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Canadian and U.S. Tax Law: A Review of 2013 and a Look Forward to 2014

The year 2013 was very eventful from a tax perspective, with significant developments on the legislative front. This article looks back at tax developments in Canada and the United States in 2013 and offers a look forward to possible Canadian and U.S. tax developments in 2014.

I. CANADIAN TAX REVIEW AND OUTLOOK

From 2008 to 2012, corporate taxpayers in Canada operated in an environment of declining tax rates, with the general federal corporate income tax rate falling to 15% in 2012. In connection with these federal tax rate reductions, the Canadian Minister of Finance had encouraged all Canadian provinces to decrease their provincial corporate tax rates to 10% by 2013 so that Canada could have a national corporate tax rate of 25%.

Only two provinces (British Columbia and New Brunswick) had responded by dropping their corporate tax rates to 10%. However, British Columbia increased its corporate tax rate to 11% on April 1, 2013 and New Brunswick increased its corporate tax rate to 12% on July 1, 2013. This leaves Alberta as the only province with a combined federal and provincial rate of 25% - Alberta's provincial corporate tax rate has been at 10% since 2006.

While Ontario had originally intended to gradually decrease its provincial tax rate to 10% by July 1, 2013, in its 2012 budget Ontario announced that its corporate tax rate would be frozen at 11.5%, with any further rate decreases deferred until Ontario's deficit had been eliminated. Thus, the combined federal and provincial corporate tax rate in Ontario remains at 26.5%.

Although the goal of a 25% Canadian national corporate tax rate by 2013 was not achieved, the corporate tax rates across Canada generally compare very favourably with those of the United States and the other members of the G7 (other than the United Kingdom).

Key Canadian Tax Developments in 2013

2013 was a remarkable year for federal income tax legislation. An embarrassing back-log of legislative initiatives, budget proposals and technical "tweaks" that had accumulated over more than a decade was finally enacted. In addition, an unusually large number of new income tax measures were proposed (and, in some cases, enacted) in 2013 outside of the usual budget process. Separately, Canadian courts at all levels delivered important tax decisions.

The following provides a brief overview of some of the more significant developments.

Budget and Bill C-4

The 2013 Canadian federal budget, delivered March 21, 2013, continued the recent trend of tightening tax rules and eliminating perceived loopholes. A number of the income tax initiatives announced in the budget were included in Bill C-4, which received Royal Assent on December 12, 2013. The significant tax measures include:

- *Thin Capitalization Amendments.* The Canadian thin capitalization rules were amended by extending their application to Canadian trusts, certain non-resident trusts and non-resident corporations that carry on business or own rental properties in Canada. The thin capitalization rules were also significantly tightened in 2012 (see "Taxation Measures in the 2012 Federal Budget"). When these changes are taken together, the scope and restrictiveness of the Canadian thin capitalization rules have been significantly expanded, while their basic framework has been retained.

- *Loss Trading Amendments.* Rules in the *Income Tax Act* (Canada) (the "ITA") restricting tax loss trading have focused on corporate tax losses and keyed off the acquisition of legal control of the corporation (in most cases). These rules have been expanded through the introduction of loss restriction rules triggered by the acquisition of equity ownership (rather than voting control) of a corporation, and their extension to trusts that have experienced a "loss restriction event".

- *Character Conversion Rules.* These new rules target transactions that are used to convert what would otherwise be ordinary income into capital gains. A significant number of mutual funds used investment strategies that were affected by these rules. The rules have much broader application than their understood purpose and apply to many transactions that have no tax motivation. For example, these rules can apply to many typical put/call transactions.

- *Synthetic Disposition Arrangement Rules.* These new rules are intended to target so-called "monetization" transactions that limit a taxpayer's economic gain or loss from a security which the taxpayer continues to own. They apply both to deem dispositions where the securities involved have appreciated in value and to prevent the use of such transactions to avoid dividend and foreign tax credit stop-loss rules in the ITA. As with the character conversion rules, these rules have much broader application than their understood purpose and can apply to many transactions that have no tax motivation. In addition, both the character conversion and the synthetic disposition arrangement rules may apply to the same transaction.

- *Non-Resident Trust Amendments.* To address aspects of the Federal Court of Appeal's decision in *The Queen v. Sommerer*, the 2013 budget included amendments relating to non-resident trusts. For a summary of the *Sommerer* case, see "U.S. and Canadian Tax Law: A Review of 2012 and a Look Forward to 2013".

In the 2013 budget, the Minister of Finance also stated that the government had completed its previously announced initiative to consider adopting a formal loss transfer system or consolidated tax reporting regime for corporate groups in Canada. The Canadian government has determined that moving to a formal system of corporate group taxation is not a priority, and it appears that the government has (once again) abandoned the concept.

For a more detailed discussion of the measures mentioned above and the other 2013 budget measures, see "2013 Federal Budget Highlights".

Enactment of butterfly and tax bump amendments

Bill C-4 also enacted amendments to the butterfly rules (which facilitate divisive reorganizations) and the tax bump rules announced on December 21, 2012.

These amendments generally implemented technical corrections to the butterfly and bump rules which the Department of Finance had promised to make in comfort letters issued to taxpayers that date as far back as 2002. In addition to addressing the comfort letters, the changes included other amendments intended to allow the tax bump in a wider range of circumstances.

