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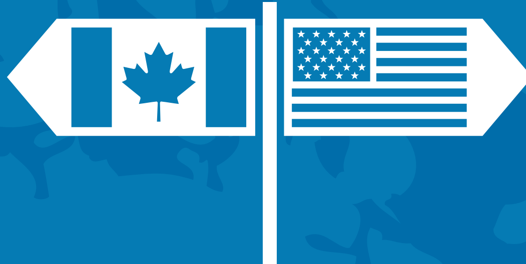
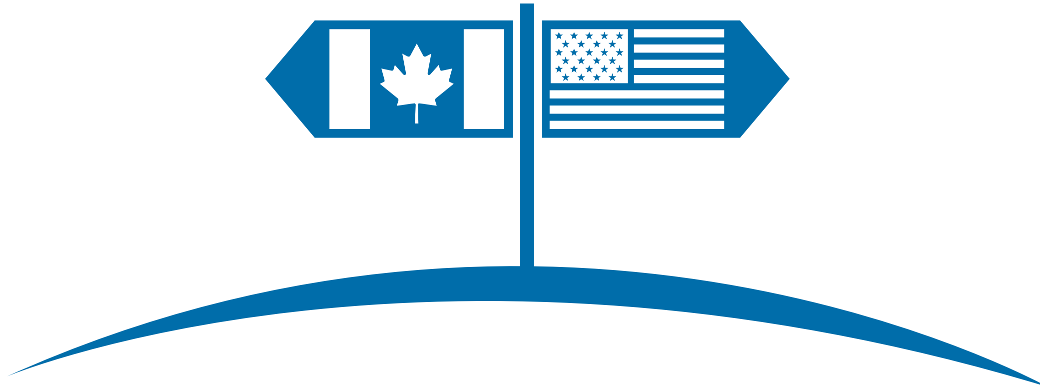


TAX HORIZONS

Torys explores the latest developments
in cross-border tax



OVERVIEW

Tax Horizons brings together our team's take on the latest developments, pitfalls to avoid and new opportunities for business that crosses borders. Some of the issues we cover in our inaugural installment include the changing state of transfer pricing in light of new BEPS rules, considerations for foreign issuers looking to raise capital in the U.S., and new approaches to cross-border income funds. Several of our authors explore various aspects of cross-border real estate investment, from REITs to mezzanine financing to fund development. This year's publication also features an analysis of how recent case law and other developments are affecting interest deductibility and hedging matters.

To discuss any of the issues in the report, please contact the authors.

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HITTING THE MARK IN U.S. REAL ESTATE AS A FOREIGN INVESTOR

Scott Semer

United States real estate continues to be an attractive target for foreign investors seeking exposure to this asset class. However, due to U.S. FIRPTA rules (i.e., the Foreign Investment in U.S. Real Property Tax Act), tax structuring considerations often make the difference between a potential investment making financial sense or missing the mark.

REITs and Foreign Investment

A U.S. real estate investment trust (REIT) is one the most tax-efficient vehicles for these investments because a REIT that distributes all of its current operating income pays no tax at the entity level, and insulates a foreign investor from having to file a U.S. tax return with respect to this distributed income. Shares of a domestically controlled REIT are also exempt from FIRPTA tax on exit, provided the exit transaction is structured as a sale of REIT shares.

Creative approaches can allow investors to use REITs across a diverse range of property classes.

For foreign pension plans organized in a jurisdiction that has a beneficial tax treaty with the U.S., or which qualify as foreign "governmental" investors, distributions of operating income can be wholly exempt from U.S. tax, provided the investor owns less than 50 percent of the REIT. Gains realized from a sale of shares of a REIT that a foreign governmental investor does not control are also exempt form FIRPTA tax even if the REIT is not domestically controlled.

Innovative Structuring

We have helped develop several innovative structures in recent years that allow for investing through REITs in a diverse range of properties, from hotels, multi-family residential, long-term housing, office, industrial and similar property, to healthcare properties and farmland. Several recent deals have used multiple REITs and parallel structures to own entire ground-up developments that feature a variety of uses, including uses that are not REIT-compliant, such as condominium developments, that are held in parallel tax vehicles. These structures have included features that allow delaying a final decision on the exact mix of components between REIT-eligible assets and non-eligible assets (primarily condominiums) until construction is underway.

Other innovations include structures that allow non-U.S. governmental investors to get a preferred return during an initial development phase and tax-efficiently convert to a non-controlled structure after the property is stabilized, as well as structures that allow exposure to assets owned by a U.S. investor seeking to defer the current realization of gain.

REITs can also be used to invest in newly originated loans without causing foreign investors to be considered to be engaged in a U.S. trade or business.

Conclusion

The ability to work within the rules to achieve a large variety of objectives continues to make REITs one of the most flexible avenues for a foreign investor to tax-efficiently structure a diverse range of investments in U.S. real estate.

