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Canada Finalizes International Tax Proposals: An Update on Conduit, Tracking, and Foreign Affiliate Rules

by Nathan Boidman

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In this article, the author examines the final version of a package of international business taxation rules that Canada released in late October, including antiavoidance rules that target the use of tracking shares, provisions on controlled foreign affiliate status, alleviating rules for some corporate divisions, and amendments to the cross-border surplus-stripping rules.

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On October 25 the Canadian government formally released proposed changes to the tax law in the form of a notice of ways and means motion (NWMM) and the accompanying explanatory notes. The NWMM would implement policies that the government announced in draft legislation and explanatory notes on July 27 (the July proposals).[1] The July proposals included antiavoidance measures affecting some cross-border transactions and alleviating rules for some foreign split-ups or demergers. On October 29 the government introduced the Budget Implementation Act, 2018, No. 2 (Bill C-86), into Parliament to give effect to the NWMM.

Of particular interest are the proposed rules for outbound tracking share arrangements — rules that involve Canada's controlled foreign affiliate (CFA) system — and the introduction of the term "conduit" into the Income Tax Act (Canada) in connection with the ITA's anti-surplus-stripping measures. This article examines the extent to which the NWMM incorporates the July proposals and any significant departures from that package.

I. Tracking Interests and Foreign Affiliates

The September report describes how Canada emulated the 1962 U.S. controlled foreign corporation and subpart F initiative by creating Canada's CFA and foreign accrual property income rules in 1972. These rules seek to prevent Canadians from deferring Canadian tax on generically passive investment income through the use of closely held foreign corporations (or sometimes trusts), which are often based in tax havens. Broadly, under section 95(1) ITA, a CFA is a nonresident corporation in which a Canadian shareholder owns 10 percent or more of any class of stock — which makes the nonresident corporation a foreign affiliate (FA) — and that is controlled in specified ways. Section 95(1) ITA also defines FAPI.

According to section 91 ITA, a Canadian is immediately taxed on its share of a CFA's FAPI. A Canadian shareholder is not taxed on undistributed business income of a CFA. Furthermore, under section 113 ITA and part 59 of the Income Tax Regulations, there is no tax on distributions of business income by either an FA or a CFA if the Canadian resident shareholder is or is deemed to be a corporation and other specified conditions are met.

The July proposals created new deemed inclusions in FAPI when Canadians own so-called

[1] *See* Nathan Boidman, "Canada Targets Conduits and Tracking Shares," *Tax Notes Int'l*, Sept. 17, 2018, p. 1223 (hereinafter "the September report").

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tracking interests in CFAs, and they also expanded the CFA notion when there are tracking interests in entities that are not CFAs under current law. As the September report explains, the core concept in new section 95(8) ITA is whether the right to receive payments in connection with an interest in the entity is determined by reference to some — but less than all — of the property, revenue, or profit of the tracked entity. Although several other jurisdictions refer to these arrangements as cell corporations, segregated accounting corporations, or segregated portfolio companies, section 95(8) ITA does not use that language.

The first change — the new deemed inclusion in FAPI — remains intact in the NWMM. This rule expands a key component of FAPI: an investment business. The September report explains that under the existing rules, an investment business of an FA is a business that has deriving income from specified types of investments (or related income or profits) as its principal purpose and, *inter alia*, that does not employ more than five individuals full-time to carry out this business.

The key question is whether an FA is carrying on more than one business, which would mean that each business must employ more than five individuals to avoid investment business status. That in turn raises the question of whether different activities constitute separate businesses. The September report examined this by considering whether a hypothetical FA that had a shopping center in New York and one in Dallas would be one business or two. For tracked interests, the July proposals would eliminate the benefits of finding that there is only one business. New section 95(9) ITA would deem each activity that involves a separate class of tracked interests to be a separate business — thus, each category would need to have more than five employees or it would trigger the investment business characterization and FAPI. The October NWMM retains this element of the July proposals intact.

The second change in the July proposals — that is, proposed sections 95(10), (11), and (12) ITA — attacked tracking interests that did not engage CFA status under existing law. The NWMM retains the basic notion, but it uses revised mechanics. This should be a helpful amendment. This change focuses on arrangements that avoid CFA status, meaning that even if there was FAPI, the rules would not provide for attribution.