Enactment of comprehensive technical amendments

On June 26, 2013, the most voluminous piece of Canadian income tax legislation in over a decade (Bill C-48) became law. Bill C-48 implemented a wide range of proposed technical amendments that had been outstanding for a number of years. The legislation included, among other things:

- amendments affecting reorganizations of and distributions from foreign affiliates;
- rules targeting "upstream loans" by foreign affiliates;
- rules taxing non-resident trusts and their beneficiaries;
- amendments to the offshore investment fund rules;
- rules targeting "foreign tax credit generator" transactions;
- rules limiting the deduction of contingent interest and other expenses;
- amendments to the real estate investment trust rules;
- rules affecting tax bumps in respect of shares of foreign affiliates;
- amendments to the securities lending arrangement rules;
- rules implementing a new reporting regime for tax avoidance transactions; and
- rules addressing non-competition agreements and other restrictive covenants.

Treaty shopping

The Canadian government's attempts to challenge perceived treaty shopping in court have been markedly unsuccessful. In the 2013 budget, the government restated its concern that treaty shopping poses significant risks to the Canadian tax base and announced an intention to consult on possible measures to challenge treaty shopping while preserving a business tax environment that is conducive to foreign investment. On August 12, 2013, the Department of Finance released a consultation paper on treaty shopping.

The consultation paper outlined a number of possible measures for combating treaty shopping. The paper defined treaty shopping as a situation in which a person who is not entitled to the benefits of a tax treaty uses an intermediary entity that is entitled to such benefits in order to indirectly obtain those benefits.

It appears that the Canadian government has determined that rules to address treaty shopping are necessary but is still considering which measures should be adopted in Canada. Given that Canada has substantially relaxed its taxation of capital gains realized by non-residents and interest paid to non-residents, one might have thought that treaty shopping is now a less significant concern than it may have been in the past. In published responses to the consultation paper, including by the Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada, there is substantial opposition to the perceived direction the government is taking on this issue. It remains to be seen whether the Department of Finance will propose measures that will have a significant impact on investments in Canadian companies by non-residents.

The Canadian government's treaty shopping initiative is running in parallel to the review by the Organisation for Economic Co-operation and Development (the "OECD") of base erosion and profit shifting. One of the OECD's action items is to develop model treaty provisions and recommendations for domestic rules to prevent the granting of treaty benefits in inappropriate situations by September 2014.

Amendments to the foreign affiliate dumping rules

On August 16, 2013, the Canadian government released proposals to amend various aspects of the "foreign affiliate dumping rules", which themselves were introduced in 2012. These amendments are generally intended to be relieving in nature.

While the proposed amendments are for the most part welcome, the rules are still much broader than their stated objectives would suggest necessary, contain numerous traps and will continue to deter many legitimate foreign investments in Canadian companies.

The foreign affiliate dumping rules can have significant consequences for foreign controlled Canadian corporations with foreign subsidiaries and for acquisitions of Canadian corporations with significant foreign subsidiaries, even in apparently benign situations. Taxpayers to whom these rules may be relevant are strongly encouraged to contact a member of the Davies tax group.

Foreign affiliate amendments

On July 12, 2013, the Minister of Finance released for consultation draft amendments to the foreign affiliate rules (including a number of amendments previously addressed in comfort letters) and certain other international tax measures (including a broadening of the definition of "taxable Canadian property" in circumstances where public company shares and mutual fund trust units are held by a partnership).

The July 12, 2013 legislation addresses highly technical, but often important, issues including: (i) rules providing for the inclusion of stub period foreign accrual property income ("FAPI") of a controlled foreign affiliate ("CFA") where the taxpayer's interest in the CFA changes during the year; (ii) rules clarifying certain aspects of the treatment of foreign corporations without share capital (such as U.S. limited liability companies) and Australian trusts; (iii) amendments

addressing the application of the foreign affiliate rules to structures containing partnerships; (iv) an amendment broadening an intra-group financing safe harbour (clause 95(2)(a)(ii)(D) of the ITA); (v) a relieving amendment to an anti-base erosion rule relating to the provision of services (paragraph 95(2)(b) of the ITA); and (vi) amendments denying a tax-deferred merger of foreign affiliates where the merger is part of a transaction or series of transactions that includes the sale of shares of the merged corporation to an arm's length person.

Tax information exchange agreements (TIEAs)

Canada continued to expand its TIEA network in 2013 as it signed six more TIEAs (Bahrain, the British Virgin Islands, Brunei, Panama, Uruguay and Liechtenstein). Canada now has a total of 17 TIEAs in force. Five additional TIEAs have been signed but are awaiting Royal Assent, and Canada is in TIEA negotiations with eight countries. The Department of Finance has been actively seeking TIEAs with tax haven countries in order to improve domestic tax enforcement.

To encourage tax havens to enter into TIEAs with Canada, dividends received by a Canadian corporation out of active business income of a foreign affiliate resident in a jurisdiction with which Canada has a TIEA have been made exempt from Canadian tax. As a stick to go along with this carrot, active business income of a controlled foreign affiliate is taxed in Canada on an accrual basis (in the same manner as foreign passive income) where the controlled foreign affiliate is resident in a jurisdiction that does not enter into a TIEA with Canada within 60 months of Canada seeking to enter into negotiations for a TIEA with that country.

