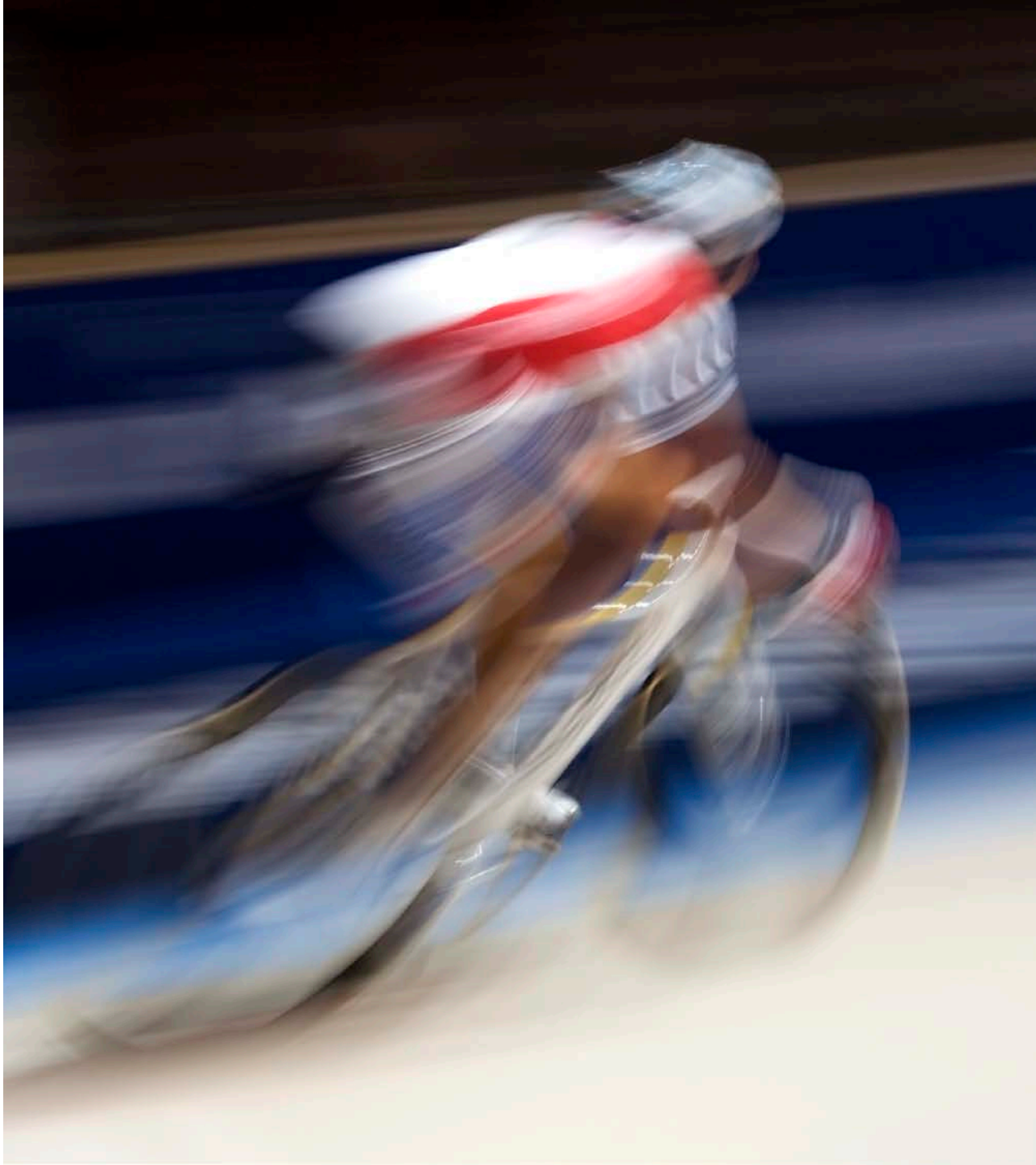
Deloitte.

International Tax Update for Canadian Businesses, Including a Legislative and Treaty Update

David Bunn
Dennis Metzler
Alex Smith
Deloitte Canada

March 1 - 4, 2015



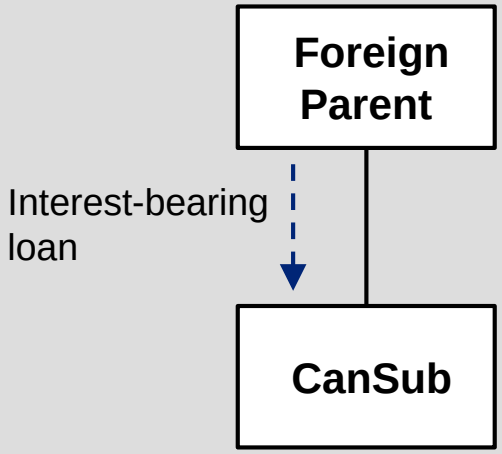
Agenda

1. Back-to-back loan rules
2. Foreign affiliate dumping rules
3. Mothership theory
4. Judicial update
5. IRS examinations

B2B loan rules
Legislative update

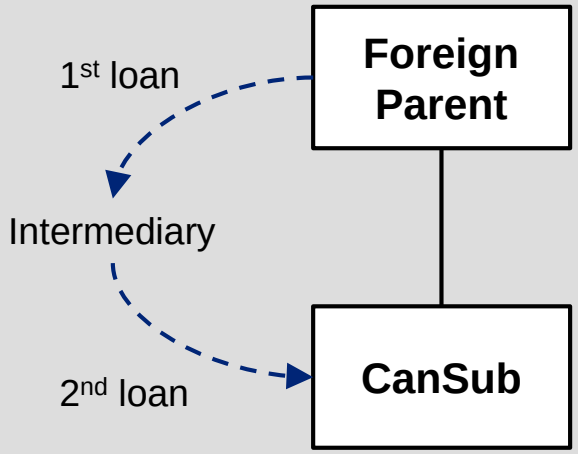
B2B loan rules
Historical context

Base case



- Thin cap 1.5:1
- 25% WHT on NAL interest
- WHT may be reduced under a tax treaty

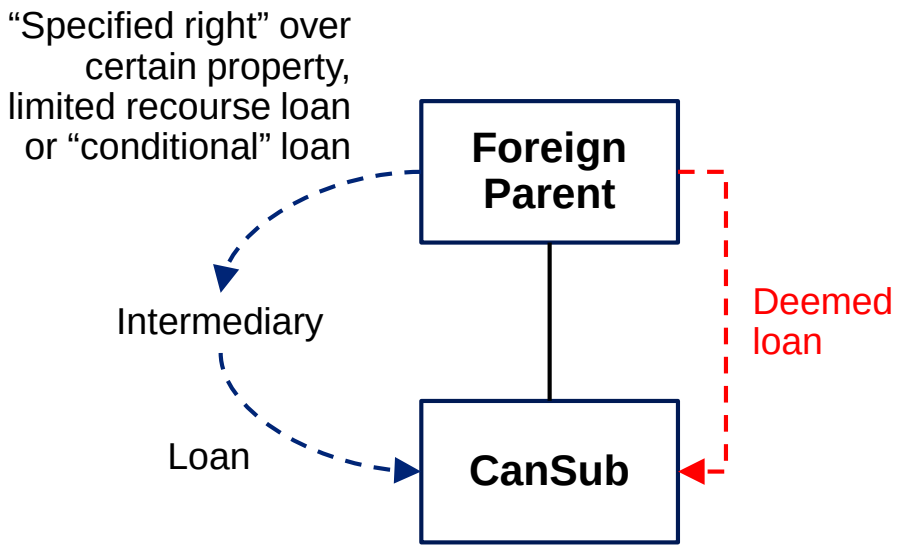
Back-to-back loan



- No thin cap on AL loans except for loans on condition under 18(6)
- Canadian banks agreed not to facilitate thin cap avoidance years ago
- No Part XIII WHT on AL interest even if conditional loans in place

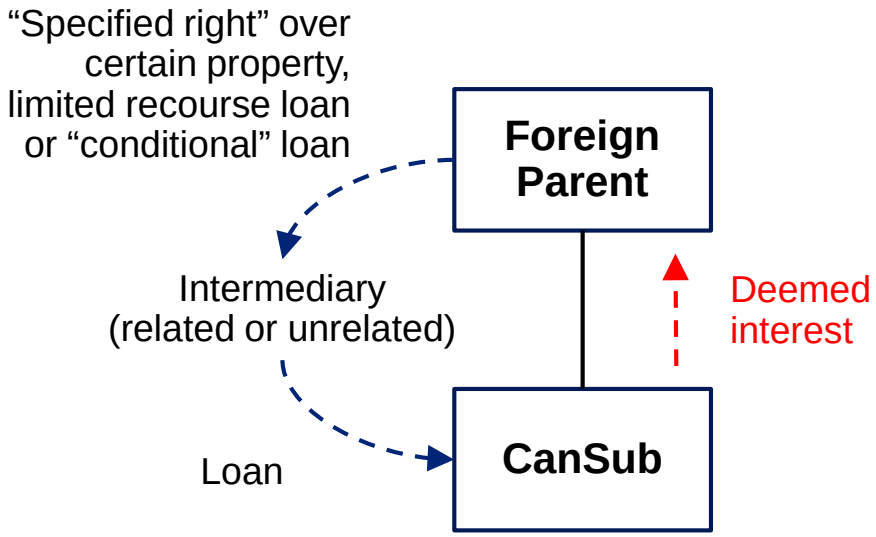
B2B loan rules
Thin capitalization

- If 18(6) and (6.1) apply, CanSub is deemed to owe an amount to Foreign Parent, such that interest becomes subject to thin cap rules and deduction may be denied if CanSub has insufficient equity
- B2B rules do not apply for thin cap purposes if the intermediary is a NAL Canadian resident or a specified non-resident
- Any non-deductible interest is deemed to be a dividend subject to WHT
- If CanSub has sufficient equity, the interest may nevertheless be subject to WHT as interest paid to Foreign Parent under the B2B rules