As noted above, similar arrangements surfaced many years ago in countries like Bermuda, the British Virgin Islands, and the Cayman Islands, and are often referred to as cell companies. Each cell is a class of shares that tracks to specified property or set of activities, and each is insulated from the liabilities of the other cells in the corporation. Presumably, while the arrangement would give rise to FA status, there would be enough parties so as to avoid CFA status.

This observer for one was of the view that a court might bifurcate this type of corporation, finding that each cell constituted a separate corporation. Therefore, each party would be a CFA and the structure would not avoid attribution of any FAPI that might exist. However, there do not seem be any reported cases in Canada involving this type of arrangement.

The July proposals would create CFA status and thus potential FAPI attribution in two ways.

The base rule in proposed section 95(10) ITA stated that a FA would be deemed to be a CFA when there is a tracking interest, the FA has any FAPI, and the taxpayer does not make an election under section 95(11) ITA (discussed below). This rule would simply wipe out the avoidance of attribution and — applying the mechanical rules in sections 91(1) and 95(1) ITA and section 5904 of the Income Tax Regulations — attribute FAPI pro rata to each taxpayer's overall dividend entitlement in the deemed CFA.

This rule could create FAPI computational issues if there is not enough information on all the cells. Also, it could create CFA status in cases when it would not arise if the cell was a separate corporation or assign a pro rata share of all FAPI of the corporation to a Canadian, whether or not the FAPI arises from the Canadian's cell (that is, the particular property to which that taxpayer's shares track).

Under the July proposals, these issues could be ameliorated if the taxpayer made an election under proposed subsections 95(11) and (12) ITA. This election would deem the cell to be a "separate corporation" — the actual words in the proposal — and would treat the holders of the shares in that cell as the shareholders of that

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separate corporation. The election would deem the separate corporation to own the property and perform the activities of the relevant cell. The rule would attribute the FAPI of that deemed separate corporation to the relevant shareholders if, according to section 93.2 ITA, the separate corporation is a CFA of the electing party.

The October NWMM reversed the order of the two options and eliminated the election. A submission made by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada regarding the July proposals prompted this change.[2] This means that if, under revised section 95(10) ITA, a Canadian (or an FA of the Canadian) in respect of which a nonresident corporation is an FA owns a tracking interest in the FA and tracking shares in the FA (which may or may not be one and the same), the rules in revised section 95(11) ITA apply. Thus, the NWMM will treat the class of tracking stock as a separate corporation that owns the tracked property (and related income) and has one class of shares outstanding, with ownership prorated to each holder's interest in the entity's income.

This will bring the preexisting rules in the ITA into play. For example, if a Canadian owns all the shares in a class of tracking shares, then the separate corporation is a wholly owned CFA and Canada will tax the Canadian on all the FAPI of the separate corporation. If two Canadians each own half of the tracking shares, they will each own half of the deemed CFA and will each pick up 50 percent of its FAPI.

If a tracking interest in an FA does not meet the requirements in proposed section 95(10) ITA, new section 95(12) ITA will treat the affiliate as a CFA so that FAPI attribution can take place. It is not clear what type of arrangement is contemplated. One example may be a tracking interest involving a debt instrument or a total return swap, not shares.

II. Lending and Foreign Affiliates

The importance of a CFA employing more than five full-time employees to avoid investment business status and therefore FAPI is discussed above. However, in some special cases, there are additional requirements. One of these cases, an issue addressed by the July proposals, involves a business dealing in debt instruments or lending under section 95(2)(l) ITA.