With 17 TIEAs now in force (including with the Cayman Islands and Bermuda), the range of attractive jurisdictions within which to establish foreign affiliates of Canadian corporations has grown significantly, and traditional notions about inappropriate offshore structuring can be challenged.

Supreme Court recognizes rectification in Québec

The taxpayers in the *Québec v. AES* and *Québec v. Riopel* cases undertook transactions that were intended to occur on a tax-deferred basis. However, in both cases, the intended tax-deferral was not achieved because of errors made by tax advisors in the implementation of the transactions. As a result of these errors, Revenue Québec and the Canada Revenue Agency issued notices of assessment claiming outstanding tax balances.

Following the Ontario Court of Appeal's decision in *Attorney General of Canada v. Juliar* in 2000, courts across the common law provinces have permitted rectification of transactions where the transactions did not achieve specific tax objectives that the taxpayers intended to obtain in undertaking the transactions. However, there has been uncertainty as to whether rectification beyond correcting mere clerical errors would be permitted under Québec's civil law.

The Supreme Court held that the *Civil Code of Québec* did not preclude the rectification of transactions. The Supreme Court stated that the common intention of the parties was expressed erroneously in all the writings prepared to carry out the tax plans on which they had agreed and it was appropriate to remedy those errors to reflect the common intention of the parties. The Supreme Court held that the tax authorities do not have the right to benefit from contractual documents that do not reflect the common intention of the parties due to an error in the preparation of documents if the parties agree to correct the error and the court has determined that the impugned documents were truly inconsistent with the parties' common intention.

The Attorney General of Canada intervened in these two cases and argued that the Supreme Court should consider and reject the common law jurisprudence developed after *Juliar*. In particular, the Attorney General argued that the common law courts have unduly extended the concept of rectification in tax cases since the *Juliar* decision. The Supreme Court did not address these arguments directly as only the Québec civil law was relevant to the cases at hand, but the decision may be seen as a favourable indicator in common law jurisdictions as well.

Solicitor-client privilege waived by including client's accountants in communications

In *Imperial Tobacco v. The Queen*, the Tax Court considered whether certain communications were protected by solicitor-client privilege. In Canada, legal advice from a lawyer to his or her client is protected by solicitor-client privilege unless the privilege is waived. Advice from an accountant is not protected by privilege in Canada.

In this case, the Tax Court considered, among other things, whether privilege in respect of advice provided by the client's lawyers through e-mails was lost by the lawyers also addressing the e-mails to the client's external accountants. The Tax Court stated that there was little evidence that the role of the external accountants was integral to the solicitor-client relationship. Accordingly, the Tax Court concluded that including the accountants in the e-mails constituted disclosure to a third party and resulted in a waiver of solicitor-client privilege.

Tax Court upholds transfer pricing adjustment

The Tax Court of Canada released its long-awaited transfer pricing decision in *McKesson Canada v. The Queen*. In this case, the taxpayer sold its receivables to its intermediate Luxembourg parent at a 2.206% discount to their face amount. The Canada Revenue Agency (the "CRA") reassessed the taxpayer's 2003 taxation year on the basis that the discount rate would have been 1.013% if the transactions had been entered into between arm's length parties. The CRA did not assess additional transfer pricing penalties since the taxpayer produced contemporaneous documentation, although in a footnote to the decision the Tax Court rather unusually appears to question whether the documentation produced by the taxpayer satisfied the contemporaneous documentation requirements in the ITA. The Tax Court considered the expert evidence produced at trial by the taxpayer and discounted much of the evidence as being advocacy work.

In considering the appropriate transfer pricing analysis, the Tax Court suggested that OECD commentaries were not relevant by stating "OECD commentaries and Guidelines are written not only by persons who are not legislators, but in fact are the tax collection authorities of the world".

The Tax Court concluded that its best estimate of an arm's length rate was between .959% and 1.17%. In addition, the Tax Court stated that the taxpayer was not able to establish sufficient credible and reliable evidence that the 2.206% discount was computed based upon arm's length terms and conditions. The Tax Court went on to uphold the CRA's transfer pricing adjustment using the discount rate of 1.013%, which was within the arm's length range determined by the Tax Court.

The CRA also made a secondary adjustment by assessing the intermediate Luxembourg parent and the taxpayer for withholding tax (in the case of the taxpayer, for a failure to withhold) on a deemed dividend. The assessment for the deemed dividend was under the shareholder benefit

provisions in the ITA on the assertion that the taxpayer conferred a benefit on its Luxembourg parent by selling the receivables at below their arm's length price. (The ITA was amended effective March 29, 2012, to add a specific provision in the transfer pricing rules that treats all secondary adjustments as dividends subject to withholding tax.) The taxpayer only challenged the secondary adjustment on the basis that the assessment for withholding tax was statute barred under the Canada-Luxembourg tax treaty but the Tax Court held it was not.

The taxpayer in *McKesson* has appealed the Tax Court's decision to the Federal Court of Appeal.

