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THE ANTI-TAX-HAVEN INITIATIVE AND THE FOREIGN AFFILIATE RULES

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In the federal budget presented to the House of Commons on March 19, 2007, Finance Minister Jim Flaherty proposed to effectively eliminate the ability to deduct interest on borrowings relating to investments in foreign affiliates. In response to widespread criticism, on May 14, 2007, Minister Flaherty announced a substantially revised and more narrowly focused interest denial rule. The revised proposal, referred to as the anti-tax-haven initiative (ATHI), has as its primary objective the prevention of "double-dipping"—the generation of two (or more) interest expense deductions in respect of one investment. The authors of this article examine the mechanics of the ATHI, including its practical limitations, and explore issues concerning the future integration of the ATHI with the foreign affiliate regime and other provisions of the Income Tax Act.

KEYWORDS: DOUBLE DIP ■ TAX HAVENS ■ INTEREST DEDUCTIBILITY ■ FOREIGN AFFILIATES ■ PARTNERSHIPS ■ TOWER STRUCTURES

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INTRODUCTION

In the second budget of the Harper government, presented to the House of Commons on March 19, 2007, Finance Minister Jim Flaherty proposed to effectively eliminate a fundamental feature of the Canadian corporate income tax system that has been in place for almost 35 years: the deductibility of interest expense relating to investments in foreign affiliates.[1] Within two months, he announced major changes to that proposal.

The 2007 federal budget proposed to restrict the ability of taxpayers (individuals and corporations) to deduct interest on funds borrowed for investment in the equity or debt of a foreign affiliate. This was intended to be achieved through the adaptation of the existing tracing rules for interest. Generally, under the current law, interest is deductible provided that the borrowed funds are used for the purpose of earning income, whether from a business or property (for example, shares).

Under the budget proposal, interest "relating to" an investment in a foreign affiliate would constitute a use of borrowed funds that would no longer support an immediate deduction. Instead, such interest expenses would be accumulated in a "disallowed interest pool," and would be deductible to the taxpayer in a particular year only to the extent that the investment in the foreign affiliate resulted in a net addition to the taxpayer's taxable income for that year. The receipt of income from the affiliate that was not taxable (for example, a dividend from exempt surplus) would result in permanent disallowance of an equivalent amount of interest expense.

The budget proposal garnered significant attention and controversy, as the press, taxpayers, and industry associations denounced its effects on the economic well-being and competitiveness of Canadian corporations globally.[2] Many in the tax community warned that the proposal was too broad and would have significant negative implications for Canadian companies with existing and planned global operations, including increasing the tax cost of acquiring and financing those operations, and thus eroding a competitive advantage that Canadian multinationals have enjoyed for a number of years.

1 Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007.

2 For a detailed discussion of the budget proposal, see PricewaterhouseCoopers, "A Canadian Advantage Lost: The 2007 Federal Proposal To Restrict the Deductibility of Interest in Financing Foreign Affiliates," *Tax Memo*, April 12, 2007 (online: http://www.pwc.com/ca/taxmemo).

As a result of the widespread criticism, on May 14, 2007, Finance Minister Flaherty announced substantial changes to the budget proposal.[3] The Finance news release referred to the revised proposal as "the Anti-Tax-Haven Initiative" (ATHI) and identified the following as its objectives:

1. Prevent multinational corporations from using tax havens and other tax avoidance structures to generate two expense deductions for only one investment, so-called "double dipping";
2. Provide a transition period to 2012—after the planned reductions to the federal statutory corporate tax rate are fully phased-in and the rate has been reduced to 18.5 per cent;
3. Use tax revenues generated through the Anti-Tax-Haven Initiative to further reduce business taxes in Canada; and
4. Appoint an advisory panel of experts in the near future to look for ways to further improve the fairness and competitiveness of Canada's international tax system.[4]

In announcing the ATHI, the minister acknowledged the criticisms of the budget proposal, but emphasized the government's commitment to ensuring fairness in the Canadian system. In particular, he maintained that structures that use tax havens and other low-tax jurisdictions, as well as certain hybrid entity structures that seek to arbitrage differences between Canadian and US tax rules to obtain the same results as a double-dip, are "inherently unfair."[5] Thus, the ATHI would be implemented to replace the interest restrictions proposed by the budget and would limit interest deductibility in Canada if the funds borrowed could be traced to a debt that earned "double-dip income."

This article examines the mechanics of the ATHI,[6] its practical limitations, and issues relating to its future integration with other rules in the Income Tax Act.[7] All of these concerns will need to be addressed in the draft legislation, which is expected to be released before January 2008.

3 Canada, Department of Finance, "Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative," *News Release* 2007-041, May 14, 2007, and accompanying Backgrounder; and "Notes for Remarks by the Honourable Jim Flaherty, Minister of Finance, to the Toronto Board of Trade."

4 *News Release*, supra note 3.

5 "Notes for Remarks," supra note 3.

6 See "Technical Description of Mechanism To Implement the Anti-Tax-Haven Initiative To Constrain Inappropriate Tax Planning Structures To Finance Foreign Affiliates" (herein referred to as "the technical description"), in Backgrounder, supra note 3.

7 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act and regulations made under it.

APPLICATION OF THE ATHI MECHANISM TO DOUBLE-DIP STRUCTURES

Typical Structures Targeted by the ATHI

Figure 1 illustrates the type of foreign affiliate financing arrangement that the ATHI identifies as a double-dip financing structure, and specifically targets as an example of "inappropriate" tax planning.

A Canadian company, Canco, borrows funds from a third party and invests in the equity of a foreign affiliate, Finco, located in a jurisdiction that has a tax treaty with Canada. Finco uses the funds to make a loan to FA, another foreign affiliate of Canco. FA carries on an active business and is located in a high-tax jurisdiction that has a tax treaty with Canada. The interest paid to Finco by FA is recharacterized, under paragraph 95(2)(a) of the Act, as income from an active business of Finco,[8] because it is deducted in computing the active business income of FA that would otherwise be available to be paid as a tax-free dividend to Canco. The interest earned by Finco, less any applicable foreign tax (which is assumed to be less than the tax saving in FA), is added to Finco's exempt surplus and therefore can be paid as a tax-free dividend to Canco.

Overall, under this structure, the interest on the loan from Finco to FA reduces the foreign tax that FA would otherwise have paid. It also increases the after-tax earnings of Canco and lowers its investment cost in FA. At the same time, Canco is allowed a current deduction in Canada for the interest it pays on the initial borrowing from the bank.