B2B loan rules
WHT

- If 212(3.1) to (3.3) apply, CanSub is deemed to pay interest to Foreign Parent, subject to WHT, potentially reduced by Treaty
- 212(1)(b) and relevant Treaty still applicable to actual interest paid to NAL intermediary
- Rules do not apply unless WHT would be higher if interest were paid to Foreign Parent instead of intermediary
- Rules do not apply if the intermediary is a NAL Canadian resident or a partnership of such persons

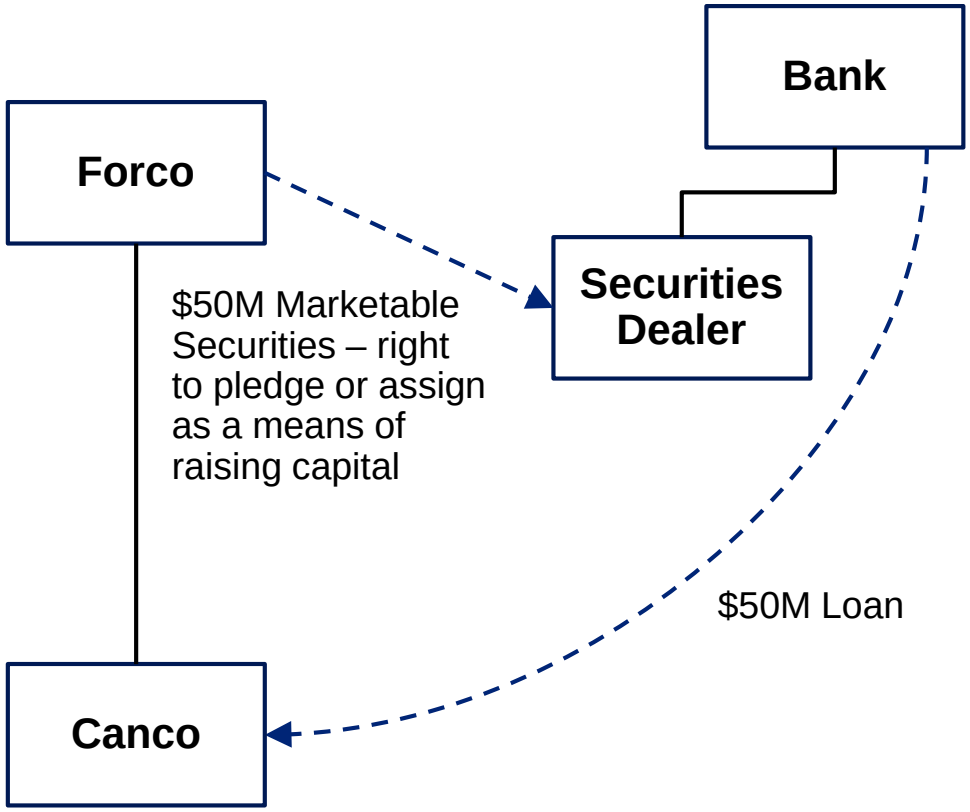


B2B loan rules

Example: Specified right concept

EN Example 1

- Forco (a connected non-resident in respect of Canco) has granted a specified right to Securities Dealer (non-arm's length with bank intermediary)
- 18(6)(c)(ii) applies if specified right is required under the terms of the loan, or if reasonable to conclude that all or a portion of the loan became owing because the specified right was granted
- De minimis exception does not apply

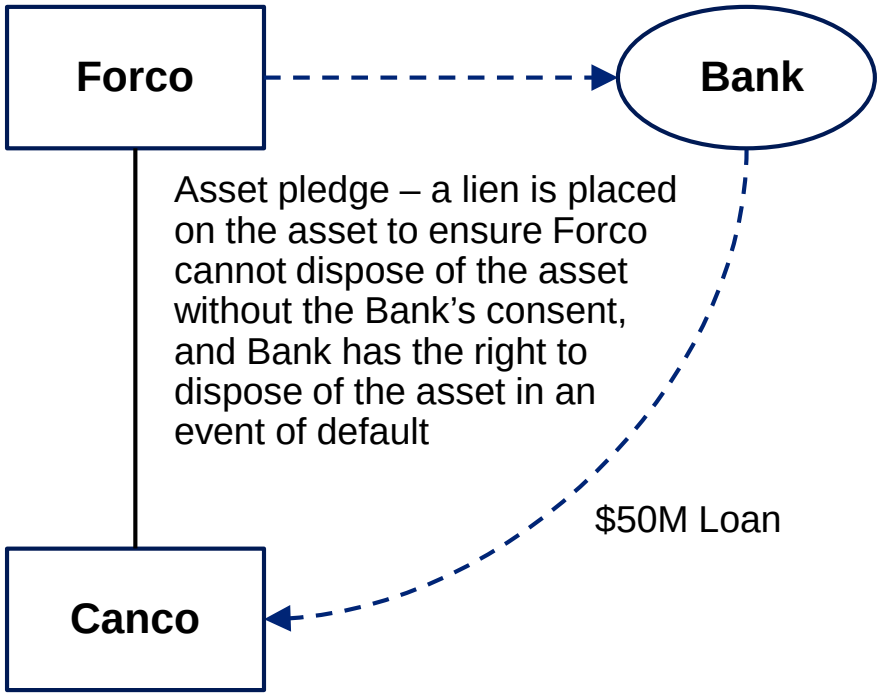


B2B loan rules

Example: Specified right concept

EN Example 2

- The lien on Forco's asset secures payment of the particular amount (i.e. the Canco debt) and is therefore not a specified right
- The additional right to dispose of the asset in an event of default is available only upon the occurrence of a future event – it does not provide the intermediary with a right to "deal" in the property at that time, and therefore is not a specified right
- 18(6)(c)(ii) does not apply

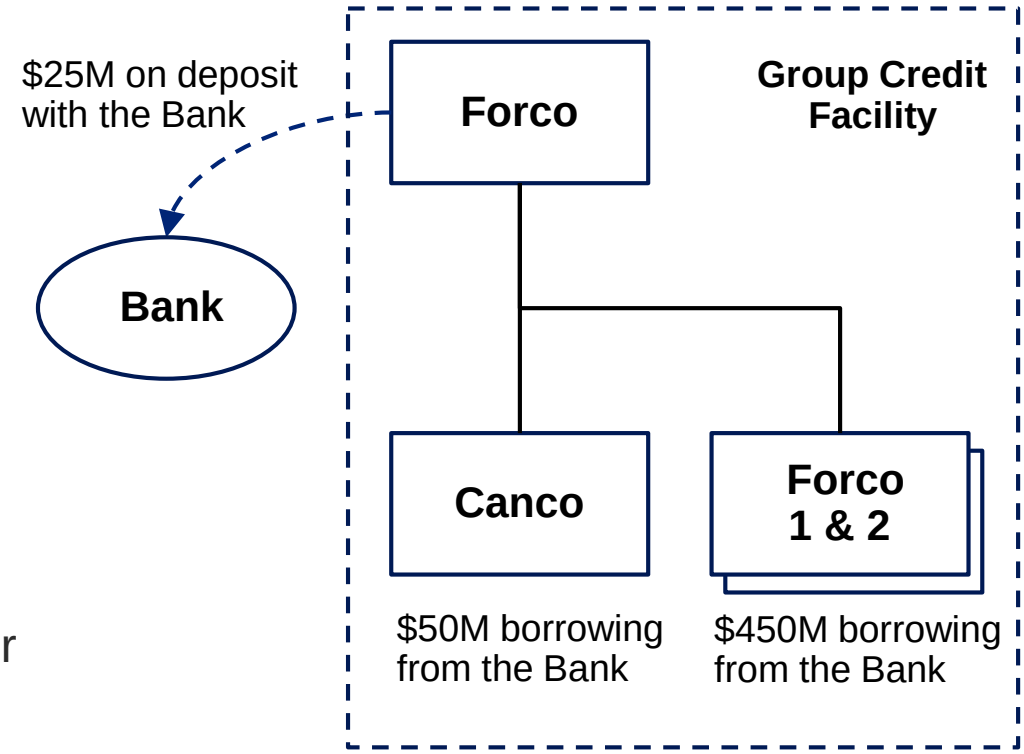


B2B loan rules

Example: Cross-collateralized loans

EN Example 3

- Amount on deposit with bank likely an intermediary debt or specified right
- De minimis test – intermediary debt or FMV of property over which a specified right has been granted must equal at least 25% of the particular amount
- In applying the 25% de minimis test in the context of group credit facilities, include amounts that persons NAL with taxpayer have outstanding to intermediary under the same or connected agreements