<u>GAAR applies to transactions that avoid debt forgiveness</u>

In *Lecavalier v. The Queen*, Ford U.S. was selling a Canadian subsidiary (Greenleaf) to a Canadian purchaser for a purchase price of $10 million, which was less than the $25 million of debt that was owing by Greenleaf to Ford U.S. To avoid the application of the debt forgiveness rules, prior to the sale of Greenleaf to the purchaser, Ford U.S. contributed $15 million in cash to Greenleaf as the subscription price for Greenleaf shares. The cash was subsequently used by Greenleaf to repay $15 million of the debt that was owed by Greenleaf to Ford U.S. The balance of the debt was then sold to the purchaser at a price close to its face amount and the Greenleaf shares were sold for a nominal amount.

If the $15 million of debt had been exchanged for Greenleaf shares, Greenleaf would have realized debt forgiveness of $15 million by virtue of paragraph 80(2)(g) of the ITA. On this basis, the Tax Court concluded that paragraph 80(2)(g) was circumvented (and, thus, abused) and GAAR applied to result in debt forgiveness to Greenleaf.

<u>Tax Court considers the paragraph 95(6)(b) anti-avoidance rule</u>

In *Lehigh v. The Queen*, the Tax Court considered the application of the anti-avoidance rule in paragraph 95(6)(b) of the ITA. Paragraph 95(6)(b) provides that where a person acquires or disposes of shares of a corporation and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer any amount payable under the ITA, for the purposes of the foreign affiliate rules the acquisition or disposition is deemed not to have taken place.

In *Lehigh*, the taxpayers (two Canadian corporations) established a U.S. limited liability company (the "LLC") to which they contributed funds which were loaned by the LLC to a U.S. operating affiliate ("US Opco") – a variation on a relatively common internal financing structure. US Opco paid interest to the LLC and it was intended that under the Canadian foreign affiliate rules the interest would be deemed to be active business income and exempt surplus to the LLC. The LLC used the interest income to pay dividends to the taxpayers. The taxpayers reported on the basis that they received dividends from a foreign affiliate (the LLC) that were exempt from Canadian tax. For U.S. tax purposes, the LLC was a partnership and the interest income of the LLC was allocated to the taxpayers and subject to a 10% U.S. withholding tax. Therefore, from a U.S. tax perspective, the transactions resulted in a reduction of US Opco's operating income by virtue of the interest deductions at the cost of a 10% U.S. withholding tax on the interest received by the LLC.

The Canada Revenue Agency reassessed the taxpayers under paragraph 95(6)(b) arguing that the LLC interests were acquired by the taxpayers principally to avoid tax under the ITA and, therefore, the LLC interests were deemed to not be acquired by the taxpayers for the purposes

of the foreign affiliate rules. On this basis, the LLC would not qualify as a foreign affiliate of the taxpayers and the dividends would not constitute exempt dividends.

The Tax Court held that paragraph 95(6)(b) did not apply to the taxpayers on the basis that the transactions were intended to reduce U.S. tax and were not undertaken to avoid tax under the ITA. Although the Tax Court came to a favourable conclusion for the taxpayer in *Lehigh*, the Tax Court comments on the breadth of paragraph 95(6)(b) are quite controversial. In particular, the Tax Court stated "[a] textual, contextual and purposive analysis leads to the conclusion that the provision can apply to any acquisition or disposition of shares that is principally tax-motivated." Since dividends on shares of foreign affiliates generally receive beneficial tax treatment under the ITA, the acquisition of any share that results in a non-resident corporation becoming a foreign affiliate of a taxpayer could be argued to be tax-motivated and potentially subject to paragraph 95(6)(b). The comments are all the more troubling in that subsection 95(6) has received very little judicial consideration. The Crown has appealed the decision in *Lehigh* to the Federal Court of Appeal and it is hoped that, whatever the outcome for the taxpayer involved, the Federal Court will limit the scope of these comments made by the Tax Court.

Assumption of reclamation obligations, not proceeds of disposition

In 2013, the Supreme Court of Canada released its decision in *Daishowa v. The Queen*. Daishowa agreed to sell timber rights which carried with them certain reforestation obligations. The price was $180 million less the preliminary estimate of $11 million for the assumption of the reforestation obligations by the purchaser, which amount would be adjusted based on a final estimate of the reforestation obligations. The Federal Court of Appeal held that the purchaser's assumption of the reforestation liabilities constituted consideration (and additional proceeds of disposition) to the taxpayer and because the parties specifically "agreed to a price of $11,000,000 for the reforestation liability...they should be held to that price for income tax purposes". The Federal Court's decision would have resulted in double taxation because the taxpayer was treated as having received taxable proceeds of disposition in respect of an economic obligation for which it had no deduction or cost for tax purposes.

In overturning the Federal Court of Appeal's decision, the Supreme Court found that the reclamation obligations were "embedded" in the property to which they related and did not constitute a separate liability of the taxpayer. On this basis, the Supreme Court held that the purchaser's assumption of reclamation obligations did not constitute an assumption of a distinct existing liability of the taxpayer and, accordingly, the assumption of such obligations did not constitute additional proceeds of disposition to the taxpayer. The treatment of contingent obligations in purchase and sale transactions can be a thorny issue. The *Daishowa* decision does not put these issues to rest in general, but it is a welcome and sensible development in the area.

Outlook for Canadian Tax Developments in 2014

The Department of Finance's general policy of secrecy means any predictions about future tax developments can only be guesses. The entirely unforeseen scope of additional tax developments last year is proof of this. With that in mind, we can anticipate that Finance may release final versions of the July 12, 2013 foreign affiliate legislation and the August 16, 2013 foreign affiliate dumping legislation discussed above.