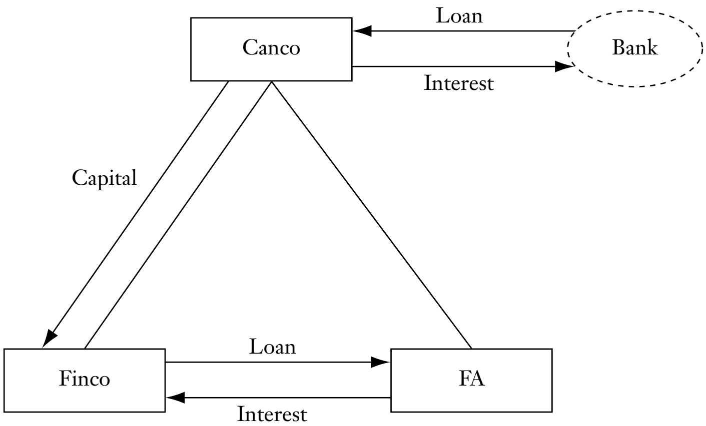
Restriction of Deductible Interest

The ATHI proposes to eliminate the "unfair" tax advantage of such financing structures by reducing the deduction for interest relating to investments in foreign affiliates by a corporation resident in Canada by the amount of the corporation's double-dip income. The following summary outlines the key components of the interest restriction formula and their potential application to the structure in figure 1.

- "Interest relating to investments in foreign affiliates" includes interest on borrowed money used to acquire shares or debts of a foreign affiliate, to lend to or contribute capital to a foreign affiliate, or to otherwise earn income from a foreign affiliate. In figure 1, the interest expense on the loan obtained by Canco from the bank and invested in shares of Finco may be restricted under the ATHI.
- "Double-dip income" in respect of a corporation is computed as the corporation's participating percentage of income attributable to a "specified debt"

8 In the absence of paragraph 95(2)(a), the interest received by Finco would be foreign accrual property income (FAPI) and therefore subject to Canadian income tax payable by Canco on a current basis.

FIGURE 1 Example of a Double-Dip Financing Structure



and recharacterized as active business income under paragraph 95(2)(a), reduced by the amount of foreign taxes paid multiplied by the relevant tax factor.[9]

- A “specified debt” is a debt owing to a foreign affiliate that arose as part of a series of transactions that included, and can reasonably be considered to have been funded by, the indebtedness of the Canadian corporation that was used to invest in the foreign affiliate. In figure 1, the loan from Finco to FA will be considered a specified debt because it is funded by the bank loan that Canco used to invest in shares of Finco.

Assuming that the loan from Finco is used in an active business of FA, the interest received by Finco will be recharacterized as active business income under clause 95(2)(a)(ii)(B). This interest, less any foreign taxes (times the relevant tax factor) paid by Finco, will be Canco’s double-dip income and will reduce its eligible interest expense.

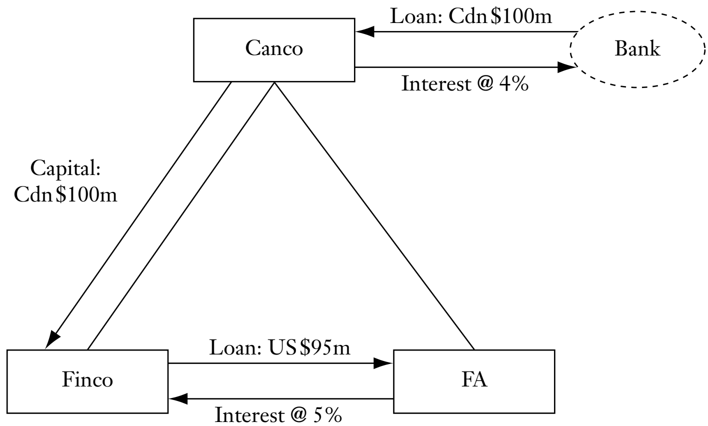
The following example illustrates the calculation of the restricted interest deduction under this formula for a similar financing structure, shown in figure 2.

Example: Restricted Interest Calculation

As shown in figure 2, Canco borrows Cdn $100 million from an arm’s-length lender at 4 percent interest and uses the funds to capitalize a foreign financing affiliate, Finco. Assuming an exchange rate of US $0.95 to Cdn $1.00, Finco uses the funds to make a US $95 million loan at 5 percent interest to FA, another foreign affiliate of Canco. FA uses the funds in an active business. Assume that Finco pays income tax at a rate of 10 percent.

9 “Relevant tax factor” is defined in subsection 95(1). Currently, the relevant tax factor is 3.2258 (being 1 divided by 31 percent).

FIGURE 2 Restricted Interest Deduction for Double-Dip Income



Under the ATHI formula, the double-dip income of Canco is calculated as the interest earned by Finco that is recharacterized under paragraph 95(2)(a) (US $4.75 million), less foreign taxes paid by Finco grossed up by the relevant tax factor. Using the current relevant tax factor of 3.2258, Canco's double-dip income is calculated as follows:

US $4.75m – [(US $4.75m × 0.10) × 3.2258] = US $3.22m.

The double-dip income would be converted to Canadian dollars, possibly at an average rate of exchange. Assuming that the Canada-US exchange rate remains constant, the allowed interest deduction in respect of Canco would be equal to the interest on the Cdn $100 million borrowed by Canco less the double-dip income, or

Cdn $4.00m – (US $3.22m/0.95) = Cdn $0.61m.

The calculation shows that the allowed interest deduction in respect of Canco is equal to the amount of foreign taxes paid by Finco less the interest spread between the loan made by Finco to FA and the debt owed by Canco.

Foreign Taxes Paid

The ATHI formula apparently assumes that interaffiliate interest earned on a specified debt in a high-tax jurisdiction (and therefore not a tax haven) will not give rise to double-dip income to the Canadian corporation and thereby limit the corporation's interest deduction. However, a foreign affiliate receiving interest in a high-tax jurisdiction may not be subject to tax, or may not itself pay tax, in that jurisdiction in respect of that income.

