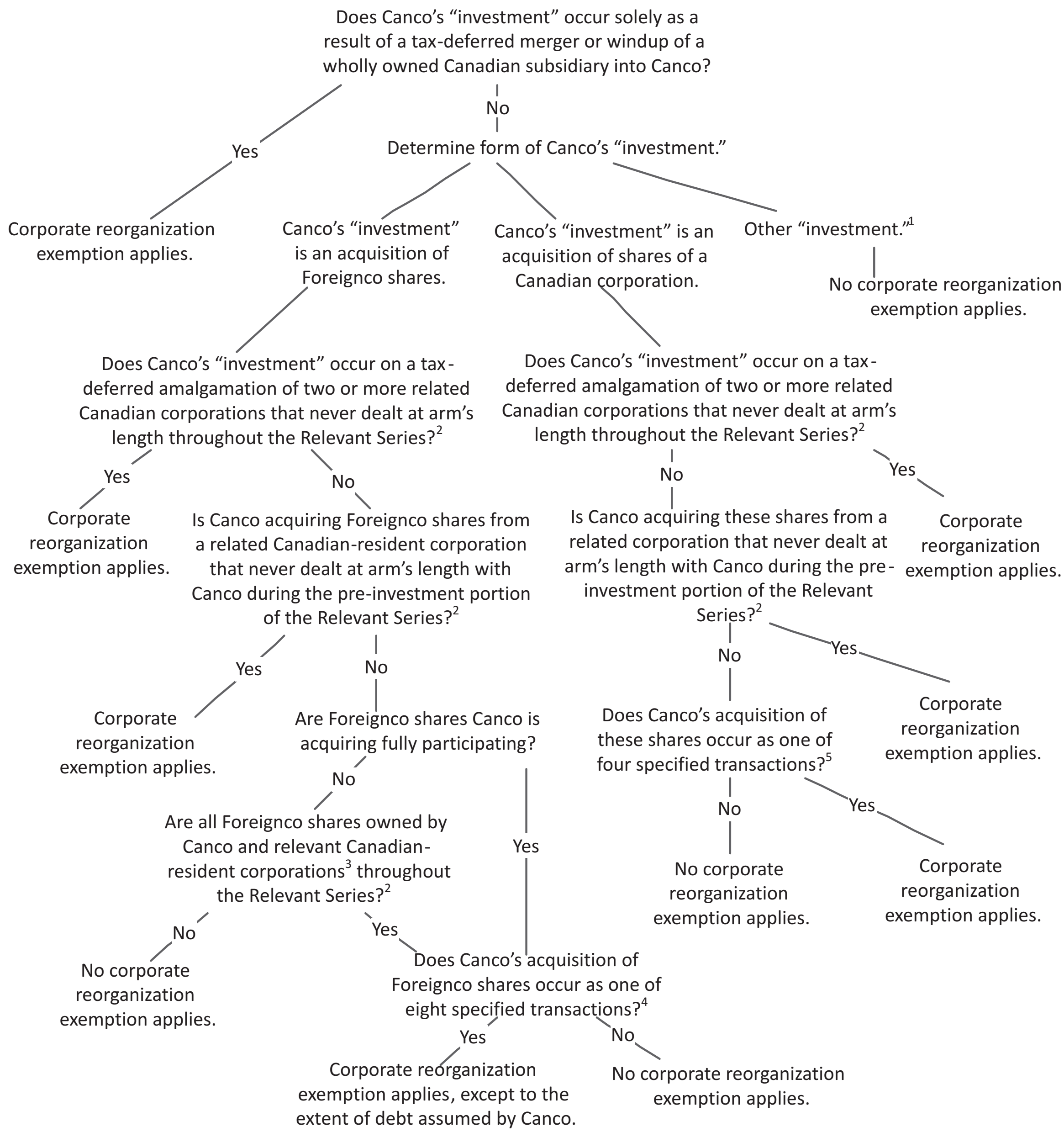
Figure 5. Corporate Reorganization Exemption



1. Canco extends credit to Foreignco or acquires a debt of Foreignco, or makes a capital contribution to or confers a benefit on Foreignco, or acquires an option in respect of or an interest in Foreignco shares or debt, or the maturity date or redemption date of any Foreignco debt or shares is extended.
2. The "Relevant Series" is the series of transactions that includes Canco's investment in Foreignco.
3. Relevant Canadian resident corporations are those that own all of Canco's shares or all of whose shares are owned by Canco.
4. Specified transactions are Canco acquiring Foreignco shares (1) from Foreignco in exchange for shares or convertible debt of Foreignco (section 51(1) ITA); (2) from Foreignco as whole or partial consideration for the transfer of shares of another foreign affiliate of Canco (section 85.1(3) ITA); (3) from Foreignco in exchange for other Foreignco shares on a reorganization of Foreignco's capital (section 86(1) ITA); (4) on the merger or combination of two or more foreign corporations to create Foreignco (section 87(8.1) ITA); (5) on the liquidation and dissolution of another foreign affiliate of Canco (section 88(3) ITA); (6) on a redemption of shares issued by another foreign affiliate of Canco; (7) as a dividend or return of paid-up capital from another foreign affiliate of Canco; and (8) exclusively in exchange for debt owing to Canco.
5. Specified transactions are Canco acquiring shares of the other Canadian corporation (1) from that other corporation in exchange for shares or convertible debt of that other corporation (section 51(1) ITA); (2) from that other corporation in exchange for other shares of that other corporation on a reorganization of its capital (section 86(1) ITA); (3) where the other corporation (or another Canadian resident corporation related to both corporations) uses the property transferred by Canco on Canco's investment to make a direct investment in Foreignco within 30 days of Canco's investment and as part of the same series of transactions; and (4) exclusively in exchange for debt owing to Canco.

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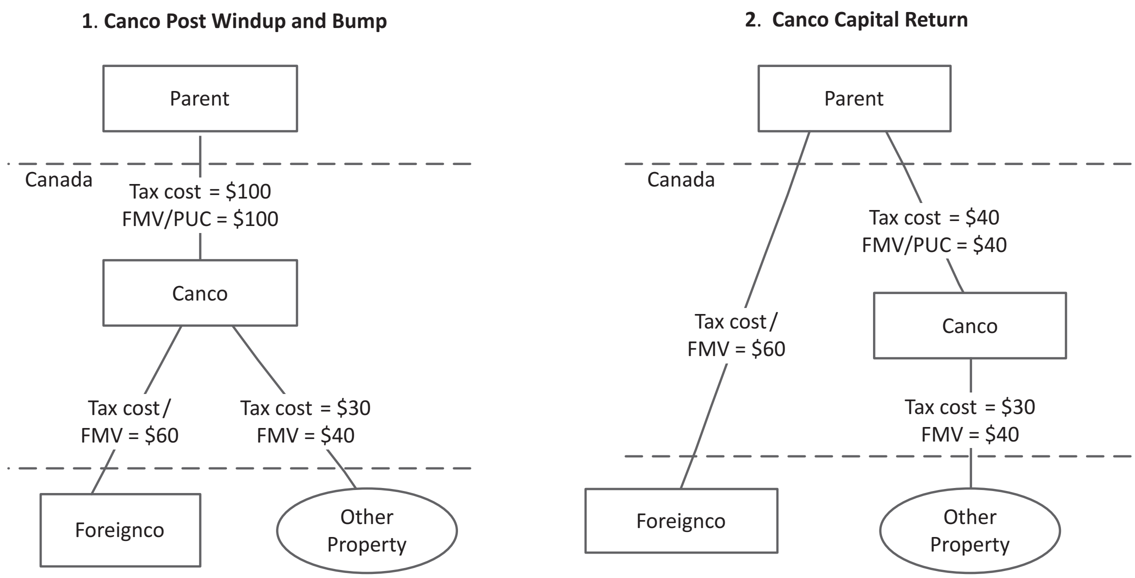
Figure 6. Purchase, Bump, and Foreign Subsidiary Extraction



- Canco receives $100 from Parent as a share subscription and acquires CanTarget for $100.
- Canco liquidates CanTarget and "bumps" the tax cost of Foreignco shares up to their fair market value of $60.
- Canco distributes the Foreignco shares to Parent as a $60 PUC reduction.

