Tax Notes
Banana Republic

By: David Louis, J.D., C.A., Tax Partner.
Minden Gross LLP, and a member of Meritas Law Firms Worldwide

*(*This release is based on an article published in Tax Notes, June 2005, Number 508, CCH Canadian Limited)*

Suppose I told you about a regime where new laws are announced only to a few and even then, only in generalities. Suppose this regime allowed only transactions specifically approved by the government, with little or no variations allowed.

A Central American banana republic? Or perhaps an oppressive former member of the Soviet Union? Nope. Astonished tax practitioners at last month's IFA seminar were confronted with a similar scenario, by virtue of presentations by senior government officials.

I'm writing as fast as I can

Like other attendees, I found myself feverishly scribbling notes on the surprise announcement of a series of substantial amendments to the foreign affiliate rules.**[1]** Sadly, I am reluctant to tell you a lot about what's in them because, quite frankly, I am not sure whether I got things right. And discussions with colleagues in attendance revealed that they were just as confused as I was.

The presentation began with a series of provisions with which practitioners who do not specialize in international tax may be only vaguely familiar.**[2]** However, other changes are more fundamental. Notably, there are to be substantial revisions to subsection 88(3), which governs distributions from foreign affiliates. Similar to domestic tax rules, there will be a deemed-dividend-in-excess-of-capital concept, for example, when shares of a controlled foreign affiliate are redeemed.

Also, there are to be major amendments to the foreign affiliate reorganization provisions. For example, in paragraph 95(2)(d.1) (foreign affiliate mergers), the 90% surplus entitlement percentage requirement is to be removed, as well as the requirement that there be no foreign tax imposed in respect of the merger. With respect to paragraph 95(2)(e.1) (foreign affiliate liquidations), the no-foreign-tax requirement is, likewise, to be removed.

Based on a recent discussion with a Department of Finance official, some of the amendments will be effective retrospectively to December 20th, 2002, while others will be effective on the "announcement date", which, notwithstanding the seminar, has not happened as yet. The Department of Finance official could not tell me when the details of the foregoing proposals would be released. (In addition, several changes to the October 2003 Notice of Ways and Means Motion pertaining to non-resident trusts and FIEs were announced, but for the most part, they are fairly minor.)

CRA panel shocker

If attendees were confused by this onslaught, it may be that they were still reeling from an earlier presentation – a Canada Revenue panel focusing on paragraph 95(6)(b). This is an anti-avoidance provision which has now come into the international tax spotlight as a result of recent reassessments. The provision itself is astonishingly broad. It provides, in part, that where a person acquires or disposes of shares (directly or indirectly), and it can be reasonably considered that the principal purpose of the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of Canadian income tax, the acquisition or disposition is deemed not to have taken place.

Taken to its extreme, there is no end of situations to which this avoidance rule can potentially apply. For example, the mere incorporation of a foreign branch could arguably trigger the provision, e.g., potentially denying deductions for exempt surplus dividends – i.e., because the shares are deemed not to exist! Happily, though, the CRA indicated that non-tax considerations would generally prevail in this situation.

But a much less cheerful view was expressed in respect of so-called “mixer” holding companies, which have long been used to maximize exempt surplus distributions, for example, where some lower-tier affiliates operate in non-treaty countries.**[3]** The presentation then turned to financing structures (e.g., “double-dips” and “towers”). To me, the thrust of the presentation appeared to be that, if the CRA had specifically accepted such a transaction, things would be ok. However, it appears that the CRA’s tolerance to variations (such as the assumption of a foreign operating company’s debt by a Canco in a double-dip structure) is quite limited.

In short, with its broad take on paragraph 95(2)(b), the government effectively lobbed a broadside at international tax planners, a move which was amply reflected by the silence in the audience. I can only imagine the consternation of my colleagues in King and Bay office towers (just a hundred yards or so south of my office) as they anxiously check their tax opinions as to whether they covered-off the possibility of a paragraph 95(6)(b) reassessment.

As I said, the problem stems from yet another overly-broadly drafted provision. For those who read my articles, this is a familiar tune.**[4]** But perhaps out of fear of wrath from Finance’s tax policy deities, one that few others seem willing to sing.

---

[1]These will presumably find their way into the next round of revisions of the December 20, 2002 “technical bill”, last revised on February 27th, 2004.

[2] I am probably out of my mind to try this, but here goes. Some, but not all, of the provisions that were discussed include: paragraph 88(1)(d.4) (this is a bump mechanism re foreign affiliates; the bump would be reduced by pre-acquisition surplus); subsections 92(1.2) *et seq.* (adjustments to adjusted cost base of foreign affiliate shares where a subsection 93(1) election is made); subsections 93(2)-(2.3) (clarification re embedded foreign exchange losses in respect of foreign affiliate shares); paragraphs 95(2)(u) to (x) (“look-through rules” for corporations, partnerships and trusts; one change is to prevent double counting); subparagraph 95(2)(a)(vi) (to pick up hedge transactions re liabilities, with similar changes in respect of excluded property); subsection 93(1) elections and Regulation 5905 adjustments (changes are to be made in respect of reductions of group surplus, giving the ability to “pick a smaller group” where gains are less than consolidated net surplus); clause 95(2)(a)(ii)(D) and Regulation 5907(2.8)(taxable surplus grinds). For corrections to the foregoing, stay tuned to upcoming articles.

[3] The CRA indicated that paragraph 95(6)(b) may apply even if the foreign holdco was established to reduce foreign withholding tax.

[4] See, for example, “Buckaroo Bureaucracy”, in last month’s *Tax Notes*; “Still More Overkill”, *Tax Notes* No. 503, December 2004; “Stealth and Edict”, *Tax Notes* No. 468, January 2002.