A typical example is shown in figure 3, where the foreign affiliate is part of a US consolidated group. The financing affiliate, Finco, which lends to another foreign affiliate in the same group, will not itself pay income taxes unless it is the reporting agent for the consolidated group. In figure 3, Holdco pays the tax on behalf of the consolidated group.[10] Finco's interest income will be included in the income of the consolidated group and be subject to US tax. The interest income will be recharacterized income for Canadian tax purposes and included in the calculation of Canco's double-dip income, but a deduction may not be available in respect of the foreign taxes paid. Therefore, under the formula, the Canadian interest deduction may be reduced even though the recharacterized income is subject to foreign income tax in a high-tax jurisdiction.

The ATHI formula refers to "foreign income taxes that can reasonably be considered to have been paid in respect of" recharacterized income.[11] However, the ATHI does not specify which entity should pay the tax in order for it to qualify. In contrast, the definition of "foreign accrual tax" (FAT) in subsection 95(1) requires that the tax must be paid by either the foreign affiliate that earns the FAPI or its immediate shareholder;[12] and if tax compensation payments are made, regulation 5907(1.3) requires that the compensatory tax must be paid by the foreign affiliate that earns the FAPI. Therefore, the ATHI mechanism may have to be more specific to recognize tax compensation payments similar to FAT in the deduction allowed for foreign taxes paid.

A similar issue arises when, for example, Finco in figure 3 is a US limited liability company (LLC) that is owned by a US C-corporation (Holdco). Assuming that LLC is a disregarded entity for US tax purposes, it is Holdco that would be subject to and pay tax to the US government in respect of LLC's income. In this case also, a rule similar to the FAT provision is necessary to recognize the tax paid by Holdco as foreign tax paid when LLC distributes its income.

Adopting the FAT rules will not address foreign withholding tax on dividends paid out of Holdco, however. Under the FAPI and foreign affiliate regime, such tax will be included in the underlying foreign tax[13] and be available for a grossed-up deduction under paragraph 113(1)(b) when Finco's income is ultimately distributed to Canco. Under the ATHI, assuming that Finco's income retains its character and continues to be included in Finco's exempt surplus pool, a paragraph 113(1)(b) deduction will not be available. If the withholding tax is allowed as foreign tax paid for purposes of computing Canco's double-dip income, a mechanism in the ATHI formula will be necessary to allow for the fact that the withholding tax may be paid several years after the year for which the double-dip income is determined.

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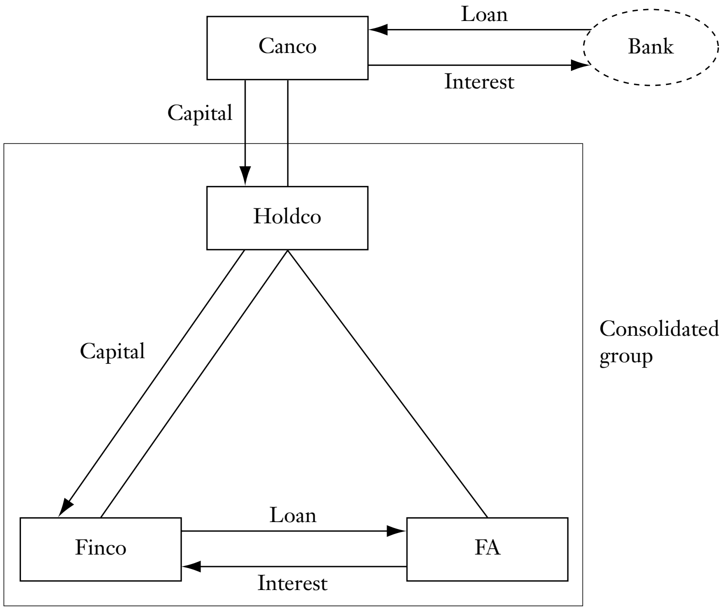
10 Treas. reg. section 1.1502-77(a)(1) under the Internal Revenue Code of 1986, as amended.

11 See element C of the formula in paragraph 3 of the technical description, Backgrounder, supra note 3.

12 Provided that the shareholder is another foreign affiliate of the taxpayer and the tax is paid in respect of a dividend received that is considered paid out of the FAPI: see subsection 95(1), paragraph (a)(ii) of the definition of "foreign accrual tax." Also see Canada Revenue Agency (CRA) document no. 9830545, November 25, 1999.

13 As defined in regulation 5907(1).

FIGURE 3 Interaffiliate Financing Within a Consolidated Group



Double-Tracing Requirement

To determine the amount of interest expense denied under the ATHI, it is necessary to establish

1. the amount of debt potentially subject to interest deductibility restrictions; and
2. the amount of such debt that can be linked to the earning of double-dip income.

Debt potentially subject to interest deductibility restrictions is debt borrowed or incurred by a corporation (or partnership) that has been used to invest in shares of a foreign affiliate, to contribute to the capital of a foreign affiliate, or to invest in debt of a foreign affiliate. If no debt can be traced to such investments, there will be no interest deductibility restrictions and the second tracing is unnecessary.

If debt is potentially subject to interest deductibility restrictions, the second tracing test is necessary to establish whether there is a link between that debt and the earning of double-dip income. According to the ATHI, any recharacterized income of a foreign affiliate attributable to specified debt owing to a foreign affiliate is included as double-dip income. As discussed above, specified debt is debt that can reasonably be considered to have been funded through a series of transactions by the first debt.

The word "funded" implies a tracing test, and the reference to a series of transactions indicates that the tracing can be direct or indirect through a number of companies or types of investments. The challenges that this will entail will be similar to those identified for the tracing requirement in the original budget proposal.[14] In particular, Canadian companies with significant borrowings and investments in foreign affiliates will find it extremely difficult or impossible to carry out the requisite tracing without establishing the history of investments and financings. Because corporations generally treat cash as fungible, there may not be clear evidence to support the origin of funds used to finance investments in foreign affiliates as distinguished from investments in Canadian operations.

It is hoped that one of the tasks of the Department of Finance in drafting legislation will be to clarify the tracing requirement so that taxpayers can apply the rules in practice.

Aggregation Rule

The ATHI includes a related-group aggregation rule that allocates excess double-dip income in respect of a particular corporation to another related corporation that has incurred interest expense on debt relating to investments in foreign affiliates. Specifically, this rule applies when

> a particular corporation's interest relating to investments in foreign affiliates exceeds the amount of the particular corporation's double dip income, and another corporation that was related to the particular corporation . . . has . . . double dip income that exceeds its interest relating to investments in foreign affiliates.[15]

Effectively, once a debt owing to a foreign affiliate is a specified debt, any borrowing by a related corporation that is invested in a foreign affiliate becomes subject to the ATHI. Any excess double-dip income will reduce any interest expense on debt incurred by any related corporation that used such debt to invest in shares or debt of a foreign affiliate. This debt need not be traced to any double-dip income. Therefore, the application could be so broad that investments by related companies in other chains of foreign affiliates could be affected.