The exemption of these parent-subsidiary consolidations will facilitate the continued use of ''buy, bump and extract'' transactions, whereby a foreign purchaser (Parent) of a Canadian target company that owns foreign affiliates can use a Canadian acquisition company (Canco) to effect the purchase of the Canadian target (for cash, not Parent shares), and then liquidate it and acquire direct ownership of its property such that the cost of that property for Canadian tax purposes is increased (or ''bumped up'') to its fair market value under section 88(1)(d) ITA. This cost basis increase allows the property to be disposed of (on an internal reorganization or otherwise) without incurring Canadian capital gains tax. When such bumped property includes shares of a foreign affiliate (Foreignco), Parent often wishes to extract those shares out from under Canada so as not to incur various inefficiencies (tax and otherwise), and it does so by causing Canco to distribute these Foreignco shares to Parent as a reduction of PUC on Canco's shares (as illustrated in Figure 6).[35] This form of planning would be greatly impaired if the liquidation of the Canadian target into Canco were treated as an investment (an acquisition of Foreignco shares by Canco) to which the new rules apply. As discussed earlier, Canco's initial acquisition of the Canadian target's shares will still trigger the FAD rules if the value of the Canadian target's property is more than 75 percent attributable to shares of foreign affiliates. In those circumstances, a buy, bump, and extract transaction may still work by using the PUC reinstatement rule described in Section VI below to effectively reverse the initial reduction of Canco's PUC and facilitate the distribution of the shares of the foreign affiliates as a PUC return (or the emigration of Canco out of Canada).

B. Amalgamation of Related Corporations

If Canco's investment is either (1) an acquisition of shares of Foreignco or (2) an acquisition of shares of another Canadian corporation that constitutes an indirect acquisition, another exemption may apply when two or more Canadian resident corporations amalgamate (that is, merge) to create Canco on a tax-deferred basis for Canadian tax purposes under section 87(1) of the ITA. This provision requires that the corporation resulting from the amalgamation (Canco) own all of the property owned by each corporation participating in the amalgamation (other than shares of, or amounts owing from, another participating corporation) and inherit all of the liabilities of each of those participating corporations (other than amounts owing to another participating corporation). Moreover, each shareholder

[35]This form of planning and the basis ''bump'' generally are discussed in Suarez, ''Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know,'' *Tax Notes Int'l*, Dec. 4, 2006, p. 779, *Doc 2006-21865*, or *2006 WTD 237-7*.

of each participating corporation (other than another participating corporation) must receive shares of Canco on the amalgamation.

A further requirement is that each participating corporation must be related to one another immediately before the amalgamation. The definition of ''related'' is somewhat complex, but essentially two corporations will be related when one controls the other, both are controlled by the same person (or group of related persons), or both are related to a third corporation. Finally, this exception requires that at no point during the relevant series did any participating corporation deal at arm's length with another participating corporation.[36]

C. Acquisition of Related Corporation Shares

Another exception exists when Canco acquires Foreignco shares from another Canadian resident corporation, whether or not on a tax-deferred basis. This exemption requires that the seller be related to Canco immediately before the transaction, and that the two corporations not have dealt at arm's length at any time during the relevant series before the transaction.

A corresponding exception exists where Canco acquires shares of another Canadian resident corporation that constitutes an indirect acquisition. The terms of the exception are the same as that described in the preceding paragraph, except the seller need not be resident in Canada.

D. Acquisition of Foreignco Shares

Eight specific forms of corporate reorganizations may be exempted from the application of the FAD rules, but only when two conditions are met, namely:

- the form of Canco's investment must be an acquisition of Foreignco shares; and
- either those acquired Foreignco shares must be fully participating common shares (that is, not fixed-value shares such as preferred shares), or all outstanding Foreignco shares[37] must be owned by Canco and/or Canadian resident corporations that own all of Canco's shares or all of whose shares are owned by Canco throughout the relevant series.

The first four specific forms of corporate reorganizations that come within this exception are an acquisition of Foreignco shares from Foreignco:

- solely in exchange for either (1) other Foreignco shares, or (2) a debt of Foreignco that confers the right to make the exchange on the holder (that is, a convertible debt)[38];
- in exchange for shares of another class of Foreignco shares occurring upon a reorganization of Foreignco's capital[39];
- received upon a merger of two or more corporations resident outside of Canada to form Foreignco, that is, when Canco owns shares in a merger participant[40]; or
- as whole or partial consideration for Foreignco's acquisition of shares of another foreign affiliate of Canco.[41]

Also, the acquisition of Foreignco shares by Canco on three further forms of transaction involving foreign affiliates of Canco is potentially eligible for full or partial exclusion from the FAD rules:

- upon a liquidation and dissolution of another foreign affiliate of Canco[42];
- upon a redemption of the shares of another foreign affiliate of Canco; or
- as a dividend or PUC return from another foreign affiliate of Canco.

To the extent that Canco assumes any debt on the liquidation or other transaction, no exception from the FAD rules is permitted. Finally, Foreignco shares received as exclusive consideration for the repayment of debt owing to Canco is excepted.

E. Acquisition of Canadian Corporation

A smaller number of exceptions conceptually similar to those described in the preceding subsection exist for

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[36]Two corporations will deal not at arm's length with each another if either:

- they are related; or
- as a factual matter, they are governed by a common mind or do not have separate interests in dealing with one another.

[37]Other than any shares required to be owned by Foreignco's directors under relevant corporate law.

[38]Canco must hold the existing Foreignco shares or convertible debt as capital property. This constitutes a tax-deferred exchange under section 51(1) of the ITA.

[39]Canco must hold the existing shares as capital property and must dispose of all shares of that class of Foreignco shares that it owns. This constitutes a tax-deferred exchange under section 86(1) of the ITA.

[40]Such a foreign merger under section 87(8.1) of the ITA requires that Foreignco acquire all or substantially all of the property of the merging corporations (other than shares of, or amounts owing by, another merging corporation) and inherit all or substantially all of the liabilities of each such merging corporation (other than amounts owing to another merging corporation). Moreover, all or substantially all of the shares of each merging corporation (other than those owned by another merging corporation) must be exchanged for, or become, shares of Foreignco.

[41]Canco must own the foreign affiliate shares as capital property. This can be a tax-deferred exchange under section 85.1(3) of the ITA.

[42]Such transactions under section 88(3) of the ITA may be wholly or partially tax-deferred, depending on the facts.

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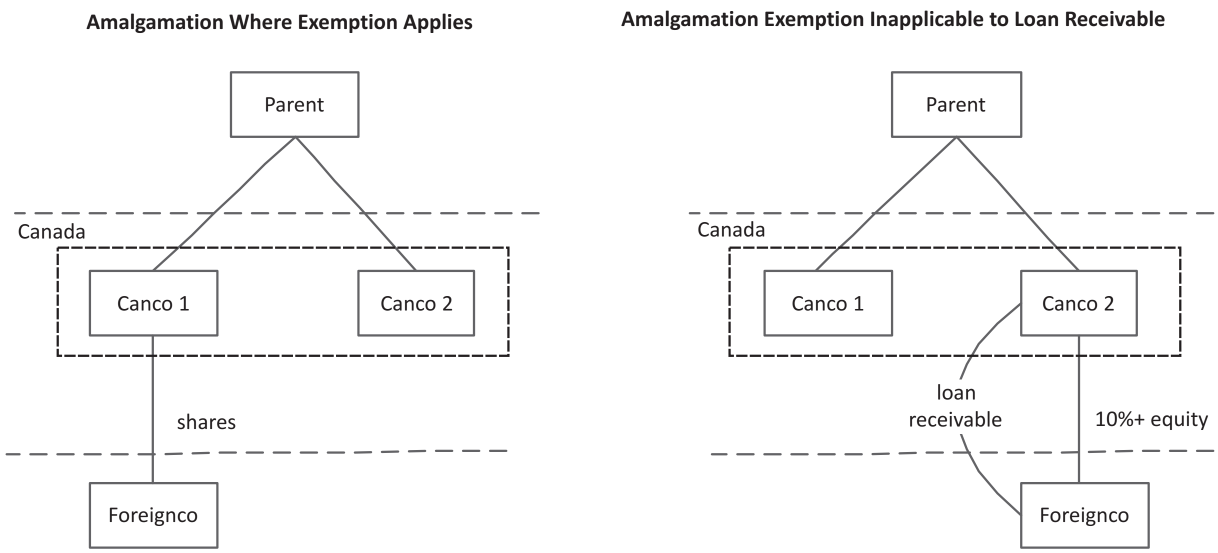
Figure 7. Illustration of Corporate Reorganization Exemption Limitations



indirect acquisitions (acquisitions of shares of a Canadian resident corporation owning shares of foreign affiliates). These consist of shares of the other Canadian resident corporation received:

- solely in exchange for either (1) other Foreignco shares, or (2) a debt of Foreignco that confers the right to make the exchange on the holder (that is, a convertible debt);
- in exchange for shares of another class of Foreignco shares occurring upon a reorganization of Foreignco's capital;
- if the other Canadian resident corporation (or a third Canadian resident corporation related to both of them) uses the property transferred by Canco to make a direct investment in a Foreignco to which the FAD rules apply, if both transactions occur within 30 days and as part of the same series of transactions[43]; and
- as exclusive consideration for the repayment of debt owing to Canco.