In addition, the Minister of Finance typically delivers the annual budget at the end of March - although there has been recent speculation that the 2014 budget will be delivered in February

this year. At the annual tax conference in November 2013, the Department of Finance suggested that the revenue-raising measures in the previous few budgets have been a significant factor in reducing the government's deficit and that taxpayers should expect that the 2014 budget will continue the trend of including measures focusing on "unintended tax preferences". One likely measure is rules that address tax treaty shopping.

Another possible measure is a broadening of the circumstances in which taxpayers are taxed on an accrual basis in respect of FAPI of foreign subsidiaries. Currently, taxpayers are only taxed in respect of FAPI of a foreign subsidiary where the foreign subsidiary is a "controlled foreign affiliate" of the taxpayer. A 2008 government-sponsored advisory panel recommended a number of amendments to Canada's internal tax system. The government has adopted a number of the panel's recommendations (including the 2012 and 2013 amendments to the thin capitalization rules and the foreign affiliate dumping rules). One of the tightening measures considered by the panel was whether the FAPI regime should be extended to apply to certain non-controlled foreign affiliates. It is unclear whether the government is considering possible amendments in this regard.

II. U.S. TAX REVIEW AND OUTLOOK

Worldwide attention has shifted to BEPS, but in the United States, the IRS and Treasury remain busy trying to implement FATCA, case law continues to be spare (and generally taxpayer-favorable), and tax reform proposals by both the Obama Administration and the Senate Finance Committee in Washington, D.C., which seek major changes to the way foreign investors and U.S. and foreign multinationals would be taxed by the United States, are expected to get bogged down in 2014 due to it being a mid-term election year. At this stage, it is difficult to imagine a plausible outcome from those elections that would break the gridlock in the nation's Capitol.

Review of Major U.S. Tax Developments in 2013

Legislative Developments

In our January 2013 client bulletin, we predicted that, notwithstanding the fresh success of Congress in barely avoiding the fiscal cliff, "the American citizenry should still hold out little hope for passing more tax legislation". Unfortunately, we were correct.

Avoiding the Fiscal Cliff

On the legislative front, 2013 was characterized by continuing Congressional gridlock, with the only significant exception occurring on January 2, 2013, when Congress and the White House agreed on a compromise to prevent the nation from going over the "fiscal cliff". The compromise included an extension of the Bush-era tax cuts for individuals making $400,000 ($450,000 for joint-filers) or less, an increase in the highest marginal tax rate on individual earnings above those thresholds (from 35% to 39.6%) and an increase in long-term capital gain rates (from 15% to 20%). Both the unearned income Medicare contribution tax of 3.8% and an increase in the earned income Medicare contribution tax to 3.8% (from 2.9%) came into effect on January 1, 2013 (these taxes were enacted years ago in connection with the Obama health care reform bill). Eligibility of qualified dividend income for long-term capital gain rates became permanent, while corporate tax rates remained unchanged.

Another important aspect of the compromise involved the U.S. estate tax. The 2012 exemption amount of $5 million for U.S. estates was adjusted for inflation, and the estate tax rate rose to 40%.

The fiscal cliff compromise also extended the facility for U.S. multinationals to finance foreign operating subsidiaries through third-country finance subsidiaries under Code Section 954(c)(6) through 2013. That provision broadly exempts from subpart F inclusion payments made by one related controlled foreign corporation ("**CFC**") to another, and is analogous to ITA section 95(2)(a)(ii) in Canada.

Regulatory Developments

FATCA Developments

There were several developments on the *Foreign Account Compliance Act* ("**FATCA**") front as the IRS moved forward with implementation of the notorious reporting and withholding regime.

Final regulations under FATCA were released on January 18, 2013. Those regulations contain a number of taxpayer-friendly changes from the proposed regulations released in February 2012. They narrow the categories of foreign financial institutions ("**FFIs**") required to enter into an agreement with the IRS to monitor and report on U.S. account holders, expand and clarify exemptions for foreign governments and foreign pension plans, expand grandfathered instruments, and provide other important guidance. FFIs generally include foreign entities holding or managing investment assets or accounts for others, but can include other entities as well. Other major changes include: expanded relief for private trusts and holding companies that are not managed by an FFI; expansion of the "owner certified-deemed compliant" FFI category; and expanded grandfathering for existing obligations.

In Notice 2013-43, the IRS also announced a six-month delay of the application of the key provisions of FATCA to payments made on or after July 1, 2014. The Notice also includes relief for FFIs located in countries that have entered into "**Model 1**" type intergovernmental agreements ("**IGAs**") with the IRS. Treasury has concluded such IGAs with a number of countries, but the IGAs have not yet come into force due to delays by the Senate Foreign Relations Committee. Under the Notice, any FFI that is located in a country that is listed by the IRS as having signed an IGA will be permitted to register and obtain a global intermediary identification number ("**GIIN**") as a registered deemed compliant FFI, even if the IGA is not yet in force.

The IRS entered into several new IGAs, including one with the Cayman Islands. Although Canada and the United States announced last November that they were in discussions to enter into an IGA by the end of 2013, Canada and the U.S. have not yet entered into an IGA.