INTEGRATION WITH THE FOREIGN AFFILIATE RULES

With the reference in the double-dip income formula to paragraph 95(2)(a), the ATHI is using the recharacterization rules as an indicator of tax abuse. However, the ATHI bases this measure on assumptions that are not always present in interaffiliate financing arrangements. Examples are assumptions relating to (1) exempt surplus; (2) the deductibility of interest expense in the foreign jurisdiction; (3) recharacterized income; and (4) the matching of interest expense and interest income.

14 See, for example, supra note 2.

15 Paragraph 7 of the technical description, Backgrounder, supra note 3.

A further issue is the determination of the Canadian corporation's participating percentage in respect of an affiliate's recharacterized income. Each of these concerns is discussed below.

Exempt Surplus

The ATHI assumes that, in the structure shown in figure 1, Finco includes the double-dip income in its exempt surplus. Therefore, any dividends paid by Finco are from exempt surplus and are not subject to tax in Canada. This assumption is key to the ATHI's objective of limiting the taxpayer to one interest expense deduction for a single investment. The Department of Finance Backgrounder describes the tax-avoidance issue as follows:

> The interest deduction in Canada offsets the group's Canadian-source income, while another deduction, claimed in the country in which the business being financed is located . . . shelters the structure from tax there. Taking advantage of another feature of Canada's rules, the group recharacterizes the resulting investment income as active business income, allowing it to be returned to Canada as exempt surplus dividends (and sometimes paid in turn to a foreign parent company). As a result, the group enjoys two deductions for what is economically the same expense. The extra deduction allows it to shelter other, Canadian-source income from Canadian tax.[16]

The exempt surplus assumption does not consider the result if either Finco or the borrowing foreign affiliate (or both) are located in a non-designated treaty country. In this situation, the double-dip income will be included in Finco's taxable surplus and will be subject to tax in Canada when paid to Canco as a dividend.

The result under the ATHI is that all or a portion of the interest expense in Canada will be non-deductible while the income earned by Finco will be subject to tax. The original budget proposal would have denied the interest only to the extent that Canco's dividend income was reduced by a deduction under paragraph 113(1)(b) for underlying foreign tax. The ATHI denies the interest deduction whether or not the dividend income paid to Canco out of Finco's surplus accounts is subject to tax in Canada.

Given this result, a corporation with an otherwise restricted interest deduction would be better off if the interest income failed the recharacterization test in paragraph 95(2)(a) and was characterized as FAPI. Although the interest would then be included in the corporation's income, the deduction of any interest expense would no longer be restricted because there would be no double-dip income. The proper result under the ATHI should leave the corporation no worse off than if the income were otherwise FAPI.

16 Backgrounder, supra note 3, under "International Taxation: The Canadian Experience."

Foreign Tax Deduction

As noted above, the ATHI intends to allow a single interest deduction for one investment. In doing so, it reduces or denies the Canadian interest deduction because it assumes that a tax deduction is allowed in the foreign jurisdiction.

In the structure shown in figure 1, subparagraph 95(2)(a)(ii) applies where the interest paid by the borrowing affiliate (FA in figure 1) is deducted in computing its earnings from an active business in the current or subsequent taxation year.

The ATHI assumes that in meeting this condition, the borrowing affiliate deducts the interest in computing its taxable income under foreign tax law. However, subparagraph 95(2)(a)(ii) does not require that the interest be deductible under foreign tax law, but rather that it be deducted in computing earnings as defined in regulation 5907(1).

In computing earnings from an active business of a foreign affiliate, the starting point is taxable income computed under the foreign law of the country in which the affiliate is resident.[17] However, under that country's tax law, interest expense incurred by the foreign affiliate may not be deductible owing to thin capitalization limits or other restrictions.

Where the foreign law denies the deduction, regulation 5907(2)(j) still requires a deduction in computing earnings from an active business if there has been a cash outlay or expense. Therefore, even if there is no foreign tax deduction, subparagraph 95(2)(a)(ii) may still apply to recharacterize the interest income as income from an active business. As a result, there will be double-dip income but no foreign tax deduction. By virtue of the ATHI formula, the resulting double-dip income will reduce or eliminate the Canadian interest deduction, whether or not a foreign deduction is allowed.

The preceding example illustrates how the Canadian interest deduction is reduced even though there is no foreign deduction. Therefore, if the goal of the ATHI is to prevent double interest deductions for a single investment, the interest restriction formula should be modified to apply only if there is a deduction in the foreign jurisdiction.

Recharacterized Income Under Paragraph 95(2)(a)

The calculation of double-dip income refers to recharacterized income under paragraph 95(2)(a), which presumably would include the proposed technical amendments in subparagraphs 95(2)(a)(i) to 95(2)(a)(vi).[18] The ATHI assumes that recharacterized income under paragraph 95(2)(a) will be interest on specified debt; however, the recharacterized income may not be just interest.

17 See the definition of "earnings" in regulation 5907(1).

18 Canada, Department of Finance, *Legislative Proposals and Draft Regulations Relating to Income Tax* (Ottawa: Department of Finance, February 2004) (herein referred to as "the 2004 technical amendments").

Consider the example in figure 4. Finco is resident in Europe and its calculating currency is the euro. If Finco makes loans in another currency—say, US dollars—to a related US company, USco, Finco will realize a gain or loss on the repayment of the loan. If the loans are held on income account,[19] foreign exchange gains and losses will be FAPI unless recharacterized under paragraph 95(2)(a). Under the 2004 technical amendments, subparagraph 95(2)(a)(v) will deem the gain or loss to be a gain or loss from an active business if the loan is excluded property. The loan will be excluded property if the interest on the loan is recharacterized under subparagraph 95(2)(a)(ii).

In this example, a gain on the settlement of the loan would be included in the computation of double-dip income because the gain would be considered to be attributed to the debt owed to Finco. Therefore, assuming no foreign tax, the gain would reduce the amount of the interest deduction in Canada.