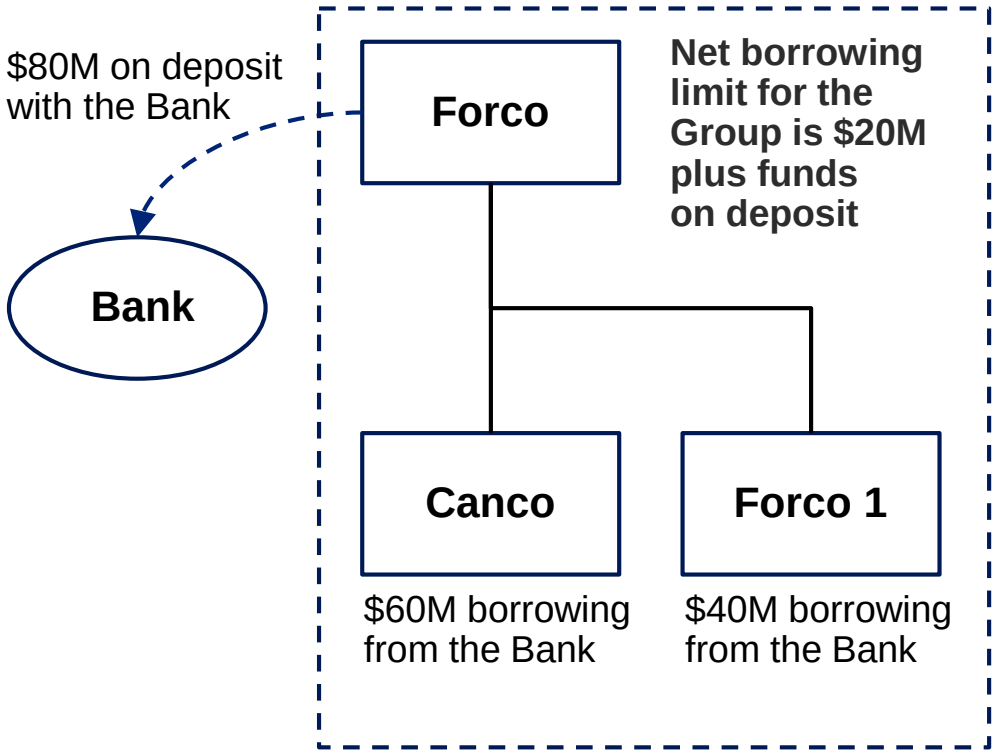


B2B loan rules

Example: Notional cash pooling

EN Example 4

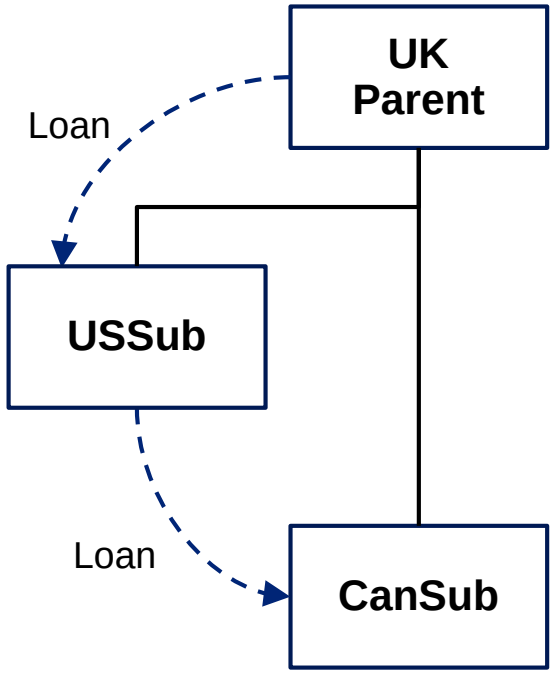
- Amount on deposit with bank likely an intermediary debt or specified right
- If amount on deposit is property in which Bank has a security interest that secures payment of both Canco's debt and Forco 1's debt, then Forco 1's debt included in applying de minimis test
- However, as $80M > 25% of $100M ($60M + $40M), the de minimis exception does not apply



B2B loan rules

Example: UK with U.S. intermediary

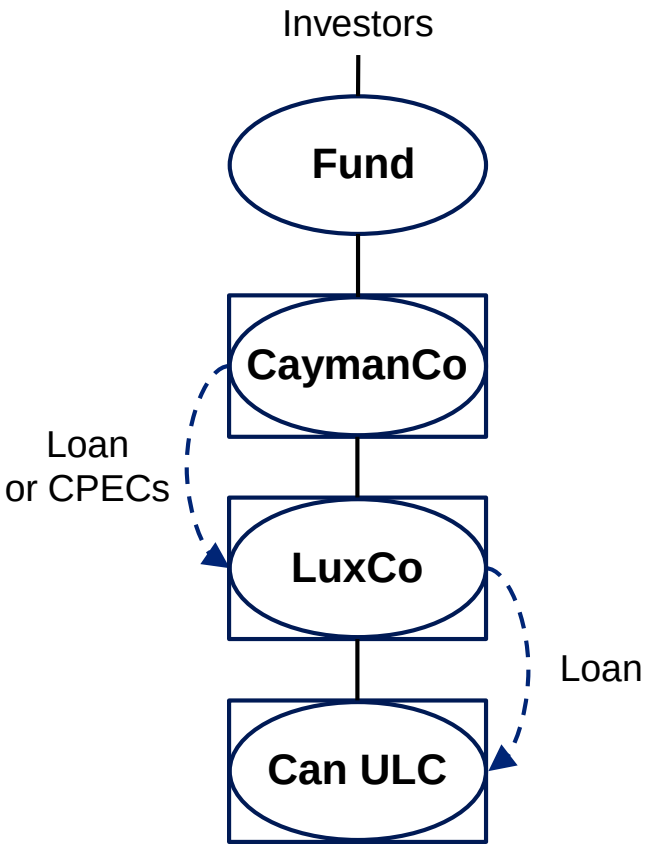
- Thin cap applies to CanSub debt regardless so B2B rules not an issue for thin cap
- Reasonable to conclude that CanSub debt was entered into because USSub debt was entered into or permitted to remain outstanding?
- If so, compare WHT on interest paid to USSub (0%) with WHT on deemed interest payment to UK Parent (10%)
- Interest still considered paid to USSub and subject to 0% WHT but there is also a deemed interest payment to UK Parent resulting in additional WHT of 10%
- Back door anti-treaty shopping rule



B2B loan rules

Example: Private equity

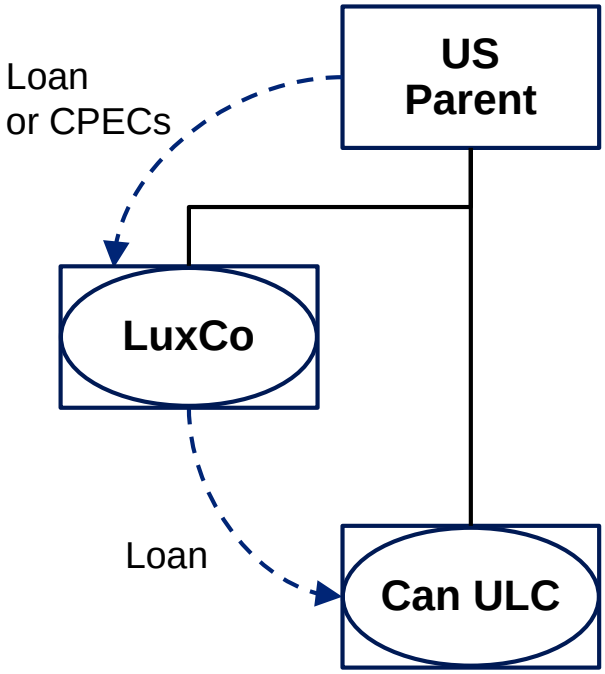
- Similar considerations apply where Canada is funded through a Lux intermediary
- Compare WHT on interest paid to LuxCo (10%) with WHT on deemed interest payment to CaymanCo (25%)
- Interest still considered paid to LuxCo and subject to 10% WHT but there is also a deemed interest payment to CaymanCo resulting in additional WHT of 15%



B2B loan rules

Example: US with Lux intermediary

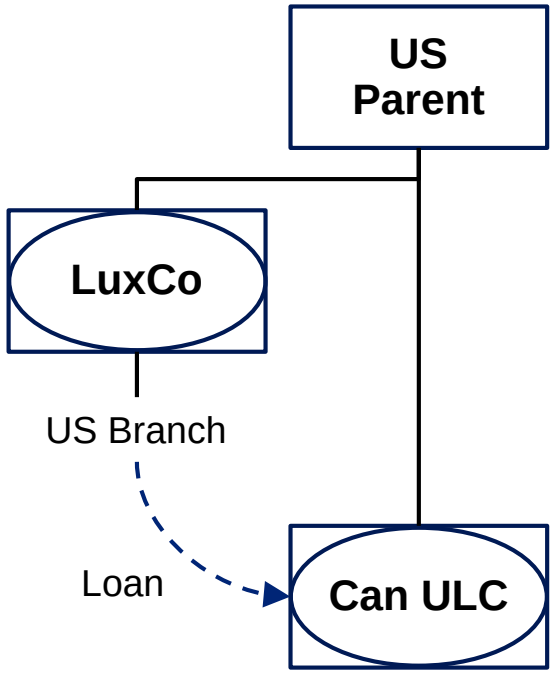
- Thin cap applies to Can ULC debt regardless so B2B rules not an issue for thin cap
- Reasonable to conclude that Can ULC debt was entered into because Luxco debt was entered into or permitted to remain outstanding?
- If so, compare WHT on interest paid to Luxco (10%) with WHT on deemed interest payment to US Parent (25% because of Article IV(7)(b))
- Interest still considered paid to Luxco and subject to 10% WHT but there is also a deemed interest payment to US Parent resulting in additional WHT of 15%