As the September report explains, the earlier proposals added to preexisting requirements[3] — namely, the requirements that the CFA qualify as a "foreign bank" or other financial institution whose activities are regulated and that the Canadian shareholder's activities meet other specified requirements — a new requirement under section 95(2.11) ITA: The Canadian shareholder must be (or it must be affiliated with a corporation that is) registered and regulated as a specified financial institution in Canada. In some cases, it must have equity of at least C $2 billion; in other cases, more than half of its capital employed in Canada must be attributable to businesses carried on in Canada that are subject to the supervision of specified Canadian regulatory authorities.[4]

This proposal is retained intact in the NWMM, as is the July proposal that the lending business be conducted principally with third parties.[5]

III. Foreign Corporate Divisions

The September report notes that depending on the particular facts and circumstances, Canadian taxation of Canadian shareholders in nonresident corporations involved in spinoffs, split-offs, demergers (split-ups or divisive reorganizations), or liquidations ranges from immediate full taxation to immediate full deferral or exemption. It clarifies that the existing section 86.1 ITA — a tax-deferred spinoff rule enacted in 1998 — affected spinoffs in some countries (including the United States) but only applied if the spinoff involved a dividend in kind.

The problem with the dividend in kind requirement — and the focus of the July proposals

[2] Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, "Re: Legislative Proposals Released July 27, 2018" (Sept. 10, 2018).

[3] Boidman, "CIT: Foreign Banks and Canada's CFC System," *Tax Notes Int'l*, Aug. 1, 2016, p. 423.

[4] This requirement was originally enacted for purposes of an exemption from the definition of investment business in section 95(1) ITA for some regulated businesses.

[5] For a related discussion, see Boidman and Michael Kandev, "The Tax Court of Canada Strikes Offshore Bank in *Loblaw*," *Tax Notes Int'l*, Oct. 29, 2018, p. 513.

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— is that the corporate laws in some countries generally effectuate spinoffs in a manner that does not on its face involve a dividend in kind. Instead, in these countries, a spinoff splits the distributing corporation into two or more corporations that may include the original and the property of the original entity is spread around the corporations. In Mexico, for example, a spinoff can, but is not required to, include the original corporation. Because spinoffs in these countries do not technically involve a benefit in kind, section 86.1 ITA does not apply to the relevant Canadian shareholder and Canada has been treating these divisions as fully taxable under section 15(1.4)(e) ITA.

The July proposals seemed to improve the situation in some — but not all — cases. The new rules in section 15(1.5) ITA addressed these divisions in two ways. If all the shareholders in the original corporation receive shares of the new corporation pro rata, July's proposed section 15(1.5)(i)(A) ITA would deem:

> the original corporation . . . to have distributed and the shareholder of the new corporation . . . to have received, as a dividend in kind, the shares of the new corporation.

That deeming rule seemed to meet the requirement in section 86.1(2) ITA that there be "a distribution by a particular corporation that is received by a taxpayer." But it was unclear whether the lack of black letter compliance with the requirement in section 86.1(2)(b) ITA that the original corporation own the shares of the new corporations immediately before the (deemed) distribution could be remedied by implied compliance.

If the proposal did not trigger section 86.1 ITA, at a minimum the new section 15(1.5) rule seemed to provide Canadian shareholders for whom the original corporation is a FA with benefits that can arise for dividends from FAs as discussed above. Also, the July proposals included changes to section 5907 of the Income Tax Regulations that might increase the surplus accounts of the original corporation.

Proposed section 15(1.5) ITA, a second — and inferior — rule in the July proposals, held that if the original shareholders did not receive shares of the new corporations pro rata, then the rule would deem the fair market value of the shares received to be a fully taxable benefit that the original corporation conferred on the Canadian shareholder. This is the same treatment that existing section 15(1.4)(e) ITA, which was being repealed, provided.

The October NWMM appears to carry forward this portion of the July proposals intact, with some language changes. Therefore, it is still unclear whether the proposal triggers section 86.1 ITA. The government's explanatory notes to the September report seemed to contemplate pre-distribution ownership by the original corporation, which would satisfy the requirements of section 86.1 ITA. In particular, the government pointed to proposed section 15(1.5)(b) ITA — which would deem any gain or loss to the original corporation from the distribution of shares of the new corporation during the division to be nil — suggesting that the distribution could be possible "because of the application of clause 15(1.5)(a)(i)(A) or otherwise." The October explanatory notes, however, emphasize the opposite. They do not repeat the comment from July's version about section 15(1.5)(b) and specifically state — twice — that the proposed rules mean that "the new shares are at no time owned by the original corporation." Furthermore, they state that the only reason for proposed section 15(1.5)(b) is to counteract effects that might otherwise arise under section 52(2) ITA, which generally regulates the tax effects of dividends in kind.