F. Problems With Reorganization Exceptions

The various exemptions for specific forms of corporate reorganizations are certainly helpful, but one cannot help but note how narrowly and specifically they are drafted (as with the other exceptions), in contrast to the broad ambit of the charging provision. Rather than providing a general exception for transactions ''if no incremental value is being transferred from [Canco] to [Foreignco]'' (as stated in the Department of Finance explanatory notes accompanying this provision), the corporate reorganization exemptions are drafted very specifically, and as such cover less than they could.

In some cases the exemptions impose limitations for no apparent reason. In most cases the exemptions are limited to acquisitions of Foreignco shares, and as such do not cover Foreignco debt, options to acquire (or interests in) Foreignco shares or debt, or acquisitions of shares of a Canadian corporation that owns Foreignco shares. For example, the exemption for an amalgamation of two related corporations doesn't include Foreignco debt (see Figure 7), for no discernible reason. The corporate reorganization exemptions should cover all forms of investment that trigger the application of the FAD rules if no new investment is being made from a Canadian tax perspective.

Also, some of the exemptions often do not apply unless the share investment in Foreignco consists of common shares, rather than preferred shares. Again, the reason for this restriction is not apparent: If there is no new investment being made, why shouldn't the transaction be exempted from these rules? The potential for leakage seems rather remote.

As noted earlier, buy, bump, and extract transactions are an important tax planning technique that foreign purchasers of Canadian companies with foreign subsidiaries employ for both tax and nontax reasons. Indeed, given the potentially punitive results for foreign-controlled Canadian corporations with foreign affiliates under the FAD rules, foreign purchasers of Canadian companies will very likely want to extract any foreign affiliates out from under Canada whenever possible.

[43]This exception is meant to prevent double counting of successive investments.

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While continued use of such planning is possible even when the Canadian target's property is more than 75 percent attributable to shares of foreign affiliates (via the PUC reinstatement mechanism described later), this may not be so in all cases. When the incremental investment from a Canadian perspective is temporary, such as when a foreign purchaser acquires a Canadian company and then plans to extract its foreign affiliates out from Canada as described above, it is hard to see what the tax policy concern is. The CBA-CICA Joint Committee has made a very sensible suggestion that an acquisition of Foreignco shares should be exempted when the investment is not owned by Canco (or any non-arm's-length Canadian corporation) 30 days after the time of the investment.[44]

V. The CBC Exception

The original version of the FAD rules released in March 2012 applied only to investments that could not reasonably be considered to have been made primarily for purposes other than to obtain a Canadian tax benefit, for example, bona fide business reasons. The absence of a primary business purpose for the investment was in fact part of the charging provision. In making this determination specified factors were required to be taken into account, relating to where the decision-making for the investment occurred, the degree of Canco's involvement in the process, the nature of the investment, and the similarity of Canco's business with Foreignco's business. While the business purpose test certainly had its flaws, relying on it to prevent the application of the FAD rules was a realistic possibility for many affected taxpayers.

In a major step backward, the August and current versions of the FAD rules have deleted the reference to a primary business purpose in the general rule and instead created a very narrow exception that is unlikely to be relevant in very many cases. Essentially the business purpose element of the analysis has been completely eliminated, and the specified factors previously required to be considered in making the purpose determination have been elevated into themselves *being* the basis on which the new exception applies. The result is a major expansion of the charging provision and a new exception that is largely of theoretical interest but impractical in a business context.

Given how unlikely the new ''closest business connection'' (CBC) exception is to be of use in the vast majority of circumstances, the terms of this exception will merely be summarized briefly rather than discussed in detail. (The relevant analysis is illustrated in Figure 8.) Essentially, in order for the CBC exception to apply, the following must be demonstrated:

1) All of the collective business activities of Foreignco and those entities in which it has a direct or indirect ownership interest (the ''Foreignco business activities'') must be *more* closely connected[45] with the business activities *in Canada* of Canco or any other Canadian corporations with which it does not deal at arm's length (the ''Canco business activities'') than they are connected with the business activities of *any* nonresident corporation with which Canco does not deal at arm's length (other than a nonresident corporation whose activities are included in the Foreignco business activities, or a ''section 17 affiliate,'' being any other nonresident corporation that is a Canco foreign affiliate controlled by Canco (alone or together with non-arm's-length Canadian residents or by any four or fewer other Canadian residents)).

2) It must be the case that condition 1 is expected to remain satisfied in the future.

3) Canco officers (a majority of whom are resident and working principally either in Canada or in the country of residence of a connected affiliate, being a section 17 affiliate carrying on a business that is as closely connected to the Foreignco business activities as the Canco business activities are) must have exercised the principal decision-making over Canco's investment at the time it was made.[46]

4) Condition 3 must be expected to remain satisfied in the future regarding ongoing decisions concerning Canco's investment.

5) It must be reasonably expected that the performance evaluation and compensation of Canco officers who work principally and reside in Canada or the country of residence of a connected affiliate will be based on the results of Foreignco's operations *to a greater extent* than the performance evaluation and compensation of *any* officer of a nonresident corporation not dealing at arm's length with Canco (other than Foreignco, any corporation it controls, or any connected affiliate).

Also, if Canco's investment is an acquisition of shares of Foreignco, one of two further conditions must be satisfied. Either those acquired Foreignco shares must be fully participating common shares (that is, not fixed-value shares such as preferred shares), or

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[44]Joint Committee submission, p. 23.

[45]''Connected'' is to be interpreted as meaning either:
- ''similar'' or parallel (that is, making or selling the same goods or providing the same services); or
- ''upstream'' or ''downstream'' (that is, one business providing inputs to, or selling the goods of, the other).

[46]For this purpose, any Canco officer who is also an officer of a nonresident corporation not dealing at arm's length with Canco (other than Foreignco, corporations it has a direct or indirect ownership interest in, or connected affiliates) is deemed not to satisfy this test.

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all outstanding Foreignco shares[47] must be owned by Canco and/or Canadian resident corporations that own all of Canco's shares or all of whose shares are owned by Canco throughout the relevant series.

Even when all of these myriad conditions are satisfied, Canco must be careful not to run afoul of a residual antiavoidance rule (separate and apart from the general antiavoidance rule in the ITA potentially applicable to all transactions) that disqualifies from the CBC exception a transaction that would otherwise qualify for the exception. An otherwise qualifying transaction does not benefit from the CBC exception if, as part of the relevant series, one or more properties received by Foreignco as a result of Canco's investment (or property substituted for such property) can reasonably be considered to have been used by Foreignco, directly or indirectly, in a transaction that would be caught by the FAD rules had Canco taken the action that Foreignco did. In many cases it will be difficult to ever get comfortable about not having strayed into the path of a rule of such breadth.

A new relieving provision was introduced in the October version of the FAD rules that allows Canco to make an investment in Foreignco without the FAD rules applying, if within 30 days Foreignco in turn uses the property received from Canco to make a loan to a section 17 affiliate for use in an active business it carries on in its country of residence, so long as throughout the relevant series the section 17 affiliate remains a corporation in which Canco could make an investment and come within the CBC exception. In effect, this exception is intended to allow Canco to achieve indirectly via a financing foreign affiliate an investment that Canco could make directly and come within the CBC exception. As with other exceptions to the FAD rules, it is narrowly drafted and does not accommodate, for example, the use of funds to acquire another foreign affiliate, or loan substitutes such as leasing.