B2B loan rules

Potential solution

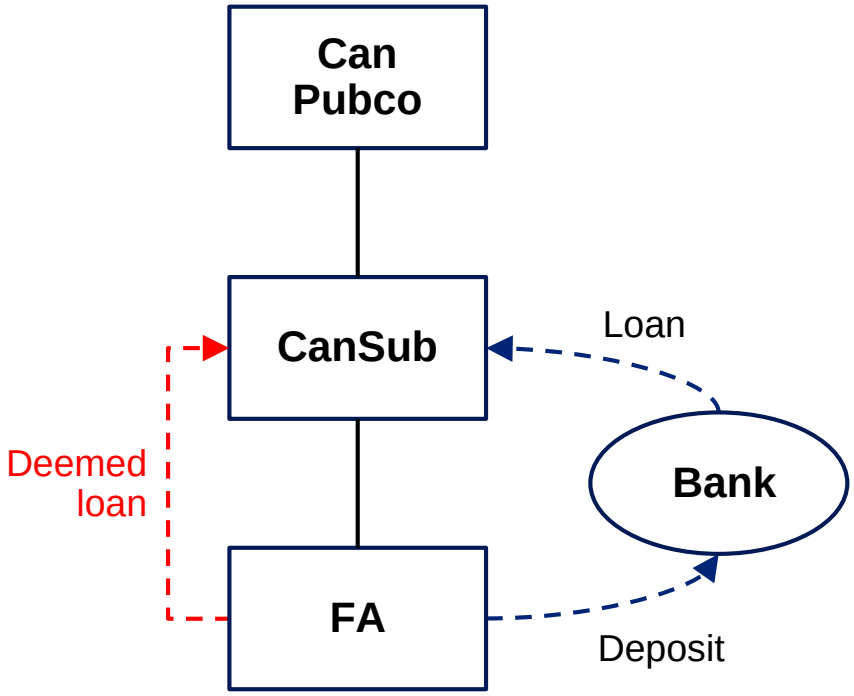
- Capitalize loan (or CPECs) between US Parent and LuxCo
- Transfer loan receivable to a US branch of LuxCo
- US branch income not taxable in Luxembourg (other than minor head office income)
- Interest income not taxable in US, regardless of amount of substance in the branch, since loan is disregarded
- Canada-Lux Treaty still applicable to interest paid to US branch of LuxCo
- B2B rules should not apply going forward since LuxCo has no debt or obligation outstanding – but no relief for interest accruing prior to the restructuring



B2B loan rules

Example: Canadian MNC/FA cash pool

- CanSub may be deemed to pay interest to FA
- CanSub may be deemed to have borrowed from FA rather than the Bank for thin cap purposes even though CanSub is controlled by a Canadian public company
- FA is a non-resident that is NAL with a specified shareholder of CanSub
- 18(8) not applicable to prevent application of the thin cap rules



FA dumping rules
Legislative update

Status of the Legislation

Introduced in the 2012 Budget, effective for transactions/events after February 28, 2012

Proposed amendments released for consultation August 16, 2013 and August 29, 2014

NWMM released October 10, 2014 (Bill C-43), Royal Assent received December 16, 2014

With only minor changes from August to October, many amendments are retroactive to March 29, 2012

Discussion topics

- Timing of a dumping event
- PUC suppression
- PUC reinstatement
- Other technical changes

Timing of dumping events

First test is whether Parent controls the CRIC at the time of the FA investment

Now to be tested immediately after the investment time

- Example: FP controls CRIC, CDN MNC invests in CRIC shares in exchange for shares of a FA of CDN MNC, resulting in loss of control of CRIC by FP immediately after the investment
- Acquisition of the FA shares would no longer be a dumping event

Timing of dumping events (cont'd)

Dumping rules apply if series test met (where CRIC became controlled by FP before or after the investment time as part of a series that includes the FA investment)

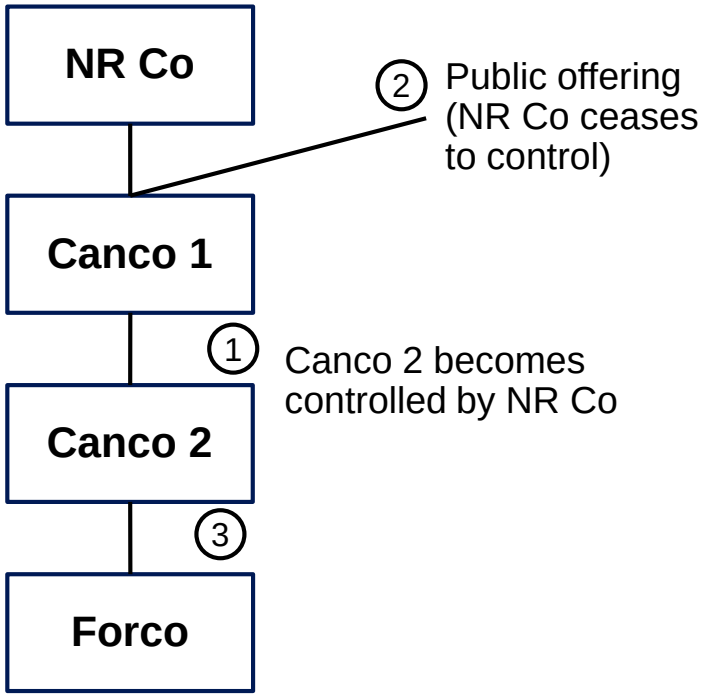
Now only an issue if control of CRIC is acquired after the investment time

Also, new safe harbour provides no dumping event will occur even if control is acquired, unless, at the FA investment time

- Parent and certain NAL persons/partnerships own shares of the CRIC having 25% or more of votes or value
- Investment is a 212.3(19) investment, i.e. an investment in preferred shares of non-subsidiary wholly-owned corporation
- CRIC has no risk of loss/gain re the investment

Foreign affiliate dumping

Example 1: 212.3(1)(b)



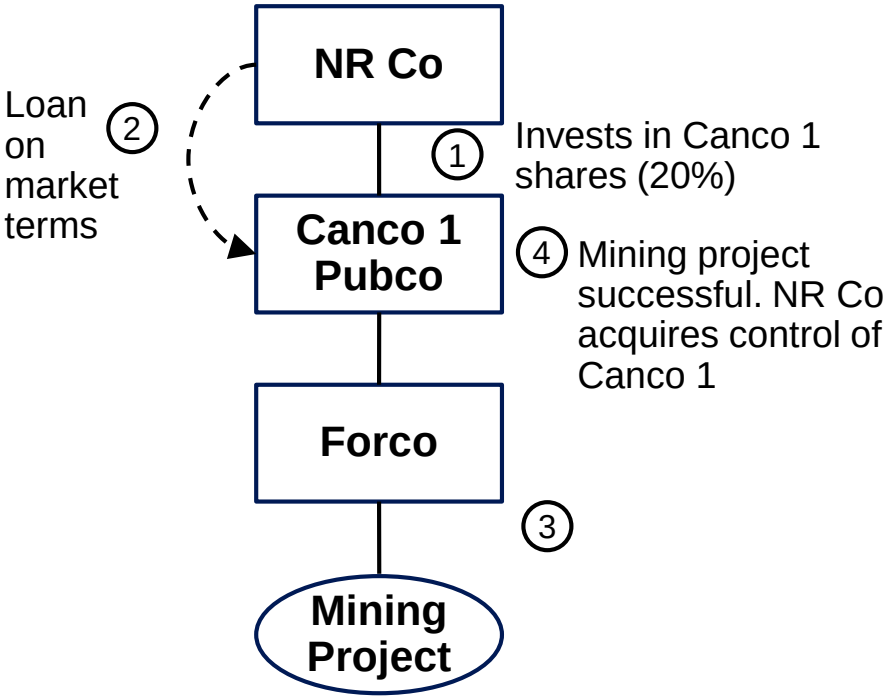
Analysis

- Investment by Canco 2 in Forco did not occur while Canco 2 was controlled by NR Co
- Canco 2 became controlled by NR Co only prior to investment time, as part of the series
- Therefore, conditions in 212.3(1)(b) not satisfied – 212.3(2) should not apply in respect of investment in Forco

Assume Steps 1 through 3 are part of a series

Foreign affiliate dumping

Example 2: 212.3(1)(b) (cont'd)