IV. Section 212.1 and Conduits

The July proposals introduced the term "conduit" into Canadian tax law while addressing a narrow and seemingly noncontroversial deficiency in section 212.1 ITA, a cross-border antiavoidance rule that has attracted a lot of headlines in recent years.[6] Section 212.1 prevents a foreign shareholder of a Canadian corporation from disguising a dividend distribution from the latter to the former that would incur Canadian withholding tax of 25

[6] *See* Boidman, "The *Univar* Appeal: A Pyrrhic Victory for Indirect Acquisitions in Canada," *Tax Notes Int'l*, Oct. 30, 2017, p. 467; and Boidman, "Judicial and Legislative Developments Threaten Indirect Canadian Acquisitions," *Tax Notes Int'l*, Oct. 10, 2016, p. 163.

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percent (subject to treaty reduction) as tax-free proceeds of an intercompany sale of the Canadian corporation's shares.

The September report detailed the mechanics of those planning efforts[7] and explained that the government intended the proposals to address statutory gaps and unintended results that could arise in the operation of section 212.1 because partnerships are not taxpayers for purposes of the ITA and trusts are hybrid taxpayers. In particular, interposing a partnership or trust in an internal sale of the Canadian corporation — whether as seller, buyer, or the target of the sale — could allow an entity to avoid section 212.1.

Under the July proposals, those partnerships or trusts would sometimes be designated conduits, and all such transactions would be subject to the basic rules in section 212.1 by looking through the partnership or trust. Section 212.1(6)(d) would pick up a sale to a conduit, paragraph (b) would pick up a sale of a conduit, and paragraph (c) would pick up a sale by the conduit. Section 212.1(6)(a) would define conduit so that a taxpayer could not avoid connected status for section 212.1 purposes. Connected status refers to an element of the rules governing dividends between Canadian corporations that was integral to the planning efforts that section 212.1 ITA targeted. When that status arises under Part IV ITA, a refundable tax will not apply to an intercorporation dividend, and that will trigger section 212.1 ITA. Finally, the September report notes that there may be some ambiguity in the initial legislative draft that would require modification.

The October NWMM retains all the features of the July proposals, makes one correction, and addresses the ambiguities by restructuring some of section 212.1(6). Now, paragraph (a) deals with a conduit as a target, paragraph (b) with a conduit as a seller, and paragraph (c) with a conduit as a buyer. Paragraph (d) addresses the connected status factor.

The correction involves the sale of a conduit, a topic now covered by paragraph (a). Since section 212.1 would not apply to a nonresident's sale of shares in a nonresident corporation that happens to own shares of a Canadian corporation, paragraph (a) carves out the sale of an interest in a conduit that only owns Canadian corporation shares through nonresident corporations.[8]

V. Other Matters

The September report made note of other cross-border matters in the July proposals, including:

- Technical changes to the effects of a corporation converting contributed surplus that arose when it was a nonresident to paid-up capital. One change decreases equity for the debt-equity (thin capitalization) rules and the other increases taxable deemed dividends.
- The adoption of partnership and trust look-through (conduit) rules — similar to those in revised section 212.1 — to prevent the avoidance of deemed dividends that can arise when an immigrating corporation owns a Canadian corporation.
- For all taxpayers other than corporations that are not Canadian controlled private corporations under section 125 ITA, the extension of a special six-year reassessment period for transactions with foreign affiliates. The proposed extension is seven years for corporations that are not Canadian controlled private corporations. The proposals also call for the adoption of a new nine- or 10-year reassessment period for cross-border non-arm's-length transactions.
- A heavily criticized reduction of the deadline for filing some information returns involving FAs from 15 months after the end of the Canadian shareholder's tax year to only six months after.

Except for a change to the last item, the October NWMM keeps these elements of the July proposals intact. As for the deadline for the information return, the government partly acknowledged the criticisms by adopting a 12-month deadline for tax years beginning in 2020 and a 10-month deadline for tax years beginning thereafter. ■

[7] *See* sections 84, 89(1), 112, 115, 186, 248(1), and 251.

[8] The Joint Committee letter, *supra* note 2, brought this glitch in the July draft to the government's attention.

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