The many deficiencies of the CBC exception have been the subject of extended commentary in the CBA-CICA Joint Committee submission[48] and elsewhere, and there is little point in spending much time on them here. It is hard to imagine taxpayers relying on the CBC exception in all but the clearest of cases, and as a result this exception will rarely be of any practical value. It is difficult to see how one would ever be reasonably able to prove that in a multinational group engaged in, say, oil and gas extraction, one entity's business is ''more'' connected with Foreignco's activities than the activities of another group member doing the very same things, or how one person's evaluation and compensation is ''more'' based on Foreignco's results than another person's elsewhere in the group, or how one group of persons exercised ''more'' decision-making than another. Indeed, these factors are not even necessarily indicative of a genuine nexus between Canco's investment and economic benefit to Canada. Moreover, when Canco is a holding company or a financing company for other operational entities in the group (as often occurs in the natural resources industry), it would seem that the CBC exception could *never* be satisfied, as Canco will not have any business activities that correspond to what its foreign subsidiaries are doing.

Given the punitive nature of the FAD rules, only the most courageous of taxpayers are likely to make planning decisions relying on the CBC exception. Trying to prove the satisfaction of its various preconditions to the CRA (or for that matter the taxpayer's external auditors reviewing and signing off on the tax provision in the taxpayer's financial statements) will be very challenging indeed, and the fact that the CRA does not provide advance tax rulings on questions of fact makes reliance on this exception all the less likely. A business purpose test, while imperfect, is vastly better than the CBC exception. Anyone who has advised taxpayers knows that a decision-maker who truly believes that he is making a decision primarily for business reasons will quite often be willing to live with the uncertainty involved in relying on a purpose test. Under the FAD rules, advisers will instead have to explain to their clients that whether the investment decision had anything to do with Canadian taxes is simply irrelevant to the application of the rules.

VI. Consequences of the Rule's Application

When the charging provision applies and no exception is available, the basic consequences are as summarized earlier:

- To the extent that in relation to its investment Canco has transferred any property (other than Canco shares) or incurred any obligation, or received any property as a reduction of any amount owing to it, the value thereof is treated as a dividend paid by Canco to Parent, triggering Canadian dividend withholding tax. The applicable rate of tax under the ITA is 25 percent, but may be reduced to as low as 5 percent under the terms of an applicable tax treaty.
- To the extent Canco has increased the PUC of its shares in relation to its investment (whether on an issuance of Canco shares or otherwise), the PUC of Canco's shares is reduced, in effect turning future Canco distributions into dividends instead of PUC returns.

There are then three ways in which these results may be altered:

- In some cases, an election may be made to treat a dividend that would otherwise be deemed to have been paid by Canco to instead be paid by another

[47]Other than any shares required to be owned by Foreignco's directors under relevant corporate law.

[48]*See* the Joint Committee submission, pp. 19-22.

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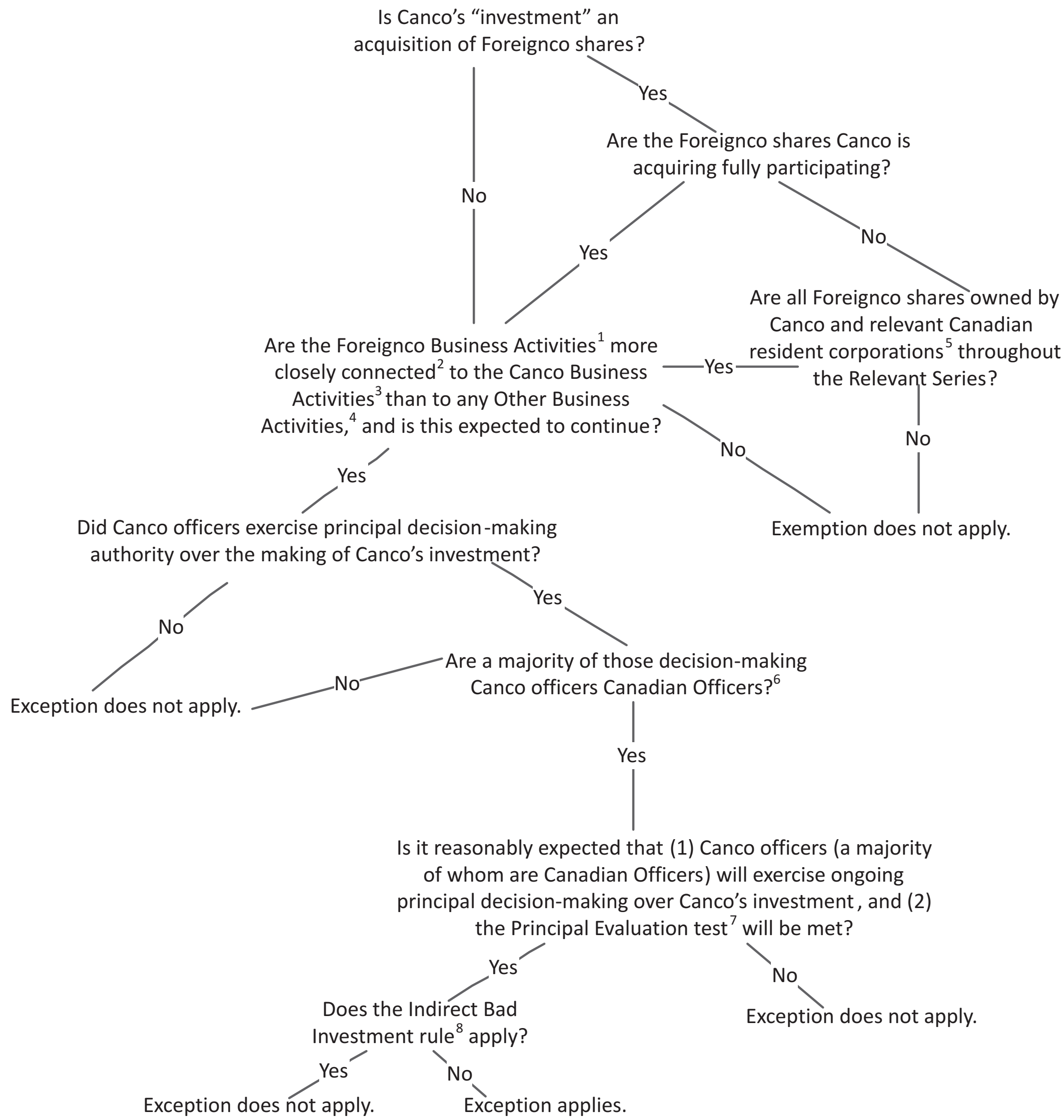
Figure 8. 'Closest Business Connection' Exception



1. " Foreignco Business Activities" are the business activities of Foreignco and corporations in which it has a direct or indirect ownership interest.
2. "Connected" is to be interpreted as meaning either (1) "similar" or parallel (that is, making or selling the same goods or providing the same services), or (2) "upstream" or "downstream" (that is, one business providing inputs to or selling goods or services of the other).
3. "Canco Business Activities" are the business activities *in Canada* of Canco or any Canadian resident corporation not dealing at arm's length with Canco.
4. "Other Business Activities" are the business activities of any corporations not resident in Canada and not dealing at arm's length with Canco, other than (1) Foreignco Business Activities, and (2) business activities of all "section 17 affiliates," being other foreign affiliates of Canco that are controlled by Canco (attributing to Canco for this purpose shares owned by certain other Canadian residents).
5. Relevant Canadian resident corporations are those that own all of Canco's shares or all of whose shares are owned by Canco.
6. "Canadian Officers" are officers of Canco who are resident in and working principally in either (1) Canada, or (2) the country of residence of a section 17 affiliate that carries on business activities that are (and are expected to remain) at least as closely connected to the Foreignco Business Activities as the Canco Business Activities are (a "connected affiliate"). For this purpose, any Canco officer who is also an officer of a nonresident corporation dealing non-arm's-length with Canco (other than Foreignco, corporations it has a direct or indirect ownership interest in, or connected affiliates of Canco) is deemed not to be a Canadian Officer.
7. The "Principal Evaluation" test is met when the evaluation and compensation of Canadian Officers is based on the operating results of Foreignco to a greater extent than the evaluation and compensation of any officer of a nonresident corporation not dealing at arm's length with Canco (other than Foreignco, corporations it controls, and connected affiliates).
8. The "Indirect Bad Investment" rule applies where as part of the Relevant Series Foreignco uses property received from Canco on its "investment" (or property substituted for such property) to make an investment (directly or indirectly) that, if made by Canco, would have caused the FAD rules to apply.