Given that the withholding rules will go into effect in less than six months, at this point it is critical for investment entities (including private investment vehicles) to determine as soon as possible whether they are subject to FFI characterization under the final rules and, if so, whether they are required to register for a GIIN or will be eligible for certified-deemed compliant FFI status (for which no GIIN registration is required). ***Any FFI that is unable to provide a GIIN to a withholding agent with respect to a U.S. source withholdable payment made on or after July 1, 2014, will be subject to a 30% withholding tax.***

PFIC Reporting Rules

At the close of 2013, Regulations under Code section 1298(f) were finalized. Those regulations require IRS Form 8621 to be filed for passive foreign investment company **("PFIC")** shareholders for the 2013 calendar year and will have an immediate impact in the 2014 filing season, but the new requirements do not apply to earlier years. Unfortunately, the regulations do not answer questions on the treatment of non-grantor trust and estate beneficiaries, but the IRS suggested that taxpayers use a "reasonable method" until guidance is issued.

Final 1411 Regulations

Treasury finalized regulations under the new 3.8% unearned income tax. The regulations generally allow for deferral of the tax on subpart F income and QEF inclusions under the CFC and PFIC anti-deferral regimes, but alternative elections should be carefully considered.

Section 871(m) Guidance

The IRS finalized temporary regulations under Code section 871(m), which treats certain dividend equivalent payments as U.S.-source income for withholding tax purposes. Under those rules, U.S. and non-U.S. payers of dividend equivalent amounts may be required to report and withhold on such items under the U.S. tax rules. These regulations were initially intended to be replaced by a proposed set of new rules to be effective for transactions entered into on or after January 1, 2014. The initially proposed rules would have adopted a seven-factor test for determining when a notional principal contract results in U.S. dividend equivalent payments. However, the IRS decided to withdraw those proposed rules and replace them with a new set of proposals that would solely test an instrument for its "delta", measuring congruence of the value of the derivative to price movements in the underlying security or equity-linked index. The new rules are proposed to be effective for transactions entered into on or after January 1, 2016; in the interim the current final regulations will continue to apply.

We have previously observed that payments on exchangeable shares may attract U.S. withholding tax under section 871(m), where the parent company is organized in the United States, but that the U.S.-Canada treaty may modify that conclusion.

Section 336(e) Regulations

On May 15, 2013, the IRS issued final regulations under Code section 336(e), allowing certain non-corporate purchasers to obtain a stepped-up basis in the assets of certain target corporations without double taxation. The new rules thus simplify structures for corporate acquisitions by private equity investors, which are often structured as partnerships for U.S. tax purposes. The new rules may also prove useful to avoid double taxation in cases in which an acquisition of a target or distributing corporation follows too closely on the heels of a tax-free spinoff.

The new rules apply where there is a "qualified stock disposition" of a domestic target which is either an S corporation or an 80%-owned domestic subsidiary of a domestic corporate parent. As under section 338, the purchaser and seller must be unrelated, and the disposition must take place within a 12-month period. The key to the new rules – and the manner in which they expand on section 338 – is that there need not be a single (or majority) purchaser, the purchaser need not be a corporation, and the election is to be made by the seller (rather than the buyer, or by both seller and buyer).

Even with the new regulations, opportunities to "bump" the tax basis of corporate assets under U.S. law remain more limited than those in Canada.

The section 336(e) regulations permit a protective election (and related mechanisms) for use in the context of a spinoff where gain is unexpectedly triggered at the corporate level (but not the shareholder level) due to the application of either Code section 355(d) (involving an acquisition of control of a distributing or controlled corporation within five years after the spinoff) or section 355(e) (where there is a plan to acquire either the distributing or controlled corporation within two years of the spinoff).

Other Regulations

The IRS also issued final regulations under Code section 367(a)(5), which allow only certain outbound asset reorganizations to qualify for nonrecognition treatment. The IRS added exceptions to the rules of Treas. Reg. §1.337(d)-7, which impose corporate-level tax on built-in gains following a conversion of a C corporation into a RIC or a REIT. The IRS also finalized regulations defining when costs incurred to repair property must be capitalized; in this area, the U.S. rules are more lenient than those in Canada.

Case Law

Sun Capital

In a case involving a domestic private equity fund, Sun Capital Partners IV, LP ("**Fund IV**"), the First Circuit Court of Appeals held that Fund IV may be liable for unfunded benefits of a multiemployer pension fund of a bankrupt company in which Fund IV had invested. Although the liability at issue in the Sun Capital case was not a tax liability, practitioners have been concerned that the case could suggest an approach the IRS could take to lowering the threshold to tax foreign investors. The statute at issue provides that trades or businesses under common control are treated as a single employer upon which the pension withdrawal liability can be imposed. In this case, the court found highly relevant a reduction in management fees for any fees paid to the sponsor by companies held by the fund. The court concluded that Fund IV's activities would be treated as a "trade or business" for this purpose. Although the court indicated that its holding did not require it to conclude that Fund IV's activities were sufficient for it to be treated as engaged in a trade or business for tax purposes, the court nevertheless insisted that its conclusions were consistent with the longstanding case law in the tax area (holding that passive investors in stocks and securities are not engaged in a trade or business). The Sun Capital case thus represents a challenge to foreign investors in private equity funds who rely on those authorities (or on the Code's statutory securities trading exemption) for the position that they are not engaged in a U.S. trade or business; private equity funds may also continue to rely on the Code's "trading" safe harbor to avoid U.S. taxation.

