

ENACTMENT OF 2011 BUDGET BILL AND OUTSTANDING LEGISLATIVE PROPOSALS

Bill C-13, which contains the 2011 federal budget measures, became law on December 15, 2011. The most significant corporate tax measure enacted as part of Bill C-13 is the elimination of the deferral of tax on partnership income allocated to corporate partners with significant partnership interests discussed below.

2011 saw the release of a number of legislative proposals. The March 2011 proposed amendments, released in response to certain court decisions, include an amendment imposing Canadian non-resident withholding tax on interest paid to an arm's-length non-resident in respect of a debt or other obligation to pay an amount to a person with whom the payer does not deal at arm's length. Proposed amendments were announced in July 2011 to address certain structures involving stapled securities perceived to frustrate the policy objectives of the Specified Investment Flow-Through (SIFT) rules. The October 31, 2011 technical amendments include amendments to the shareholder benefit rules and, in response to certain Department of Finance comfort letters, the rule that deems non-residents not to be carrying on business in Canada solely because of provision of certain services by a Canadian service provider.

The significant package of proposed amendments to the rules governing foreign affiliates of Canadian taxpayers released on August 19, 2011 (the 2011 FA Proposals) include certain long-awaited rules governing acquisitions, dispositions and reorganizations of foreign affiliates, as well as more surprising changes, such as the introduction of the new "hybrid surplus" regime to encompass a foreign affiliate's gains and losses from the disposition of other foreign affiliate shares, new rules to simplify the characterization of distributions from foreign affiliates, and the new upstream loan rules discussed below.

A large number of proposed amendments announced prior to 2011 have not yet been introduced into Parliament. These include the changes to the rules governing non-resident trusts and offshore investment funds, the proposed rules targeting "foreign tax credit generator" schemes, certain technical amendments to the foreign affiliate rules first released in 2009 and updated in 2010, the largely relieving December 2010 amendments to rules concerning real estate

investment trusts, and numerous previously announced technical amendments. It is likely that 2012 will see many of the outstanding proposed amendments enacted into law.

PARTNERSHIPS – THE DEFERRAL IS GONE

Until the 2011 federal budget, a corporation reported income from a partnership's fiscal period ending in the corporation's taxation year. A popular planning technique was to have the taxation year of the corporate partner end shortly before end of the fiscal period of the partnership. In this way, the corporate partner enjoyed an ongoing deferral of partnership income for up to one year. This deferral ended with the enactment of Bill C-13. Beginning with corporate taxation years ending after March 22, 2011, and subject to the stub period relief described below, a 10 per cent or greater corporate partner will be required to accrue an amount of income for a partnership's fiscal period that begins in the corporation's taxation year but ends after the taxation year.

As a result of including the stub period amount in income, corporate partners may have more than 12 months of partnership income included in their first taxation year that ends after March 22, 2011. Transitional relief is provided to exclude the stub period amount from the income of that first taxation year and to bring it into income over the following five calendar years.

A partnership of corporations will have a one-time right to change its fiscal year-end to another date subject to meeting certain conditions. Such a change could avoid the need to deal with ongoing stub-period accruals. Special rules will be provided for multi-tiered partnership arrangements and for participants in joint ventures that have reported income on a fiscal-period basis. These special rules are intricate and can give rise to additional income for partners or participants in such arrangements as well as the ability to claim transitional relief for such additional income.

UPSTREAM LOANS FROM FOREIGN AFFILIATES

Prior to the 2011 Foreign Affiliate (FA) Proposals, a relatively common strategy for foreign affiliates of Canadian taxpayers to repatriate funds to Canada was by lending the funds to the Canadian parent. Where the funds were sourced from a foreign affiliate's taxable surplus, such strategy enabled the Canadian taxpayer to defer the Canadian tax that would otherwise apply to the receipt of a taxable surplus dividend.