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related Canadian resident corporation (a qualifying substitute corporation, or QSC), and possibly to a recipient other than Parent, if this would produce a less disadvantageous result (for example, a lower dividend withholding tax rate).

- In some cases, some or all of a deemed dividend (including one resulting from a QSC election) is replaced with a reduction in the PUC of the shares of Canco (or a QSC). While typically (although not always) preferable to an immediate deemed dividend, such a PUC reduction has both immediate and future adverse effects, and so constitutes only partial relief.
- When PUC has been reduced due to the application of the FAD rules, in some circumstances the PUC so reduced can be reinstated solely for the purpose of distributing out of Canco (or the QSC) any Foreignco shares Canco's investment in respect of which triggered the application of the FAD rules, any shares of another foreign affiliate substituted for those Foreignco shares, or sale proceeds from or distributions received on such shares.[49]

Figure 9 illustrates the process for determining the consequences when the FAD rules apply.

When a dividend is deemed to have been paid as a result of these rules, the fact that Parent may own less than 100 percent of Canco's shares does not affect the amount of the deemed dividend. Hence, the entire amount of Canco's investment may be deemed to be a dividend even when Parent owns as little as 50.1 percent of Canco's shares. There is no time limit on the CRA's ability to assess nonresident dividend withholding tax, and both interest and penalties apply when the required withholding is not made.

The use of PUC reductions as a penalty for so-called foreign affiliate dumping represents an extremely blunt instrument that illustrates the lack of nexus between the impact of these rules and the mischief they are directed at. To begin with, unlike cost basis (which is specific to each particular shareholder), the tax attribute of PUC is a pooled concept: The PUC of any particular share of any class of Canco shares is the same as the PUC of every other share of that class, since PUC is computed as the total PUC of the class divided by the number of outstanding shares of that class. This means that the impact of reducing the PUC of any class of shares will be felt by *all* shareholders of that class, not just Parent. In fact, a PUC reduction may not affect Parent or someone dealing non-arm's-length with Parent *at all*. When a Canco controlled by Parent acquires a Foreignco (or a Canadian corporation that owns shares of Foreignco) such that the charging rule applies and the sellers accept Canco shares in full or partial payment, they may be the ones absorbing the *entire* PUC reduction if they are the only holders of the class of Canco shares issued to them, as sometimes occurs in private company buyouts, for example. This highlights the deficiencies of having the rules apply to transactions with arm's-length parties without differentiation.

A. QSC Election

Taxpayers may choose to make a QSC election when doing so would result in a reduced rate of Canadian dividend withholding tax and/or replacing some or all of a deemed dividend with a reduction of the QSC's PUC. An example is when Canco is not the top-tier Canadian entity in the group, and as a result a dividend deemed paid by Canco will not be eligible for the lowest dividend withholding tax rate found in most Canadian tax treaties, which usually requires direct share ownership of the dividend payer by the dividend recipient. (See Figure 10.)

In order for a Canadian resident corporation to be a QSC in respect of Canco, it must:

- be controlled by Parent;
- have direct or indirect ownership of at least some Canco shares; and
- be a corporation in which shares are owned by Parent or another nonresident corporation not dealing at arm's length with Parent (a ''substitute recipient'').

To make a QSC election, Canco, all QSCs and Parent (and any substitute recipient) must elect to effectively allocate the deemed dividend produced under the FAD rules among the classes of shares of Canco and the QSCs outstanding.

B. Automatic PUC Reduction

Another important relieving provision in the FAD rules is one that automatically converts some or all of a deemed dividend into a PUC reduction in some circumstances. Since the result of this is to turn what would otherwise be an immediate tax owing into a PUC reduction that (1) reduces Canco's ability to incur cross-border intragroup debt on an interest-deductible basis under Canada's thin capitalization rules and (2) reduces Canco's ability to make subsequent distributions as tax-free returns of PUC, this will typically (although not always) be the less painful alternative, particularly when the PUC reduction is one that may later be reversed under the PUC reinstatement rule described below. Since (as noted) the PUC of each share is the same as the PUC of every other share of the class, the impact of a PUC reduction will be felt pro rata by all holders of the class of shares whose PUC has been reduced.

The conditions for the automatic PUC reduction to apply differ somewhat depending on whether a QSC election has been made. When no QSC election has been made (that is, the entire dividend is deemed paid

[49]As noted, a largely comparable PUC reinstatement also applies for purposes of computing the departure tax applicable upon Canco emigrating from Canada.

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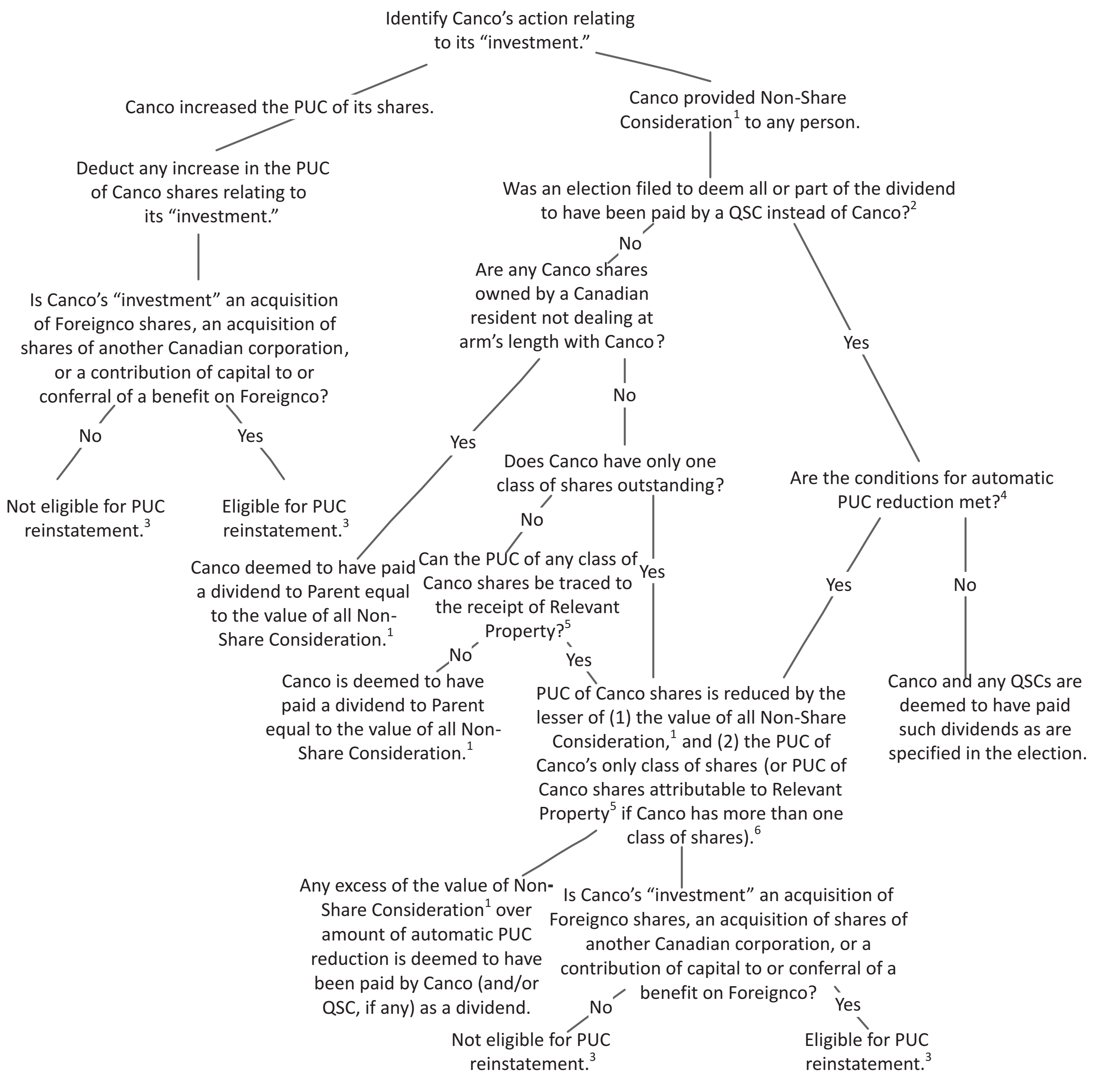
Figure 9. Consequences of Application