This result is inappropriate because there is no foreign deduction in respect of the gain. This is an example of the reference to paragraph 95(2)(a) being too broad because it assumes that all recharacterized income will be from deductible interest on specified debt.

If the foreign exchange gain or loss were on capital account, subparagraph 95(2)(a)(v) would not apply because such gain or loss would be deemed to be a disposition of excluded property, and therefore would be excluded in the calculation of FAPI under the definition in subsection 95(1). Whether the foreign exchange gain or loss is on capital or income account should not affect the deductibility of interest by Canco. This supports the conclusion above that subparagraph 95(2)(a)(v) should not be applicable in the double-dip income calculation.

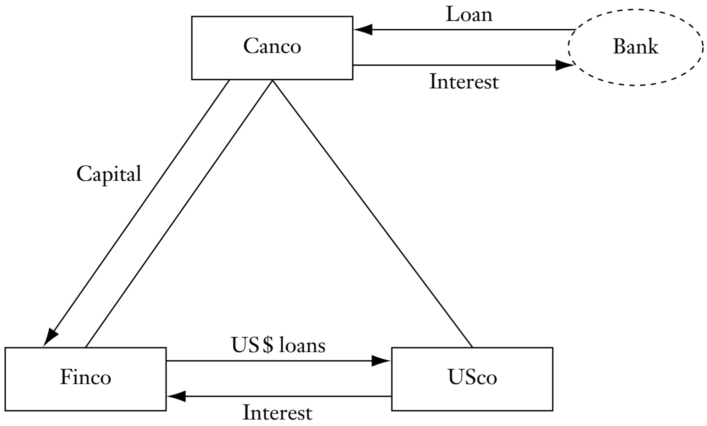
Matching of Interest Expense and Interest Income

A corporation's double-dip income is determined in part by reference to its participating percentage of certain recharacterized income earned by a foreign affiliate of the corporation. The objective is to match the interest expense incurred in Canada with the interest income earned offshore that is included in the foreign affiliate's exempt surplus in respect of the corporation. However, because the interest income is not included in the foreign affiliate's exempt surplus pool until the end of the foreign affiliate's taxation year, complications could arise if the foreign affiliate and the corporation have different taxation year-ends, or where the corporation's investment in the foreign affiliate changes over time.

To illustrate, assume that in the structure shown in figure 2, the taxation years are December 31 for Canco and October 31 for Finco. Also assume that the structure is put in place on January 1, 2012 and that all the necessary requirements are met for Finco's recharacterized income to be included in its exempt surplus in respect of Canco.

19 Loans to USco may be considered to be held on income account if Finco is carrying on a lending business.

FIGURE 4 Application of Income Recharacterization Rules



In determining Canco's double-dip income for its 2012 taxation year, presumably Finco's recharacterized income earned in the calendar year, and not in Finco's 2012 taxation year, would be included. Otherwise there would be a mismatch of Finco's interest income and Canco's interest expense. However, this methodology assumes that Finco's interest income earned in the last two months of a calendar year would be included in its exempt surplus in respect of Canco in the following year. This may not be the case if Finco is disposed of to an arm's-length person in the following year before Finco's taxation year-end. In that situation, Canco's interest expense for the last two months of the year would be denied even though Canco would receive no corresponding benefit; that is, Canco would be unable to access Finco's exempt surplus by either making a subsection 93(1) election or having Finco make a so-called 90-day dividend payment to Canco before the disposition.[20]

One possible solution would be to include in Finco's recharacterized income only the amount that is or would be included in its exempt surplus in respect of Canco. However, Canco may not be able to make this determination by the time it is required to file its tax return.

Participating Percentage

Another issue with the formula for calculating double-dip income is that Canco's share of Finco's recharacterized income is assumed to be equal to Canco's participating percentage in respect of that income. For purposes of the ATHI, the participating percentage is to be determined in the same manner as under the FAPI rules.[21] However,

20 Regulation 5902(1).

21 Paragraph 5 of the technical description, Backgrounder, supra note 3.

it is not clear at what point Canco's participating percentage should be determined in respect of a particular taxation year.[22]

To illustrate, assume the facts in figure 2, as described above, and further assume that on November 1, 2012, Canco disposes of 20 percent of Finco to an arm's-length person and uses the proceeds to reduce its bank loan to Cdn $80 million.

Canco's participating percentage in Finco is 100 percent as at October 31, 2012, Finco's year-end, and 80 percent as at December 31, 2012, Canco's year-end. If the participating percentage for the purposes of computing Canco's double-dip income is determined as at Canco's year-end, only 80 percent of Finco's recharacterized income earned in Finco's 2012 taxation year will apply to reduce Canco's corresponding interest expense on the bank loan. This will result in an understatement of Canco's double-dip income, because 100 percent of the income will be included in Finco's exempt surplus in respect of Canco.

The two last examples show that, in drafting the legislation, it will be important to ensure that appropriate rules are put in place to properly match Canco's interest expense to Finco's interest income and exempt surplus.

SECTION 17 AND THE ATHI

Section 17 contains a complex set of rules that imputes income to Canadian corporations as a consequence of certain loans made to non-residents. Subsection 17(1) prevents corporations resident in Canada from avoiding Canadian tax by lending to non-resident persons at a low interest rate or no interest where the amount owing remains outstanding for more than a year. If subsection 17(1) applies, the corporation resident in Canada is required to include in its income imputed interest calculated on the amount of the loan. Originally, this section applied only to loans to non-residents by corporations resident in Canada. However, amendments made to section 17 in 1998 introduced a new version of subsection 17(2) that extended the application of section 17 to loans between non-residents.

If the non-residents are foreign affiliates of the Canadian corporation and there is a loan that is a specified debt, in principle, section 17 and the ATHI could both apply. However, as we shall see from the following example, as a result of the operation of section 17, together with a proposed amendment to paragraph 95(2)(a) introduced with the budget (and discussed below), it will probably be uncommon for the ATHI and the rules of section 17 to apply concurrently to the same specified debt.