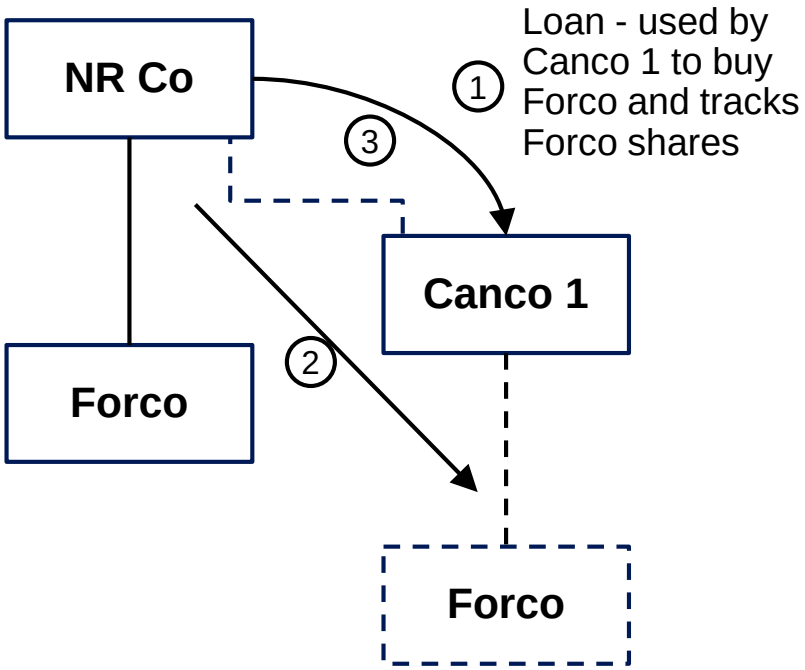


Analysis

- If none of the safe harbor barriers apply series rule is not applicable: [212.3 (1)(b)(i) – (iii)]
  - i. >25% interest in Canco 1
  - ii. preferred shares of subject corporation
  - iii. CRIC not at risk
- B/C NR Co did not control greater than 25% of votes or value in Canco 1, investment is not in preferred shares and there is there no limit to Forco's risk in the investment, 212.3(2) should not apply

Foreign affiliate dumping

Example 3: 212.3(1)(b) (cont'd)



Assume Steps 1 through 3 are part of a series

Analysis

- Transactions undertaken in advance of acquisition of Canco 1 by NR Co
- Limited risk condition in 212.3(1)(b)(iii) satisfied
- If the acquisition of Canco 1 does not go through, shares of Forco could be used to repay the loan from NR Co
- 212.3(2) should apply to investment in Forco

© 2015. For information, contact Deloitte Touche Tohmatsu Limited.
22

PUC suppression in lieu of dumping deemed dividend

Evolution of PUC suppression

Current Status: 212.3(7)(d): Automatic however required to report PUC by the T2 filing deadline

No form, deemed dividend arises (in addition to the PUC reduction). Tax on this deemed dividend refundable under new 227(6.2) – 2-year window

Penalties not applicable where 212.3(7)(d)(ii) applies

PUC "automatically" suppressed on "cross-border class" of CRIC or Qualifying Substitute Corporation (QSC)

PUC can be suppressed on shares owned by an arm's length investor

Failing PUC suppression – dividend substitute election (3)

PUC reinstatement

PUC reinstatement rule expanded

(9)(b)(i) where “subject corporation” shares distributed as return of PUC to Parent

New (9)(b)(ii) allows reinstatement even where no property is distributed to the NR shareholder; CRIC receives property from the investment (proceeds of disposition of shares or debt, PUC returns and dividends, loan repayments, interest)

- Exceptions for (16) closely connected investments and (18) rollovers; reinvesting may result in another PUC reduction

Foreign affiliate dumping – other

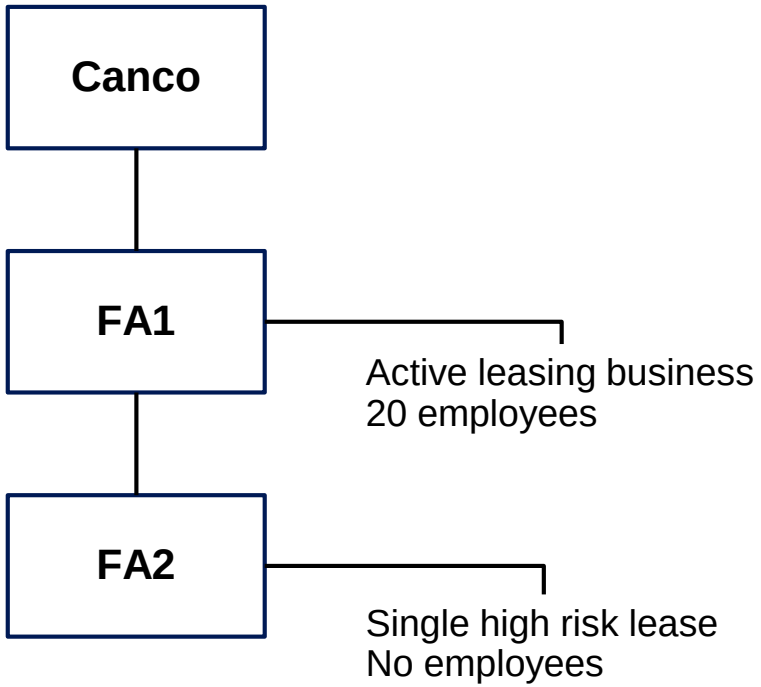
- Anti-Avoidance rules
  - Cross-border class – 212.3(6)
  - Conversion of PLOI loan to shares of FA under 51(1) – 212.3(18.1)
  - Indirect investments and funding (212.3(23)/(24)
- Relief from double counting where Canco makes investment in FA as a pre-acquisition step in a foreign takeover of Canco
- Reorganization exceptions (212.3(18))
  - Intercompany transfer of debt obligations accommodated
  - Post-acquisition restructuring
  - Amalgamations
  - 97(2) transfers to a partnership

Mothership theory
Legislative update

Mothership theory
Background

Two primary conditions

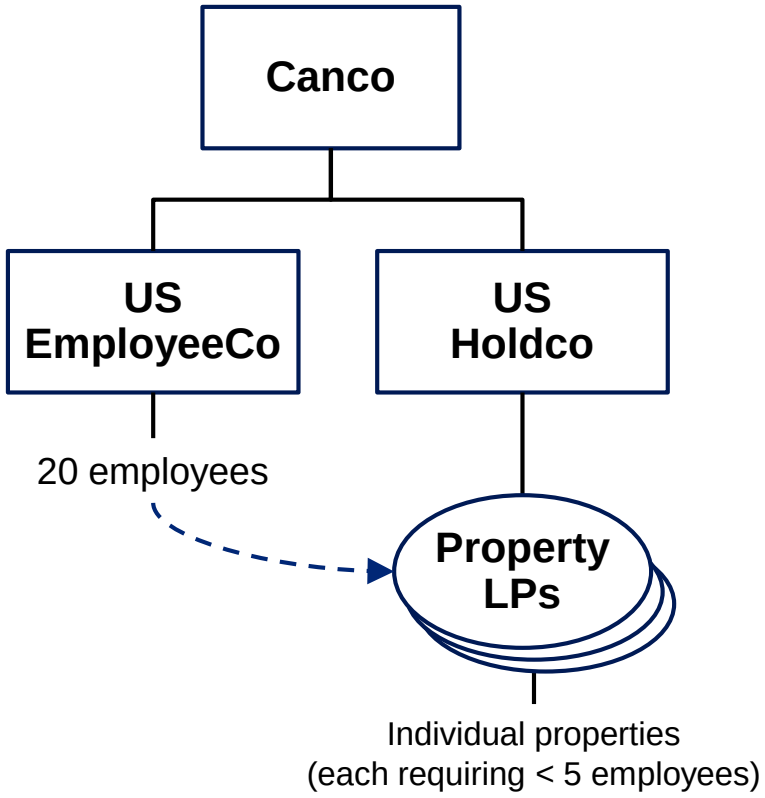
- The income from property is derived by the particular FA from activities that can reasonably be considered to be directly related to active business activities carried on in a country other than Canada by another FA; and
- The income would be included in computing the amount prescribed to be the earnings from an active business carried on in a country other than Canada of the other FA if the income had been earned by it



Mothership theory
Background (cont'd)