1. "Non-Share Consideration" means any property (other than Canco shares) transferred by Canco, any obligation assumed by Canco, or any benefit conferred by Canco or any property transferred to Canco that reduces an amount owing to it, to the extent reasonably relating to Canco's investment.
2. A QSC is a Canadian resident corporation (1) that is controlled by Parent, (2) that owns shares of Canco directly or indirectly, and (3) at least one share of which is owned by Parent or a nonresident corporation not dealing at arm's length with Parent. A QSC election allows some or all of a dividend otherwise deemed to be paid by Canco to be deemed to be paid by the QSC instead.
3. "PUC Reinstatement" means the deemed increase in PUC of Canco shares or QSC shares allowed where Canco or the QSC effects a return of share capital by distributing (1) Foreignco shares that were Canco's direct or indirect "investment," (2) shares of another Canco (or QSC) foreign affiliate substituted for those Foreignco shares, (3) proceeds from the disposition of shares described in (1) or (2) received within 180 days prior to the Canco (or QSC) distribution (excluding proceeds realized from a disposition to which the corporate reorganization exemption applies), or (4) an amount received as a dividend or PUC reduction on shares described in (1) or (2) within 180 days prior to the Canco (or QSC) distribution.
4. This requires that (1) Parent or a nonresident corporation not dealing at arm's length with Parent own shares in every class of Canco shares or QSC shares that is the subject of a QSC election, and (2) the QSC election and automatic PUC reduction result in the greatest possible reduction in the PUC of shares of Canco or a QSC that are owned by Parent or a nonresident corporation not dealing at arm's length with Parent.
5. "Relevant Property" means property transferred to Canco which Canco subsequently used to make its "investment."
6. If a QSC election was made, the PUC of the shares of Canco and each QSC is reduced by the lesser of (1) the deemed dividend allocable to Canco or the QSC under the election, and (2) the PUC of the relevant classes of Canco/QSC shares.

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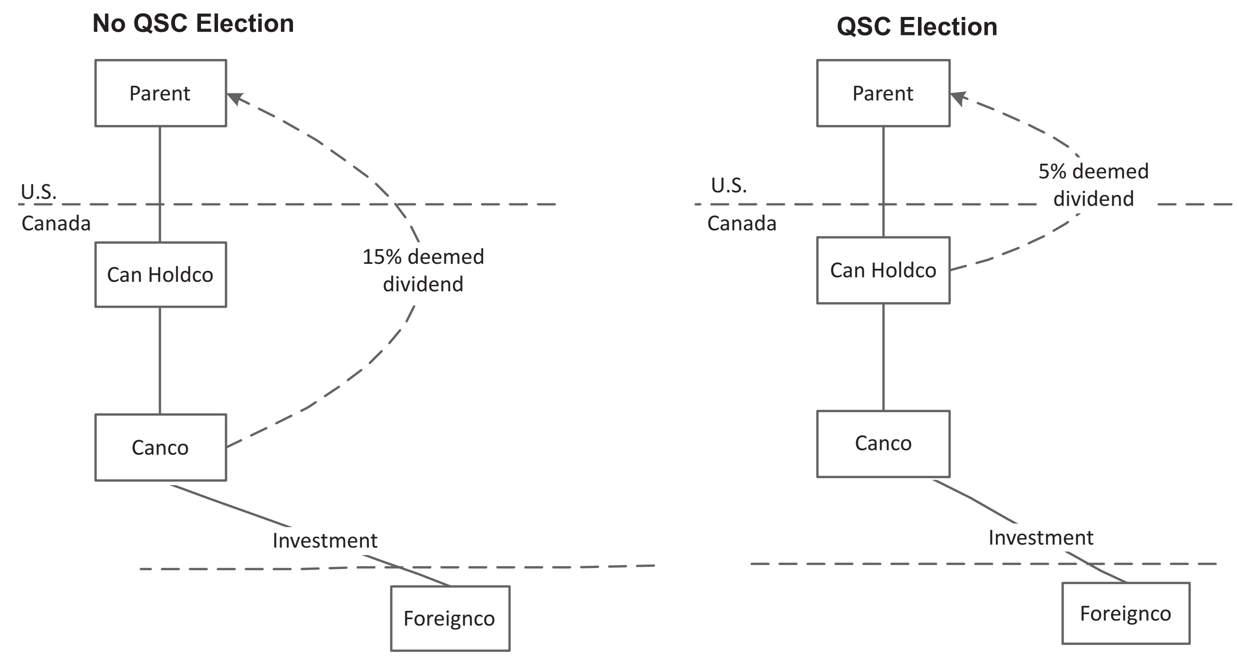
Figure 10. Effect of QSC Election on Deemed Dividend



by Canco), there must be no Canco shares owned by a Canadian resident not dealing at arm's length with Canco. This condition ensures that the consequences of a PUC reduction are suffered entirely by shareholders who are most likely to feel the impact of reduced PUC.[50] When the requisite share ownership condition is not met, a QSC election may be needed to allow a PUC reduction to occur. (See Figure 11.)

In addition, one of the following two conditions must also be met:

- there is only one outstanding class of Canco shares; or
- Canco can show that some specific amount of PUC of its shares arose from transfers of property to Canco that Canco used to make the investment that triggered the application of the FAD rules.

In the latter case, the extent to which a PUC reduction may replace a deemed dividend is limited to the amount of PUC traceable to the investment. The purpose of limiting the amount of such a PUC reduction to traceable PUC is unclear.

[50]PUC tends to be relatively less important for Canadian resident shareholders (although not entirely), and a Canadian holding company owning all the shares of Canco could liquidate or merge with it on a tax-deferred basis to eliminate any low-PUC shares resulting from a PUC reduction.

When a QSC election has been made, the conditions under which a PUC reduction will replace a deemed dividend are somewhat different. In such circumstances, there are two tests that must be met in order for a dividend deemed payable by Canco or a QSC to be replaced by a PUC reduction:

- each class of shares of Canco or a QSC to which an amount has been allocated under the election must be a class in which Parent (or a substitute recipient) owns shares; and
- the QSC election produces the greatest possible PUC reduction in shares of Canco or QSCs owned by Parent or a substitute recipient.

The result is essentially that the maximum amount of cross-border intragroup PUC must be reduced, although it is certainly still quite possible for arm's-length minority shareholders to suffer the effects of a PUC reduction under the FAD rules. It is therefore important for such shareholders to carefully consider how to protect themselves in making minority investments (for example, invest in a separate class of shares).

Although welcome, the PUC reduction rules are by no means a panacea. The reduction of pre-existing PUC still represents an incremental Canadian withholding tax at some point in the indefinite future, with a corresponding (and immediate) reduction in leverage permitted under the thin capitalization rules restricting interest expense. As such, they should be viewed as

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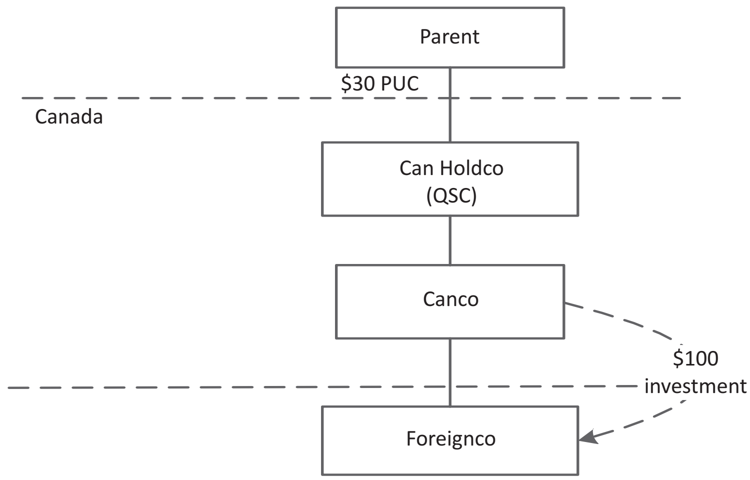
Figure 11. Example of QSC PUC Reduction



On $100 investment by Canco in Foreignco, result of making a QSC election for $100 is (1) PUC of Can Holdco shares is reduced to zero, and (2) $70 dividend deemed paid by Can Holdco to Parent.
Note: Without a QSC election, no PUC reduction is permitted since Can Holdco owns Canco shares.

merely mitigating the adverse effect of the application of the FAD rules, not avoiding it.