For example, suppose that Canco makes a loan (loan 1) to a controlled foreign affiliate, Finco, and Finco uses the proceeds to make a loan (loan 2) to another controlled foreign affiliate, Opco. This financing structure is shown in figure 5. Depending on the circumstances, loan 2 could be a specified debt. However, the ATHI would apply only if interest income earned by Finco from loan 2 were eligible for recharacterization pursuant to paragraph 95(2)(a). If that were the case, loan 1 would be exempt

22 For FAPI purposes, pursuant to subsection 91(1), Canco's participating percentage is determined as at the year-end of Finco that ends in Canco's taxation year.

from the application of subsection 17(1) pursuant to paragraph 17(8)(a), because the conditions of clause 17(8)(a)(i)(B) or subparagraph 17(8)(a)(ii) would be met. Furthermore, loan 2 should be exempt from the application of the anti-avoidance rule in subsection 17(2) pursuant to paragraph 17(3)(a), because Finco and Opco are both controlled foreign affiliates of Canco. In the result, the ATHI and section 17 should not apply concurrently when the specified debt is between controlled foreign affiliates.

Alternatively, suppose that Canco contributes to the capital of Finco, and Finco uses the proceeds to make a loan to Opco, a related non-resident corporation that is not a foreign affiliate of Canco. This arrangement is shown in figure 6. None of the exceptions in subsection 17(3) would apply in this case; therefore, subsection 17(2) would be operative and, in principle, Canco would be subject to imputation under subsection 17(1). However, resolution 30 of the notice of ways and means motion tabled with the 2007 budget would preclude the interest income received by Finco from being recharacterized under paragraph 95(2)(a).[23] As a result, even if the loan from Finco to Opco were a specified debt, the ATHI could not apply because there would be no double-dip income. In this situation as well, section 17 and the ATHI would not apply concurrently.

Section 17 and the ATHI could both apply to a financing structure similar to that shown in figure 6 where Opco is a foreign affiliate of Canco in which Canco has a qualifying interest[24] but is not a controlled foreign affiliate. Interest income earned by Finco on the loan to Opco would be eligible for recharacterization under clause 95(2)(a)(ii)(B); accordingly, the ATHI could apply if that loan is a specified debt. If Opco is also related to Canco, section 17 would apply because the exemptions in subsection 17(3) would not be available.

The above anomalous situation is an example of the so-called related-party trap in section 17, an issue well known to tax practitioners.[25] Although taxpayers could be expected to structure their affairs to avoid this pitfall, it (or others like it) could occur inadvertently. Accordingly, the Department of Finance should consider incorporating a rule in the ATHI legislation to prevent double-counting where both a reduction of interest expense and an income imputation could arise in respect of the same specified debt.

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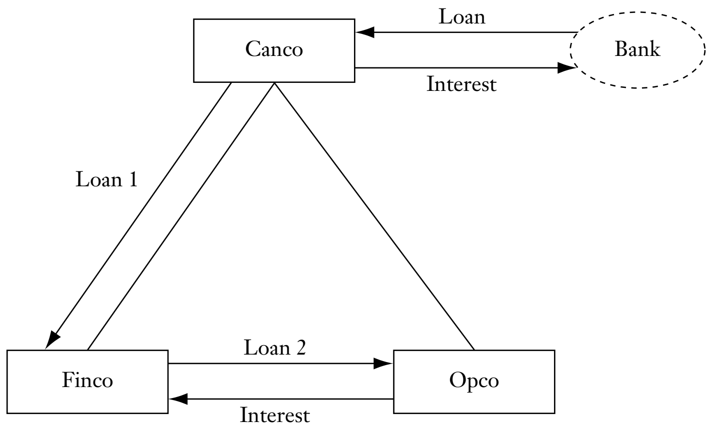
23 Pursuant to paragraph (b) of resolution 30, clause 95(2)(a)(ii)(A) is to be repealed effective for taxation years of foreign affiliates beginning after 2008. See Notice of Ways and Means Motion To Amend the Income Tax Act, 2007 Budget, supra note 1.

24 A qualifying interest in respect of a foreign affiliate is defined in paragraph 95(2)(m) and essentially requires that Canco have a direct or indirect interest in (1) 10 percent or more of the issued and outstanding shares of Opco that have full voting rights under all circumstances, and (2) shares of Opco having a fair market value of 10 percent or more of the fair market value of all the issued and outstanding shares of Opco.

25 See Evelyn P. Moskowitz, "Financing of Non-Residents and the Recent Amendments to Section 17," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 43:1-61, at 43:50-52.

FIGURE 5 Specified Debt: Exemption from Section 17



APPLICATION OF THE ATHI MECHANISM TO TOWER STRUCTURES, PARTNERSHIPS, AND OTHER OFFSHORE BORROWING ARRANGEMENTS

Tower Structures

Another financing structure specifically targeted by the ATHI is the use of hybrid entities, or so-called tower structures, to invest in related foreign subsidiaries. As explained in the Backgrounder,

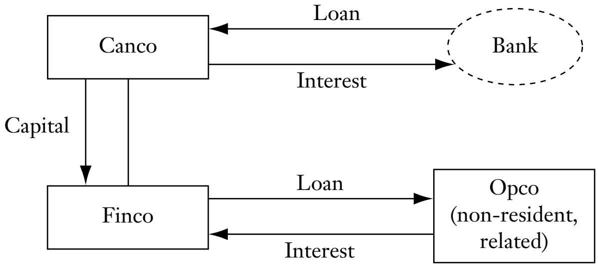
> [l]ike double dips, these are chains of holding entities that are used to reduce or eliminate tax on investments from one country into another. The distinctive aspect of a tower structure is its exploitation of hybrid entities. A hybrid entity is one that is treated differently under the tax systems of two or more countries.[26]

In particular, the tower financing structure illustrated in the ATHI employs related Canadian and US entities in order to benefit from mismatching tax treatment in the two countries. This type of structure has been described in detail in a previous article in this feature, as well as articles in other publications; readers should refer to those articles for a detailed description of the specific mechanics.[27] In brief, the tower

26 Backgrounder, supra note 3, under "International Taxation: The Canadian Experience."

27 See, in particular, Elizabeth J. Johnson and James R. Wilson, "Financing Foreign Affiliates: The Term Preferred Share Rules and Tower Structures," International Tax Planning feature (2006) vol. 54, no. 3 *Canadian Tax Journal* 726-61, at 729-30; and K.A. Siobhan Monaghan and Raj Juneja, "Selected Issues in Cross-Border Debt Financing," in *Report of Proceedings of the Fifty-Eighth Tax Conference*, 2006 Conference Report (Toronto: Canadian Tax Foundation, 2007), 16:1-70.