Historical limitations

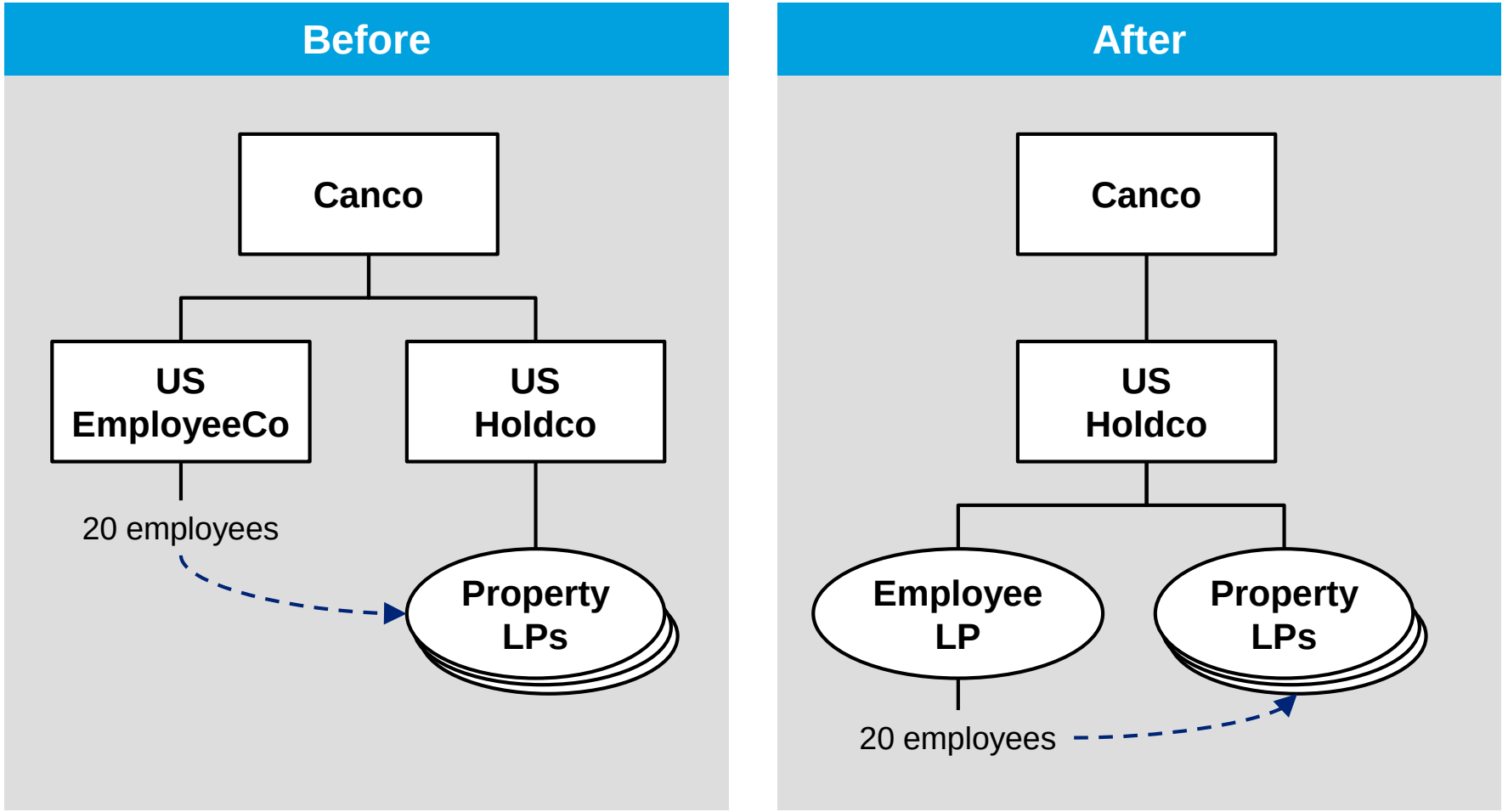
- Not available in situations where the property income-earning entity or the mothership entity is a partnership
- According to the CRA, not available where the mothership entity provides management services through its employees but does not own sufficient property in its own right to justify more than 5 full time employees (see CRA document 2000-0044387 dated October 26, 2000)



Mothership theory
Legislative developments

- Finance indicated in a 2009 comfort letter that it would recommend that subparagraph 95(2)(a)(i) be extended to foreign partnerships
- In accordance with the comfort letter, legislative amendments were released on July 12, 2013 which proposed to expand the scope of subparagraph 95(2)(a)(i) to foreign partnerships
- The legislative amendments, with slight modifications, were included in Bill C-43 which received Royal Assent on December 16, 2014
- Interestingly, the legislative amendments also provide relief from the CRA administrative position, discussed above, in certain circumstances (see next slide)

Mothership theory
Example



Agnico-Eagle Mines (TCC)
Lehigh Cement (FCA)

Judicial update

Agnico–Eagle Mines Ltd. – TCC

FX on conversion of debt

Background

- Agnico-Eagle Mines Ltd (“AEM”) in 2002 issued 143,750 US-denominated convertible debentures at an aggregate price of US 143,750,000. The debentures were traded on the TSX
- Each convertible debenture redeemable at the option of AEM for principal amount plus accrued and unpaid interest. AEM had the option of delivering common shares on redemption instead of cash
- Debentures convertible at the option of a holder into 71.429 common shares at any time prior to redemption or maturity. In the event that a notice of redemption was issued by AEM, the conversion right could be exercised up to the date of redemption
- At the conversion date, the common shares of AEM were trading at 24.15 (the shares had to be valued at more that $14 for the conversion to be favorable). Most debt holders converted into 71,429 common shares

Agnico–Eagle Mines Ltd. – TCC
FX on conversion of debt

Background (cont'd)

- 10,855 and 131,784 convertible debentures were converted in 2005 and 2006 respectively (the "Conversions"). The remaining 1,111 were redeemed for cash
- CRA assessed deemed capital gains of $4.5M for 2005 and $57.7M for 2006 based on the difference between the FX rate at the time of issuance and the time of settlement

Issue

- Whether the conversion of the convertible debentures gave rise to a taxable FX gain equivalent to the gain that would have been realized if the debentures were repaid in cash

Agnico–Eagle Mines Ltd. – TCC
FX on conversion of debt

Decision of the Court

- An FX gain or loss traditionally has been considered realized upon repayment of foreign denominated debt if there is not actual conversion of the borrowed money into CAD
- Subsections 39(2) and 261(2) deemed capital treatment and translation at relevant spot rate
- From an economic point, AEM received an amount for the issuance of the convertible debentures that was much less than what it paid out (if measured by the trading price of the common shares issued on the conversions)
- In application of the principles set out in *Teleglobe Canada Inc. v. R.,* 2002 FCA 408 and *King Rentals Ltd. v. R.,* 96 DTC 132 – amount AEM paid out by issuing common shares was not reflected by the shares' trading price, but rather the amount for which the common shares were issued (*i.e.* agreed conversion price of USD $14 per share, not the FMV of those shares at the date of conversion)

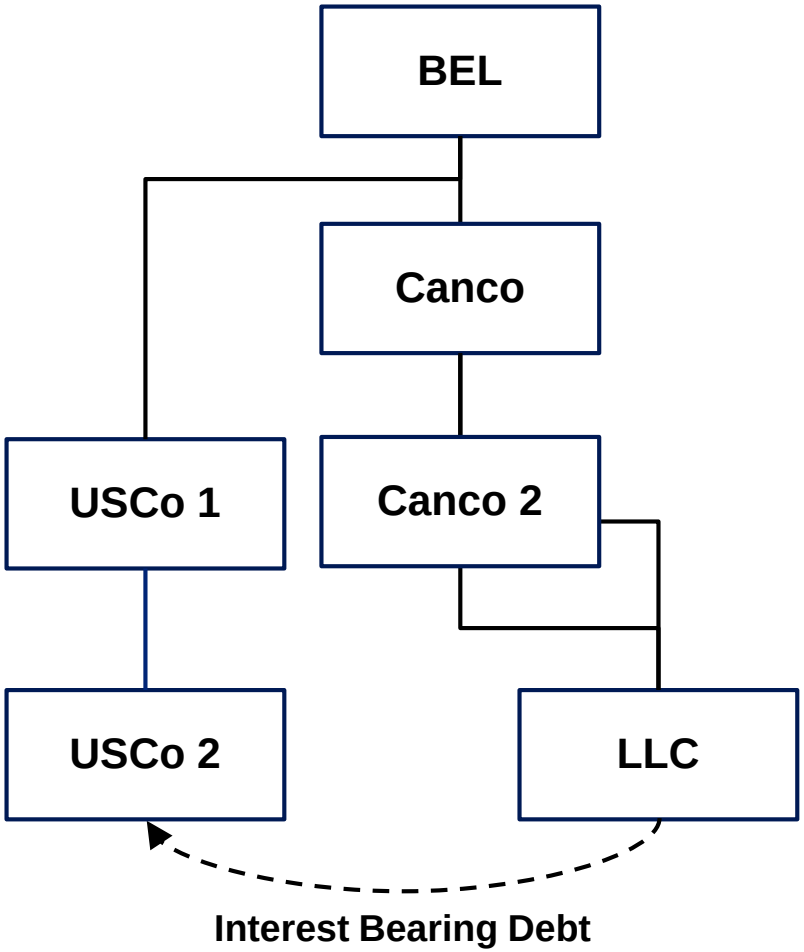
Agnico–Eagle Mines Ltd. – TCC
FX on conversion of debt

Decision of the Court (cont'd)

- The appropriate date at which to translate the amount received by AEM – date of issuance of the convertible debentures as this was the date when the consideration for the common shares was actually received by AEM. To reach this conclusion, the trial judge relied on subsection 261(2)
- As such, no FX gain (or loss) should arise to AEM upon the conversion of the convertible debentures
- For debentures settled in cash, FX gain should be realized and taxable because the measurement time was the time of payment

Judicial update – Lehigh Cement Limited (FCA)