C. PUC Reinstatement

Finally, the FAD rules include a provision allowing PUC that has been reduced (either directly on the investment or under the automatic PUC reduction rule described immediately above) to be notionally reinstated solely for the purpose of allowing a subsequent distribution of property by Canco (or a QSC, if the QSC's PUC has been previously reduced) to be made as a PUC reduction rather than a dividend to which withholding tax would apply.[51] The PUC reinstatement mechanism applies only for PUC reductions that have occurred upon investments that are an acquisition of Foreignco shares, an indirect acquisition, or a capital contribution made to (or benefit conferred on) Foreignco. A simple illustration of how this PUC reinstatement mechanism is intended to work is provided in Figure 12.

Only specified distributions of property made by Canco (or a QSC, if the QSC's PUC has been previously reduced) will trigger a PUC reinstatement, being distributions of:

1) the Foreignco shares Canco's investment in respect of which triggered the FAD rules;

2) shares of another foreign affiliate of Canco (or the QSC) that were substituted for those Foreignco shares;

3) proceeds from the disposition of the shares in 1 or 2, if distributed within 180 days of the receipt of such proceeds[52]; and

4) an amount received by Canco (or the QSC) as a dividend or PUC return on shares in 1 or 2, if distributed within 180 days of being received.

When (and only when) both the PUC reduction and reinstatement rules apply, instead of treating all Canco investments in respect of a foreign affiliate as the equivalent of profit distributions out of Canada (that is, accelerated Canadian withholding tax owing and potential double taxation), the practical impact of the FAD rules is limited to preventing Canco's investment from creating additional PUC that could otherwise:

- increase Canco's interest expense deductions by increasing equity for thin capitalization purposes; and

[51]As noted, a conceptually similar PUC reinstatement also applies for purposes of computing the departure tax applicable upon Canco emigrating from Canada, which will sometimes be an alternative to Canco distributing Foreignco's shares.

[52]Excluded for this purpose are proceeds from a disposition encompassed within the corporate reorganization exemptions (except on a windup or merger of a wholly owned Canadian corporation into its Canadian parent).

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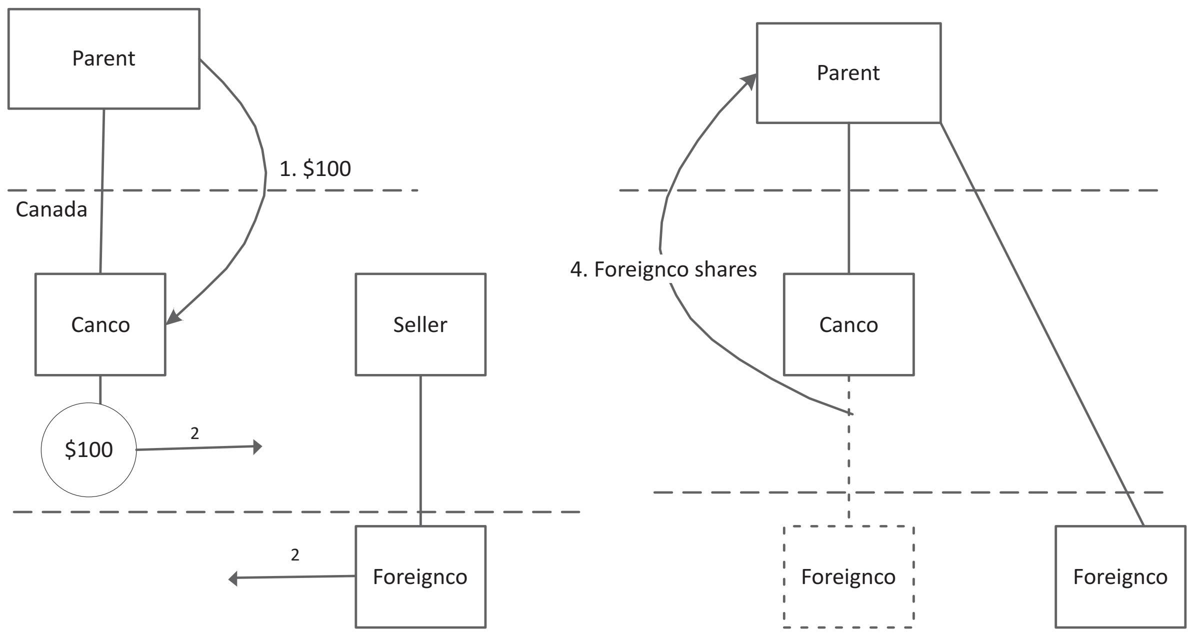
Figure 12. PUC Reduction and PUC Reinstatement



1. Parent pays $100 to Canco in exchange for Canco shares (creates $100 of PUC).
2. Canco uses $100 to purchase Foreignco from Seller.
3. Canco's PUC is automatically reduced by $100, replacing the $100 deemed dividend otherwise occurring.
4. Canco distributes Foreignco shares to Parent as a reduction of $100 of PUC reinstated under the PUC reinstatement mechanism.

- allow Canco to distribute as a tax-free PUC reduction other property completely unrelated to the investment.[53]

While the PUC reduction mechanism is clearly not as desirable as narrowing the charging provision to a more appropriate scope, it is a very important tool for taxpayers seeking to prevent double taxation from arising and is a welcome improvement.

The extension of the PUC reduction mechanism to indirect acquisitions will be particularly helpful regarding buy, bump, and extract planning described earlier, since that planning generally requires Canco to make the acquisition of the Canadian target corporation owning the foreign affiliates.[54] The PUC reduction mechanism allows Canco's acquisition of the Canadian target to occur without triggering an immediate deemed dividend (if this would otherwise occur), and the PUC reinstatement mechanism permits the distribution of the Foreignco shares to occur as a tax-free reduction of capital.[55] Some countries where Foreignco is fiscally resident may treat a distribution of the Foreignco shares by Canco to Parent as a taxable disposition of the Foreignco shares (particularly in the natural resources sector), yielding potentially unacceptable foreign tax consequences. In those circumstances, the extraction portion of the planning is often achieved by emigrating Canco out of Canada to move its fiscal residence to another jurisdiction. This in turn triggers an exit tax for Canadian purposes,[56] the impact of which depends in large part on Canco's PUC. The October expansion of the scope of the PUC reinstatement mechanism to reinstate PUC for purposes of the corporate emigration exit tax is therefore a welcome and appropriate measure.

[53]The necessity of preventing this latter result is still entirely open to question, but at least the PUC reinstatement mechanism allows the original investment to be extracted from Canada to the extent of its original value.

[54]That is, not a direct purchase by Parent. The bump in the cost basis of the Foreignco shares requires the merger of one Canadian corporation into another.

[55]While having Parent capitalize Canco with loans also permits the Foreignco shares to be distributed (as a repayment of debt) without incurring dividend withholding tax, doing so when Canco's purchase of the Canadian target constitutes an indirect acquisition subject to the FAD rules means that no PUC is created that can be the subject of a PUC reduction election to avoid triggering a deemed dividend under these rules.

[56]Section 219.1 of the ITA.