FIGURE 6 Specified Debt: Application of Section 17



structure uses a series of hybrid entities to characterize the income from foreign investment as interest for US tax purposes but as tax-free dividends for Canadian tax purposes. In the example shown in figure 7, the hybrid entities are a limited partnership, LP, which owns the shares of an unlimited liability company, ULC, which, in turn, owns the shares of a limited liability company, LLC.[28]

LP, formed under US law, is a corporation for US tax purposes and subject to tax in the United States, but a partnership for Canadian tax purposes. ULC is incorporated in Canada,[29] and is a disregarded entity for US tax purposes but a corporation for Canadian tax purposes. LLC is incorporated in the United States, and is also a disregarded entity for US tax purposes but a corporation for Canadian tax purposes.

LP borrows from an external lender (typically a US resident). From a Canadian tax perspective, LP relies on the loan meeting the conditions of subparagraph 212(1)(b)(vii) to exempt the interest paid by LP from Canadian withholding tax.

LP capitalizes ULC, which in turn capitalizes LLC, which onlends the funds to a foreign affiliate, FA, of the partners of LP. FA uses the funds in an active business. The interest received by LLC is recharacterized under clause 95(2)(a)(ii)(B) as income from an active business.[30] LLC pays exempt surplus dividends back to ULC, which then pays dividends to LP. LP uses the funds to pay interest on the external debt and allocates the interest expense and the dividend income to the partners, which deduct the dividends under section 112.

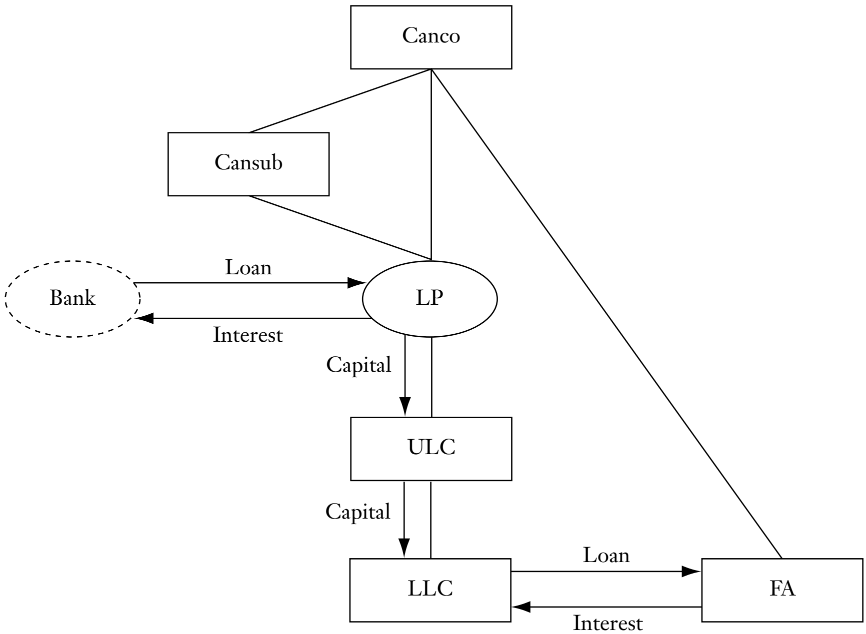
From a US tax perspective, LP, ULC, and LLC constitute a single US taxable entity, which receives interest income from FA but pays interest owing to the external lender. This single entity will be subject to US tax on the spread between the interest income and the interest paid. However, an interest deduction is available to the borrowing affiliate, FA, in respect of the loan from LLC.

28 The CRA considers the interests of ULC's members in LLC to be shares. See *Interpretation Bulletin* IT-392, "Meaning of the Term 'Share,'" September 26, 1977.

29 Specifically, in Alberta or Nova Scotia.

30 Using paragraph 95(2)(n) of the 2004 technical amendments to deem the borrowing foreign affiliate (FA) to be a foreign affiliate of ULC.

FIGURE 7 Example of a Tower Structure



From a Canadian tax perspective, the investors in the tower structure receive tax-free dividends paid from exempt surplus and are allocated a deduction for interest paid by LP on the external debt. The net result is a tax deduction for interest in the United States, another deduction in Canada, and a small amount of US tax on the interest spread.

Under the ATHI, the interest earned by LLC will be considered to be double-dip income in respect of ULC under the restricted interest formula, assuming that it is attributable to a specified debt. The debt owing to LLC is a specified debt if it is funded by a loan in respect of which interest is paid that is interest relating to an investment in a foreign affiliate. Interest relating to an investment in a foreign affiliate includes borrowed money used to acquire, directly or indirectly, a share of a foreign affiliate. Since the money borrowed by LP is used indirectly to acquire the LLC shares, the debt owing to LLC should be considered a specified debt.

However, the ATHI mechanism applies to restrict the deductibility of a corporation's interest expense relating to investments in foreign affiliates to the extent of the corporation's double-dip income. In this instance, the double-dip income is in respect of ULC while the interest expense relating to the investment in a foreign affiliate is in respect of the corporate partners, Canco and Cansub.

As discussed earlier, the ATHI mechanism includes a deeming rule to ensure that the double-dip income in respect of a related corporation (ULC) will reduce the interest expense on a debt of a particular corporation where the interest relates to an investment in a foreign affiliate.[31] Since the interest incurred by LP and allocated to the corporate partners would be considered interest relating to an investment in a foreign affiliate, the double-dip income in respect of ULC would reduce the interest expense incurred by LP.

Partnerships

Paragraphs 1 through 7 of the ATHI mechanism, discussed above, address tax avoidance in respect of a debt incurred by a corporation. Paragraph 8, the final provision, extends the application of these rules to a structure that employs a partnership to invest in a foreign affiliate. Specifically, it provides that, "where a non-resident corporation is considered to be a foreign affiliate of a partnership, the income of the partnership be determined in a manner consistent with the rules in paragraphs (1) to (7)."[32] Presumably, this rule would apply only where there is a borrowing by a partnership; otherwise, the requirement that income of a partnership be determined under the rules of paragraphs 1 to 7 would not be meaningful. Given this constraint, there are essentially only two structures that could be relevant: one where the members of the partnership are Canadian corporations and one where the members of the partnership are foreign affiliates.

The structure shown in figure 8 is an example of the first type. Assume that Partnership uses the proceeds of a bank loan to acquire shares of Finco, and Finco uses the funds to make a loan to FA. If the ATHI mechanism is to apply, the loan from Finco to FA must be a specified debt. As a result of resolution 30, referred to above, this will be possible only if FA is a foreign affiliate of Partnership in which Partnership has a qualifying interest.