The Sun Capital case is also relevant to foreign governmental investors who rely on the section 892 governmental exemption. The section 892 exemption is not available for income derived from a partnership that is engaged in a commercial activity. While proposed regulations would not invalidate the section 892 exemption for "inadvertent" commercial activity, they would still allow taxation of income from a trade or business conducted by a partnership.

We have advised our clients that the Sun Capital case will not cause major structural changes in the operation of the private equity industry to accommodate additional tax risks arising from the case, but since Sun Capital could be used by the IRS to change the legal landscape,

consideration might be given by some planners to the use of special purpose blocker corporations for investments in private equity funds, especially if the fund features a general partner management fee offset like the one present in the Sun Capital case.

U.S. v. Windsor

In *U.S. v. Windsor*, the United States Supreme Court struck down section 3 of the federal *Defense of Marriage Act* ("**DOMA**") on June 26, 2013, which provided that the terms "marriage" and "spouse" exclude same-sex partners. The Supreme Court held that section 3 violates the equal protection clause of the Fifth Amendment of the U.S. Constitution as applied to persons of the same sex who are legally married under the laws of their State. The effect of the Windsor case is by no means limited to the tax area (the *Dictionary Act* that was amended by DOMA provides rules of construction of over 1,000 federal laws), but the case does have numerous effects on the application of the income, estate and gift taxes to affected couples.

The IRS subsequently issued Rev. Rul. 2013-17, holding that for tax purposes, terms that previously applied exclusively to persons of opposite sex will apply to individuals married to persons of the same sex if the marriage is lawful under State law. However, the IRS noted that this rule does not apply to any individuals who have entered into registered domestic partnership, civil union, or any other formal relationship under a State law that is not denominated as marriage under such law.

Treaties

The United States signed protocols to the income tax treaties with Japan, Poland and Spain this year. However, those protocols, along with a number of older treaties or protocols (such as those with Hungary and Luxembourg), are still awaiting ratification by the Senate.

Other 2013 U.S. Tax Developments

On December 20, 2013, the U.S. Senate voted to confirm John Koskinen as the new Commissioner of the IRS. Mr. Koskinen has his work cut out for him, as the IRS is still struggling through the wake of a scandal involving the FBI investigating the IRS for targeting political groups applying for tax-exempt status based on their names or political themes (including conservative groups with terms such as "Tea Party" in their names).

The Department of Justice also announced a program involving deferred prosecution of some Swiss banks. Under the program, which is available only to banks that are not currently under criminal investigation by the Department for their offshore activities, participating Swiss banks will be required to agree to pay substantial penalties and provide detailed information on accounts in which U.S. taxpayers have a direct or indirect interest. Along with FATCA, such developments reflect how the era of U.S. taxpayers hiding income in offshore accounts is really ending.

2014 Outlook

Tax Extenders

In recent years, Congress has enacted numerous temporary tax relief provisions. Many of these provisions were intended by their Congressional proponents to be made permanent, but were structured as temporary provisions for budgetary reasons. Accordingly, it has become an

annual or bi-annual ritual for these provisions to be extended in one- or two-year increments, so that they do not expire (hence the term "tax extenders"). In 2013, Congress capped its year of minimal accomplishment by going on recess without extending 64 temporary provisions due to expire on December 31, 2013. Among these provisions are the research and development (R&D) credit, which many companies rely on in making investment decisions on whether to pursue R&D projects, and the extension of Code section 954(c)(6). Although the conventional wisdom that Congress will ultimately act to extend these provisions retroactively to January 1, 2014, is probably correct, recent news reports indicate that action is unlikely to occur on this front before the spring of 2014.

International Tax Reform

There appears to be broad agreement among business and politicians that the current U.S. international tax system needs reform. However, there is considerable debate on how to fix the system. Several international tax reform proposals have been advanced and they are described below, but we give low probability to action on this front in 2014.

Representative Dave Camp, Chair of the Ways and Means Committee, released a discussion draft of such proposals in 2011, proposing a territorial tax system, under which U.S. corporations would generally receive a deduction for 95% of foreign-source dividends received from their foreign subsidiaries and would be permitted to exclude 95% of capital gains from the sale of shares in a foreign subsidiary. Under Camp's proposal, the current anti-deferral rules of subpart F would generally be retained but the discussion draft proposes to disallow a portion of a U.S. corporation's interest expense if the U.S. corporation is more leveraged than its worldwide group as a whole. The Camp proposal outlines three options for addressing potential erosion of the U.S. tax base: the first option would tax currently low-taxed income earned by a foreign subsidiary that is attributable to intangibles transferred from the United States; the second option would currently tax certain low-taxed foreign income earned outside of the CFC's country of incorporation; and the third option would lower the corporate tax rate for all foreign intangible income (even income earned directly by a U.S. corporation) to 15%, but would eliminate deferral of a foreign subsidiary's income from intangibles if the income were taxed at a rate less than 90% of the maximum U.S. corporate tax rate.