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Generally, when a foreign affiliate pays a dividend out of taxable surplus to its Canadian corporate parent, such dividend, net of a deduction relating to underlying foreign taxes, is included in income for tax purposes of the Canadian corporation. This strategy had previously been accepted by the Canada Revenue Agency.

In what can be seen as a change in tax policy, the 2011 FA Proposals contain new anti-avoidance rules designed to prevent a taxpayer's foreign affiliate from making loans of taxable surplus to avoid what would otherwise be income inclusions that are not fully offset by deductions for underlying foreign tax. However, the scope of the new rules is much broader and they could apply to loans made by a foreign affiliate to any foreign or domestic borrower not dealing at arm's length with the taxpayer even where made for other bona fide business purposes, such as, to redeploy excess cash to other members of a related group. In addition, the new rules contain a number of anomalies that will hopefully be addressed in subsequent drafts.

The new rules will not only affect loans made or indebtedness created on or after August 19, 2011, but will also affect loans and indebtedness currently outstanding. Where the new rules apply to an upstream loan, a percentage of the amount of the loan (generally based on the Canadian taxpayer's percentage interest in the foreign affiliate) must be included in the income of the Canadian taxpayer, even where the actual borrower is not the taxpayer, unless one of three exceptions applies. A deduction for the income inclusion will be available when the loan is repaid. The exception most likely to be relied on requires that the loan be repaid within two years. Loans that were outstanding on August 19, 2011, are deemed to have been made on that date so that they have the benefit of the two-year repayment window. The unwinding of existing loans to comply with the new rules will require careful planning to avoid negative tax implications.

NEW LIFE FOR INCOME TRUSTS?

2011 saw the emergence of variations of income funds that avoid the SIFT rules that tax income from non-portfolio property. Non-portfolio property is property used in a business carried on in Canada or Canadian real, immovable or resource property. Before the SIFT rules, income funds avoided taxation by making tax deductible distributions of income, in the case of funds that were trusts, or by being formed as partnerships which allocated income to their members.

The first variation is represented by Eagle Energy Trust and Parallel Energy Trust. Both trusts carry on a U.S.-domiciled energy business only. Neither trust is a SIFT because neither

carries on a Canadian business nor owns any Canadian real, immovable or resource properties and so has no non-portfolio property. As a result, the income earned by the trust is not subject to the SIFT tax and can be distributed on a tax deductible basis. The level of U.S. tax applicable to the trust's income can be minimized using depreciation and depletion deductions as well as interest expense on debt that is within the structure. Gains arising on the sales of units should not be subject to U.S. tax.

An example of the second variation arose on the reorganization of Brookfield Renewable Power Income Fund into a Bermuda limited partnership that is not a "Canadian resident partnership." A partnership is a SIFT and is subject to the SIFT tax if it is a "Canadian resident partnership." This would be the case if (a) the partnership would be resident in Canada if it were a corporation or (b) it has its central management and control in Canada. The partnership resulting from the reorganization is not expected to be a Canadian resident partnership. A difference between this variation and the first is that the second does not require that the property of the partnership not be non-portfolio property. There are Canadian withholding tax issues associated with this structure that should be manageable. If more than 50 per cent of the fair market value of the partnership is attributable to Canadian real, immovable or resource properties then gains arising on the sale of units by non-residents may be subject to Canadian tax.

LOOKING AHEAD

Two potential areas of policy change merit monitoring in 2012 and beyond. Canada is one of a small number of OECD countries without any formal system for corporate group loss transfer or consolidated reporting. Since its release of the consultation paper on the taxation of corporate groups in November 2010, the federal government has received a number of submissions and is in the process of reviewing the submissions as well as consulting with the provincial governments. Obtaining support from the provincial governments is crucial but may well prove difficult. In 2008, the Advisory Panel on Canada's System of International Taxation recommended fundamental changes to Canada's international taxation system, including the exemption system for foreign source business income earned by foreign affiliates. The 2011 FA Proposals did not include the Panel's recommendations, but the government indicated that it remains committed to its review and analysis of all of the Panel's recommendations and consideration of further legislative amendments.