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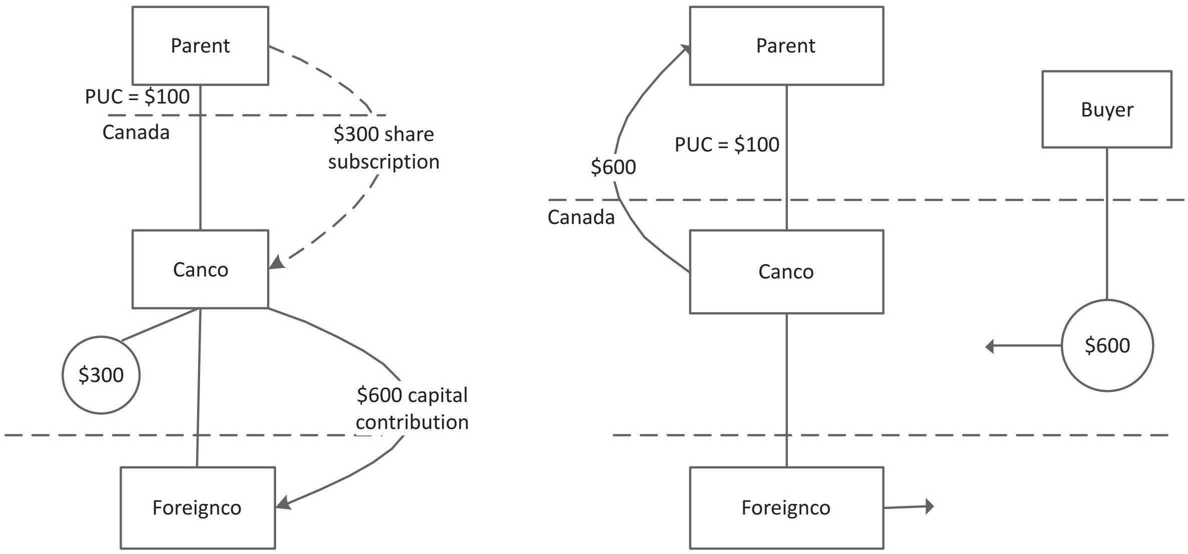
Figure 13. PUC Reinstatement and Double Taxation



- Parent, owning Canco shares with PUC of $100, subscribes for a further $300 of Canco shares, increasing PUC by $300 to $400.
- Canco uses $300 received from Parent and $300 of its own funds to make a $600 capital contribution to Foreignco.
- Result: PUC of Canco shares is reduced by $400 down to zero as an automatic PUC reduction, and Canco is deemed to have paid a $200 dividend to Parent.

- Following sale of Foreignco for $600, Canco distributes $600 proceeds to Parent; $400 of previously reduced PUC is reinstated.
- $600 distribution consists of a $400 PUC return and $200 dividend.
- Result: $200 dividend is duplicated and double-taxed.

That said, it is important to understand that except when the FAD rules have produced a PUC reduction (not a deemed dividend) that is subsequently reversed via the PUC reinstatement mechanism, the eventual double taxation will often result. This is because a deemed dividend generates no offsetting increase in Canco's tax attributes (that is, a PUC increase), and hence at some point a subsequent distribution by Canco of equivalent value will constitute an actual dividend to which Canadian dividend withholding tax applies again rather than a PUC reduction: Instead of accelerating Canadian dividend withholding tax, the deemed dividend duplicates it. The potential for double taxation to arise under the FAD rules in this form (there are others) is illustrated in Figure 13.

VI. Conclusion

The FAD rules constitute an unprecedented shift in Canadian tax policy. They inappropriately treat virtually all forms of investment by foreign-controlled Canadian corporations in entities that are (or may become) foreign affiliates as distributions of profit out of Canada, and create significant risk of accelerated and/or double taxation in many situations in which no erosion of the Canadian tax base is occurring. While there are legitimate tax policy concerns with some forms of foreign affiliate dumping that justify legislative action, the FAD rules overreach and go well beyond addressing these relatively limited situations. In contrast to steps taken in other countries' international taxation systems to encourage foreign use of domestic entities for foreign investment,[57] Canada's FAD rules will have a very negative impact on foreigners' willingness to use Canadian corporations as an element of their international business operations, with adverse effects for the Canadian economy.

The FAD rules could be improved while preserving the most important elements of their underlying tax policy by carving them back so as not to apply in situations where there is little practical risk of tax avoidance or revenue loss and where the tax policy case for treating the activity in question as equivalent to a Canco

[57]*See, e.g.*, recent changes to the U.K.'s controlled foreign corporation regime, discussed at the 2012 meeting of the Canadian branch of the International Fiscal Association, ''Global CFC Developments: Policy Choices and Practical Implications'' (panel discussion chaired by the author), May 17, 2012.

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distribution is relatively weak. For example, the application of the FAD rules to transactions that have no tax motivation whatsoever continues to be a major objection of the business community. Put simply, there is a legitimate and logical distinction to be drawn between a Canco using cash that could otherwise be paid as a dividend to Parent to purchase shares of a foreign group member purely to avoid Canadian dividend withholding tax, versus using such cash to make a purchase for business reasons. Amending the FAD rules to reflect this distinction (which existed in the original version) would be a major step forward.

Eliminating the potential for double taxation under the FAD rules would be an excellent move, as there are few things more objectionable to foreign investors. While the PUC reinstatement mechanism is a welcome step in that direction, an even more helpful response would be not to treat certain transactions as PUC reductions in the first place (rather than reducing PUC and later reinstating it in limited circumstances). Reverting to the example in the previous paragraph, if Canco distributed its cash to Parent, paid the dividend withholding tax, and then acquired shares of Foreignco from Parent in exchange for issuing shares of itself (generating PUC equal to the value of the property received), that should be an adequate tax policy result in terms of preventing surplus stripping. Under the FAD rules, Canada gives little or no tax recognition for Canco's acquisition of Foreignco shares, but yet stands ready to tax any non-exempt distributions received on, capital gains arising from the sale of, or FAPI imputed to Canco in respect of those Foreignco shares. Foreign multinationals will have little incentive to locate foreign affiliates in Canada on these terms.

Finally, the impact of the FAD rules could be greatly improved at virtually no cost in tax revenues by ensuring that foreign purchasers of Canadian corporations substantially all of whose property consists of securities of foreign affiliates can extract these securities from the Canadian tax system to avoid having to manage the FAD rules on an ongoing basis. In the mining sector, Canadian corporations are frequently used as holding vehicles for foreign affiliates with projects wholly outside of Canada, *viz.*, where there is no substantive connection between Canada and the underlying assets. In these cases, the revenue generated from having such companies located in Canada (that is, fees to Canadian bankers, lawyers, accountants, stock exchanges, geologists, and so forth) is ''found money'' for Canada. It is in Canada's interest to ensure that these companies are created here and that no tax reason exists to choose a different jurisdiction that will be more attractive to an eventual foreign purchaser of the company (the typical exit strategy).

To dispel the negative effect of the FAD rules on the attractiveness of Canadian corporations to foreign purchasers, the government should enact a regime giving foreign purchasers of a Canadian corporation with no significant Canadian assets a reliable way to remove the Canadian target's foreign affiliates easily and without taking steps that may incur tax in the foreign affiliate's home country. The extension of the PUC reduction and reinstatement rules in the current version of the FAD rules to facilitate ''bump and extraction'' and Canco emigration planning suggests that the government has no policy objection to removing foreign affiliates from beneath Canco in these circumstances. However, as noted in Section II.B, in various instances these options are not open to foreign purchasers. To address this issue, a rule should be created applicable on an arm's-length acquisition of 100 percent of the shares of a Canadian corporation by a foreign-controlled Canco, if Canco and the Canadian target emigrate from Canada within 180 days of the acquisition of control. Under such a rule:

- the FAD rules would not apply to the acquisition itself or during the period up to the date of emigration; and
- for purposes of determining the Canadian tax consequences of the emigration of Canco and the Canadian target, such determination would be made as if (A) the Canadian target had wound up into Canco, and (B) Canco had full cost basis in securities of foreign affiliates owned by the Canadian target at the time of the acquisition of control and held continuously by it up to the date of emigration: in effect, a notional merger and bump for emigration purposes only, without the unnecessary technical limitations of the section 88(1)(d) ITA bump or potentially incurring foreign taxes by merging Canco and the Canadian target (as the bump requires).

The FAD rules represent a profound revision of the government's international tax policy; what better time than now to make other elements of that policy more competitive internationally? ◆

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