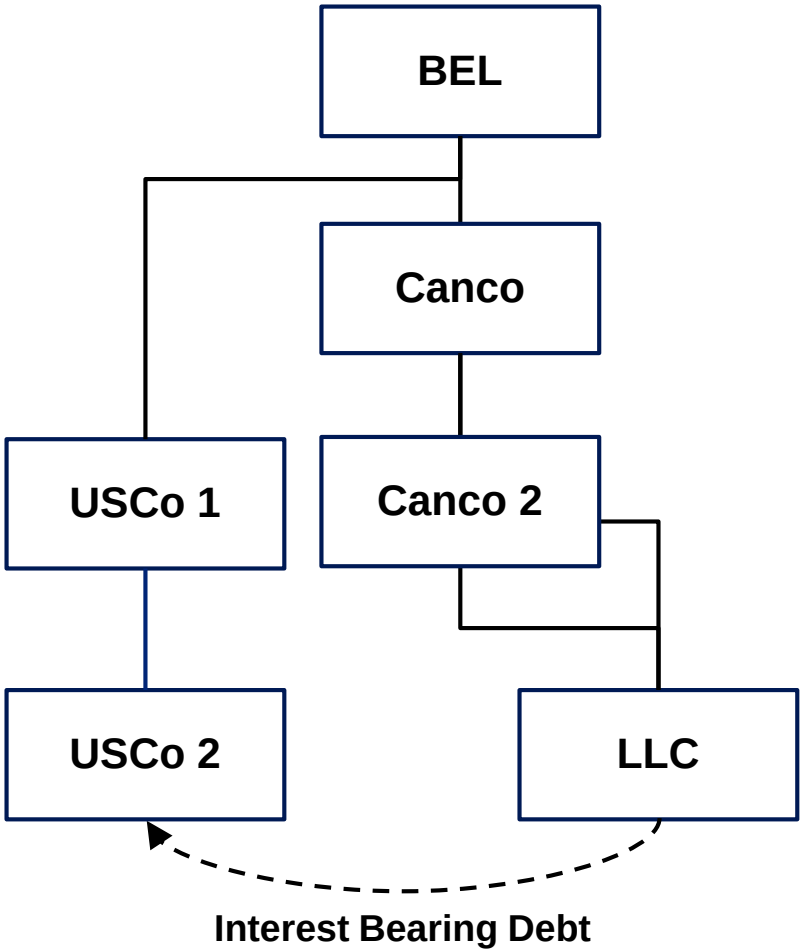
Foreign Affiliate Anti-Avoidance Rule 95(6)



Background

- Canadian subsidiary of a Belgium company together with wholly owned company formed and capitalized LLC
- LLC lent to USCo 2
- USCo 2 used the funds to redeem preferred shares held by Canco and to repay certain inter-group debt

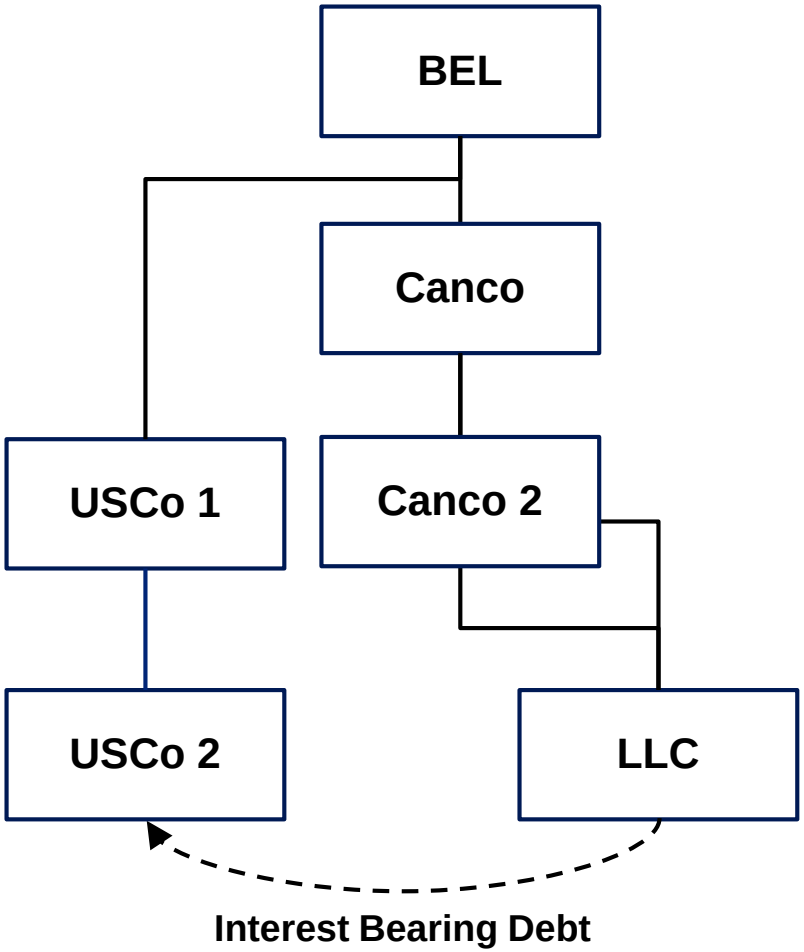
Judicial update – Lehigh Cement Limited (FCA)



Tax Court of Canada

- Taxpayer successful at the Tax Court of Canada on basis there was no alternative transaction with which to compare
- Rejected taxpayer's position that rule is limited in scope to acquisition or disposition of shares. (cannot consider series of transactions)

Judicial update – Lehigh Cement Limited (FCA)
(cont'd)



Federal Court of Appeal

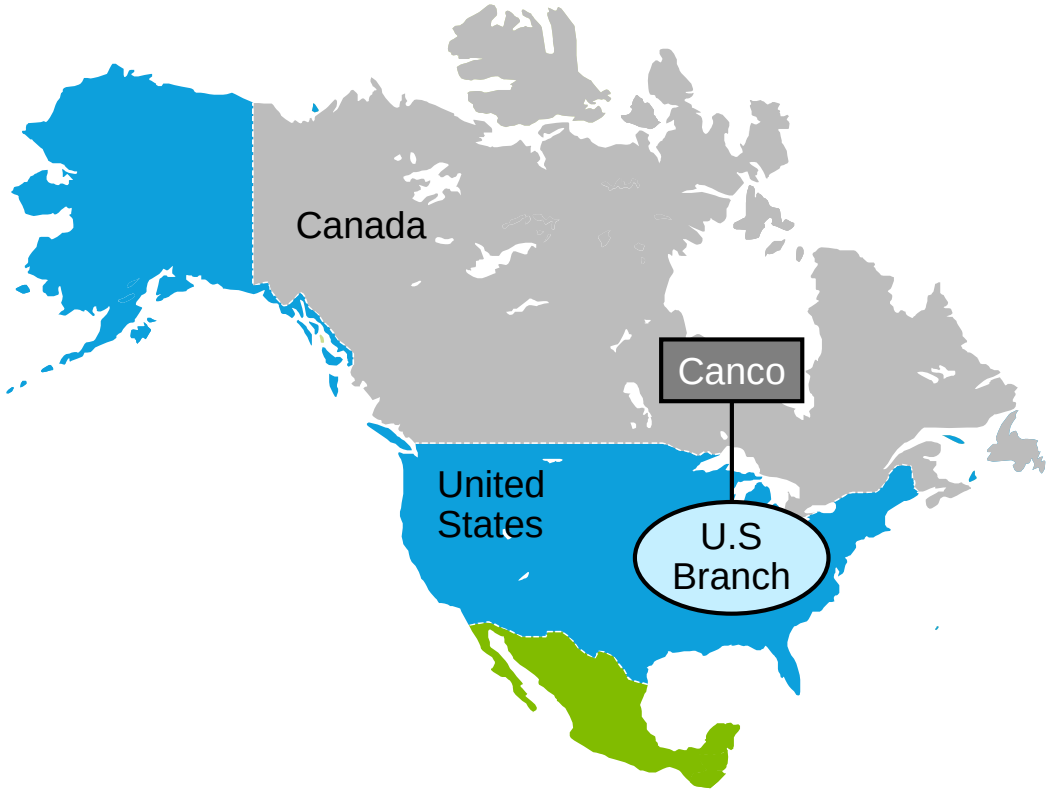
- Scope restricted to where acquisition or disposition of shares is to meet or fail relevant foreign affiliate/controlled foreign affiliate tests to avoid reduce or defer Canadian tax
- Should not import a series of transactions test into the rule
- Concern about CRA interpretation of the rule because of lack of an exception in the rule for non-abusive transactions
- Decision provides much needed guidance in interpretation of the rule