The structure in figure 8 is similar to the example of a tower financing structure in figure 7. As in that example, the interest on the bank loan appears to be caught by the definition of interest relating to investments in foreign affiliates under the ATHI; in particular, the bank loan could be considered to be used to assist Partnership, with which Canco does not deal at arm's length, in acquiring shares of a foreign affiliate.[33]

However, for the ATHI to apply to limit the deductibility of interest, Canco must also have double-dip income in respect of Finco. It appears that this would not be possible without paragraph 8. As noted above, the ATHI mechanism defines double-dip income in respect of a corporation only, and Finco, although a foreign affiliate of Partnership, is not a foreign affiliate of Canco.[34]

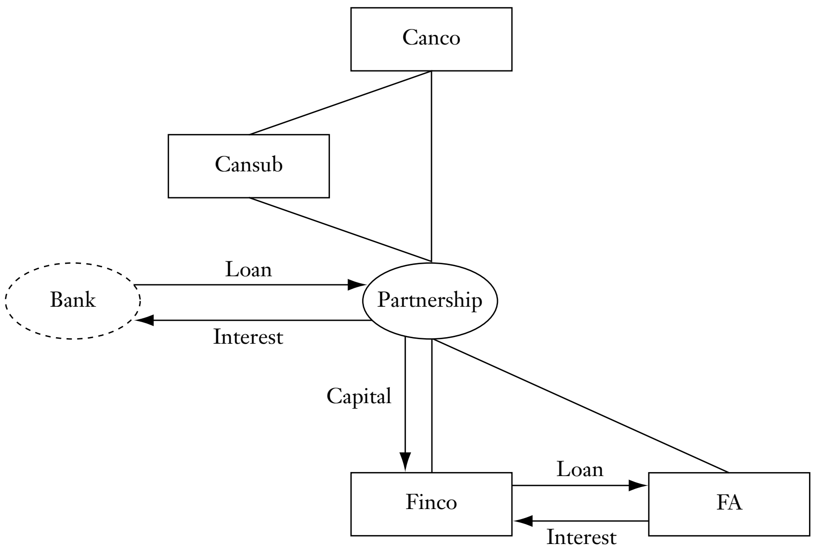
31 Paragraph 7 of the technical description, Backgrounder, supra note 3.

32 Paragraph 8 of the technical description, ibid.

33 See paragraph 2(a)(ii) of the technical description, ibid.

34 There is no indication in the Backgrounder that section 93.1 will be amended to apply for the purposes of the ATHI.

FIGURE 8 Borrowing by a Canadian Partnership



While little information is provided in the Backgrounder, it appears that paragraph 8 will bridge this gap in the rules, essentially by treating Partnership as if it were the corporation referred to in paragraphs 1 to 7.

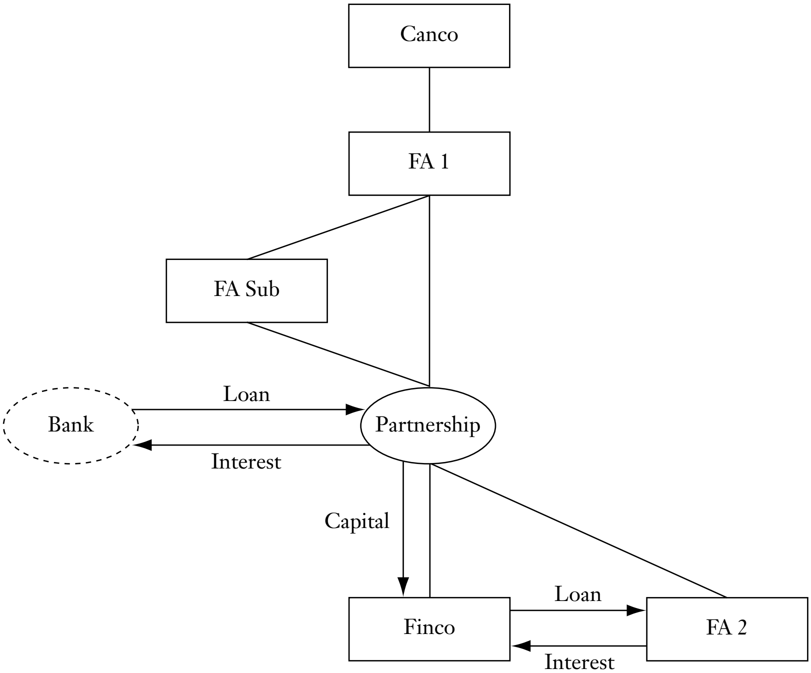
Figure 9 provides an example of the second type of partnership structure. It appears that paragraph 8 would apply to bring the ATHI provisions to bear. However, in this case, it is not clear what policy rationale would justify restricting Partnership's deduction for interest on the bank loan.

Offshore Borrowing Arrangements

It appears that a structure using a foreign affiliate to borrow and invest in another foreign affiliate could also be subject to the ATHI mechanism. For example, if Partnership in figure 9 were a corporation and a foreign affiliate, rather than a partnership, on the basis of the mechanism described in the Backgrounder, the interest on the borrowing could be interest relating to investment in foreign affiliates and be subject to the restricted interest deduction formula.[35] The application of the ATHI in this manner in an offshore context appears to be an unintended anomaly and should, we hope, be corrected in the draft legislation.

35 Pursuant to paragraph 95(2)(f.1), the income or loss of a foreign affiliate from property is to be computed as if the affiliate were a resident of Canada. One would normally not consider that a foreign affiliate itself can have foreign affiliates. However, the legislative drafter presumably thought otherwise and, accordingly, carved section 91 out of the application of paragraph 95(2)(f.1) in subparagraph (f.1)(ii).

FIGURE 9 Borrowing by a Foreign Partnership



CONCLUSION

The draft legislation to implement the ATHI rules is expected to be published sometime in 2007, and may be released before this article is published. Still, the above examples illustrate many issues that will need to be addressed in drafting the legislation. The examples show the many practical limitations and issues that arise as a result of the integration required between the ATHI mechanism and other rules in the Act, and in particular the foreign affiliate rules. The foreign affiliate rules are awaiting the final version of their own technical amendments, and the required integration with the ATHI will increase the complexity of that legislation. No doubt the long transition period proposed for the implementation of the new rules will be needed for further analysis and revisions.