Later, in February 2012, the Obama Administration released its international tax reform proposal that included a minimum tax (at an unspecified rate) on deferred earnings of CFCs. The proposal would also have imposed current tax on the "excess returns" from intangibles transferred to a CFC. The Obama Administration's budget included a proposal that would further deny companies all deductions, such as interest expense, related to "untaxed overseas" income until the company repatriates the associated income (subject to an exception for "research and experimentation" in light of the Administration's view of the "positive spillover impacts of those investments on the U.S. economy"). The Administration's Proposal would also eliminate the use of check-the-box elections for foreign entities, which (together with the elimination of section 954(c)(6)) would generate subpart F income from payments among related CFCs.

On March 29, 2013, the Obama Administration issued a press release outlining its plan to encourage private investment in infrastructure. As part of its 2014 Budget, foreign pension plans would be exempted from U.S. tax on gains from the disposition of U.S. real property interests, including both infrastructure and other U.S. real estate assets. Apparently, the exemption would be intended to apply to all foreign pension plans, both private and governmental.

More recently, an international tax reform proposal was put forward in November 2013 by Senator Max Baucus, Chair of the Senate Finance Committee, who has since been proposed as nominee for U.S. Ambassador to China. Senator Baucus's discussion draft would revise the deferral system under subpart F by providing a permanent exemption for non-subpart F income earned by a CFC, but substantially expand subpart F. The discussion draft provides two alternatives for such expansion. "Option Y" would expand subpart F income to include both U.S.-related income (derived from property or services imported into the United States) and all "low-taxed" income of a CFC. For this purpose, low-taxed income would be defined as any income that is subject to a rate of local income tax lower than 80% of the maximum U.S. tax rate. (Under current law, this would apply to Canadian subsidiaries and companies formed or managed in many other jurisdictions that are also considered to be highly taxed countries.) Such low-taxed income would be subject to an effective U.S. tax rate that is 80% of the normal U.S. rate. "Option Z" would expand subpart F even further and exempt only 40% of a CFC's active income (other than its U.S.-related income). Under either option, prior earnings of CFCs would be includible in income immediately and taxed at a rate of 20% but paid in installments over eight years.

Included in the Baucus proposal is a broad exemption for foreign pension plans from FIRPTA, like the one in the Obama Administration's 2014 Budget Proposal, an override of the IRS Notice 2007-55 that treats liquidating distributions from REITs as taxable distributions, and an expansion of the publicly traded exception for interests in REITs (to 10% from 5%). On the other hand, balancing these goodies, the package includes rules that would determine domestically controlled REIT status by applying attribution rules (up the chain to any foreign investors who hold 50% or more of an intermediate domestic corporation), tax dispositions of interests in partnerships that hold U.S. businesses (and generate effectively connected income, but not override U.S. treaties in cases where there is no underlying permanent establishment), and override the portfolio interest exemption on debt issued by corporations. The latter change in law is draconian and would adversely impact capital flows into the United States.

BEPS

The OECD has been working on a project to address international base erosion and profit shifting by multinational corporations. This project, which has become known by the acronym "**BEPS**", culminated in July 2013 in the launching of an OECD action plan identifying 15 specific actions needed in order to equip governments with the domestic and international instruments to address this challenge. To ensure that the actions can be implemented quickly, the action plan contemplates the development of a multilateral instrument to amend bilateral tax treaties among the participating countries.

The BEPS Action Plan was endorsed by the G20 Finance Ministers and Central Bank Governors at their July 2013 meeting in Moscow as well as the G20 heads of state at their meeting in Saint-Petersburg in September 2013. The actions outlined in the plan are aimed to be delivered within the coming 18 to 24 months. However, the United States is unlikely to move that quickly on any changes. In addition, the U.S. has already undertaken some of the main proposals now appearing in the Action Plan (such as the use of limitation on benefit provisions in treaties and the adoption of the information sharing FATCA regime) and Congress may not have the appetite for adopting other changes in the action plan.

Other Administration Proposals

The Administration typically proposes to tighten the earnings stripping limitation on inverted companies and the 2013 and 2014 Budgets were no exception. Proposals to tax income from "carried interests" at ordinary rates have also been included.

The Administration's 2014 Budget Proposal includes a number of other new changes that were not in the Administration's 2013 proposal. These changes include the current taxation of market discount (up to a specified cap) on fixed income instruments under rules similar to those applicable to original issue discount; a rule that requires averaging of the basis of portfolio stock; the repeal of the rule that results in a technical termination of a partnership where there is a transfer of a 50% or greater interest in the partnership within a 12-month period and the repeal of the anti-churning rules of Code section 197. The Budget Proposal would also restore the lower estate, gift and generation-skipping transfer tax exclusion amounts that applied in 2009.

If you have any questions regarding the foregoing, please contact Ian Crosbie (416.367.6958), K. A. Siobhan Monaghan (416.863.5558), or Raj Juneja (416.863.5508) in our Toronto office, Nathan Boidman (514.841.6409), Brian Bloom (514.841.6505), or Michael Kandev (514.841.6556) in our Montréal office, or Peter Glicklich (212.588.5561) or Abraham Leitner (212.588.5508) in our New York office.

Davies Ward Phillips & Vineberg LLP is an integrated firm of approximately 240 lawyers with offices in Toronto, Montréal and New York. The firm is focused on business law and is consistently at the heart of the largest and most complex commercial and financial matters on behalf of its clients, regardless of borders.

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