IRS examinations

Observations and trends for Canadian business

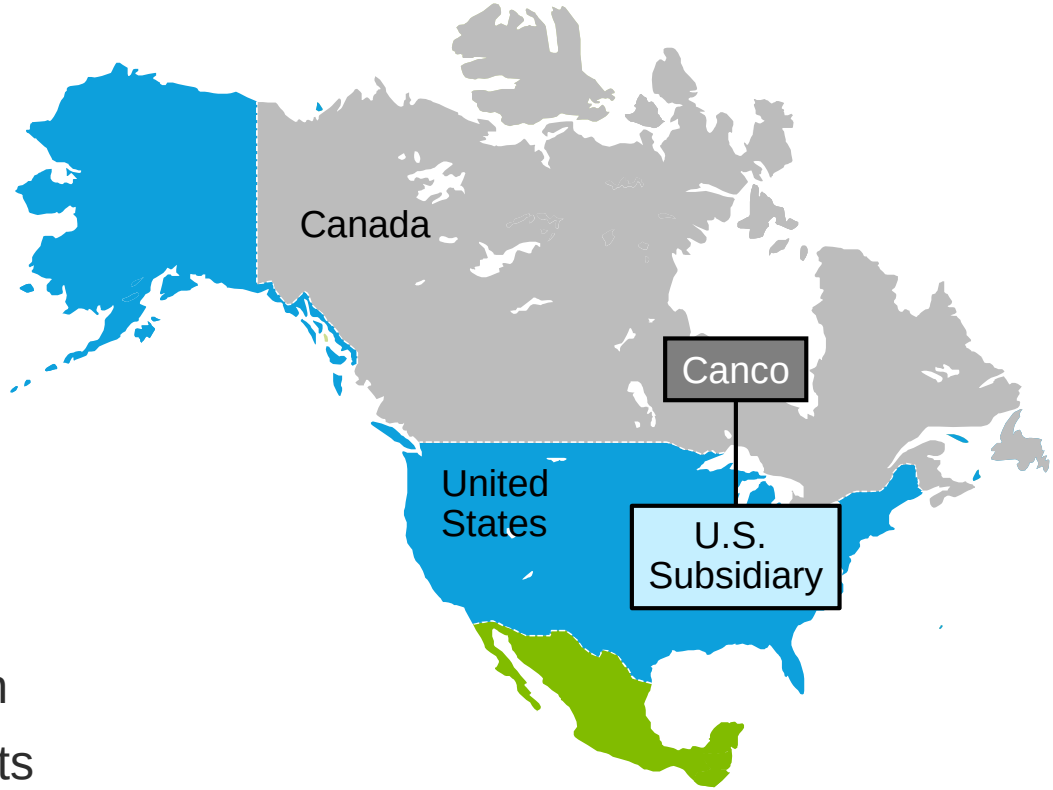
U.S. branch structures

- Concentrated audit activity
- Scrutiny of expense allocation and apportionment
- Transfer pricing
- Agent competency and specialist reliance

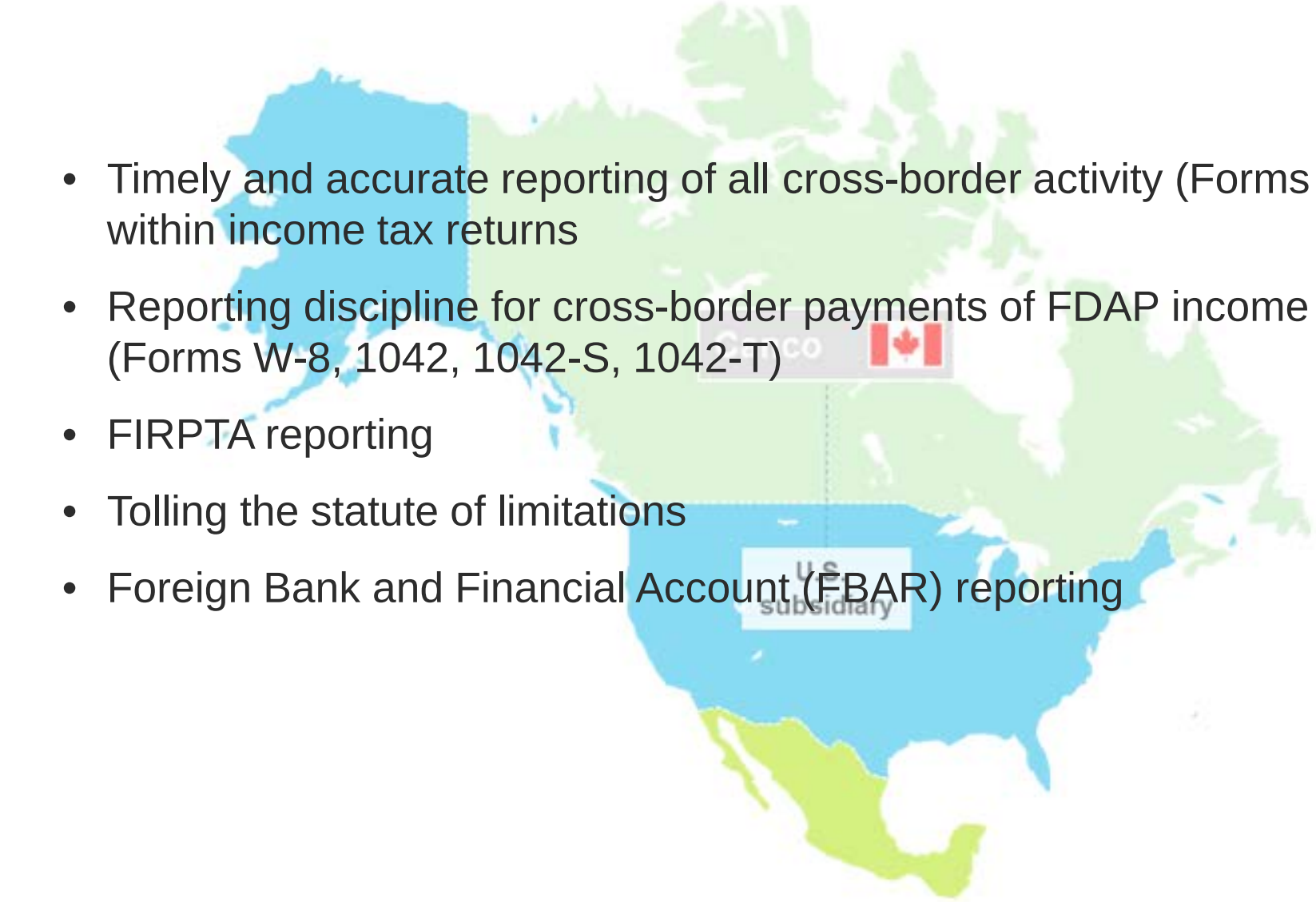


U.S. subsidiary structures

- Transfer pricing
- U.S. subsidiary related-party indebtedness
  - § 385
  - § 163(j)
  - § 163(l)
  - § 267
  - AHYDO
  - Anti-conduit
  - Treaty access and application
  - Hybrid entities and instruments
- Reserve analyses



U.S. Tax reporting considerations



- Timely and accurate reporting of all cross-border activity (Forms 5472) within income tax returns
- Reporting discipline for cross-border payments of FDAP income (Forms W-8, 1042, 1042-S, 1042-T)
- FIRPTA reporting
- Tolling the statute of limitations
- Foreign Bank and Financial Account (FBAR) reporting

Please remember to complete your evaluation

Speaker bios

David Bunn is an International Tax partner based in Toronto. He has over 10 years of experience advising Canadian and foreign-based multinationals on international tax matters, with a particular focus on structuring and financing. David is a member of the firm's International Tax Opinion Committee and a leader of the firm's Cross Border Advisory initiative.

David has experience advising clients in a number of industries, including private equity, manufacturing, consumer business, and financial services.

David is a Chartered Professional Accountant (CPA) and holds a Maters of Taxation degree from the University of Waterloo.

Phone: +1 416 601 5890
Email: dbunn@deloitte.ca

Dennis Metzler is the National Leader of the U.S. Tax Services Group for Deloitte & Touche Canada. Since his transfer to Toronto in 1995, Dennis has primarily served Canadian multinational corporations and private equity firms seeking advice on structuring tax-effective investments in the United States. He has extensive experience with income trusts and other cross-border offspring structures that have gained notoriety in Canada, and counseled a wide range of clients on their possible use. Among his clients are many of Canada's most recognized manufacturers, technology businesses, and investment firms.

Dennis has over 28 years of U.S. international tax experience. He spent the first 12 years of his career in Milwaukee, where his focus was primarily planning for U.S.-based multinationals. Dennis was a recognized Firmwide expert in U.S. tax issues affecting exporters, including DISC/FSC/ETI taxation and foreign tax credit planning. Since relocating to Toronto, Dennis has specialized in U.S. international inbound taxation including debt financing and workouts, treaty optimization and the development of merger/acquisition and repatriation strategies.

Dennis has authored articles on various international tax topics for the Canadian Tax Foundation, The International Tax Journal and other recognized publications. He is a regular lecturer at the firm's advanced international tax schools and conferences, and presenter for Insight, Infonex, CICA, CITE, the Canadian Institute, the Canadian Tax Foundation and The University of Wisconsin-Milwaukee Tax Association.

Dennis received his Bachelor of Science in Accounting (Honors) from the University of Wisconsin Green Bay. He is a Certified Public Accountant (Wisconsin) and a member of both the AICPA and WICPA.

Phone: +1 416 601 6144
Email: dmetzler@deloitte.ca

Speaker bios

Alex Smith is a Canadian Partner with Deloitte Tax LLP in the Toronto Office.

For over 17 years Alex has specialized in providing international corporate tax services to multinational clients investing into and out of Canada. From 2011 through 2013, Alex lead the Canadian Desk in New York principally focusing on US multinationals with operations in Canada. Alex has experience in dealing with international tax matters, including cross-border acquisitions and divestitures, structured financing, cash repatriation strategies and in assisting foreign-based multinationals in worldwide tax planning. Alex has worked with a variety of businesses including automotive, media, mining, engineering, printing and software and technology industries.

Alex has tutored the Canadian Institute of Chartered Accountants' Part II In-Depth sessions as well as spoken at the 14th, 15th and 16th CITE Canada-U.S. Tax Conference on Cross-Border International Tax Issues and at the 13th and 14th annual Federated Press Foreign Affiliates Tax Conference.

Alex is a Chartered Accountant and holds an MBA from the University of Toronto.

Phone: +1 416 601 5879
Email: alesmith@deloitte.ca

This presentation contains general information only and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this presentation.