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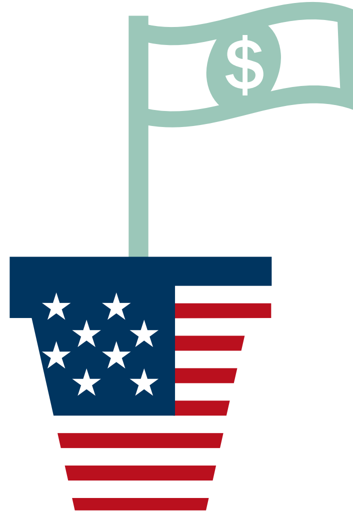
Scott advises pension plans and sovereign wealth funds on investments in the United States and around the world. Scott has extensive experience advising pension plans and non-U.S. investors in connection with negotiating and structuring various joint ventures and investments through private REITs in commercial, residential and industrial U.S. real estate portfolios.



PASSIVE FOREIGN INVESTMENT COMPANY CONSIDERATIONS FOR FOREIGN ISSUERS

David Mattingly, Jonathan Weinblatt

The U.S. markets remain a favored destination for foreign (non-U.S.) companies seeking capital. Complying with rigorous U.S. securities laws is a given. Less expected, however, is what may be an issuer's first encounter with the unusual U.S. tax regime for "passive foreign investment companies"—the so-called PFIC rules.

Purpose of the Regime

The PFIC rules aim to prevent U.S. investors from deferring tax by holding passive investment assets through a foreign corporation. If a U.S. investor owns shares of a PFIC, then gain upon the sale of the PFIC shares generally is taxed as ordinary income, increased by an interest charge. The low capital gains rates enjoyed by non-corporate U.S. investors generally do not apply to shareholders of a PFIC. Nor are dividends paid by the PFIC eligible for lower "qualified dividend" tax rates.

Because U.S. taxable investors generally balk at the prospect of investing in a PFIC, few foreign issuers can afford to ignore the possibility of becoming a PFIC.

Few foreign issuers engaged in an active business expect to be PFICs. The status arises only if a foreign corporation's passive income or assets equal or exceed certain high thresholds—75 percent and 50 percent, respectively. Nonetheless, the presence of large amounts of cash on a balance sheet, even working capital, can cause an issuer to be a PFIC. In some cases, the corporate structure itself causes an issuer to be a PFIC, particularly when the issuer holds non-controlling interests in other corporations. The risk is especially high for startups with little or no active income.

Because the PFIC regime only targets abuse by U.S. taxpayers, there are no adverse U.S. tax consequences to a foreign company itself becoming a PFIC. Nor are there adverse U.S. tax consequences to its foreign shareholders. For most foreign issuers, the PFIC concern first emerges from the plan to list in the United States.

PFIC Status Thresholds

Ways to Mitigate Risk

Because U.S. investors generally balk at the prospect of investing in a PFIC, few foreign issuers can afford to ignore the possibility of becoming a PFIC, and nearly all foreign issuers must address the PFIC risk in U.S. public filings.

Fortunately, several strategies may reduce or eliminate this risk, depending on the circumstances. For example, some foreign issuers take advantage of the U.S. "check the box" system of tax classification to elect to be classified as partnerships. An entity classified as a partnership for U.S. tax purposes cannot be a PFIC. Thus the check-the-box election, if permitted, can eliminate the PFIC risk. Foreign issuers with meaningful U.S. assets may take another approach to risk reduction. By making small changes in the corporate structure, it may be possible to cause all U.S. assets and income to be "active" and thus favorably viewed for purposes of the relevant tests. These and other minor changes may dramatically affect the potential for a foreign company to be a PFIC.

If PFIC status cannot be prevented, a company can still take steps to mitigate, if not eliminate, the adverse tax consequences for its U.S. shareholders. For example, some PFICs provide "qualified electing fund" information to their U.S. shareholders. This allows a U.S. shareholder to include in annual income a pro rata share of the PFIC's undistributed "ordinary earnings" and "net capital gain." By paying tax on such earnings before they are distributed, a U.S. shareholder avoids the otherwise adverse consequences described earlier when selling PFIC shares or receiving PFIC distributions.

Foreign issuers must plan carefully to avoid the "once a PFIC, always a PFIC" rule.

Traps for the Unwary

The PFIC regime is replete with traps for the unwary. For example, a new vehicle created and funded with a small amount of cash too soon before going public can create an "inadvertent" PFIC. Even if the company's active assets and income later provide comfortable margins under the 50 percent and 75 percent tests, the company can remain a PFIC with respect to initial U.S. investors under the "once a PFIC, always a PFIC" rule. This rule also has the strange result of causing some companies to be PFICs with respect to some U.S. shareholders but not others.

Conclusion

A company's PFIC status meaningfully affects its reception among U.S. investors. A foreign issuer that pays early attention to PFIC matters stands to substantially boost the chances of a successful offering.

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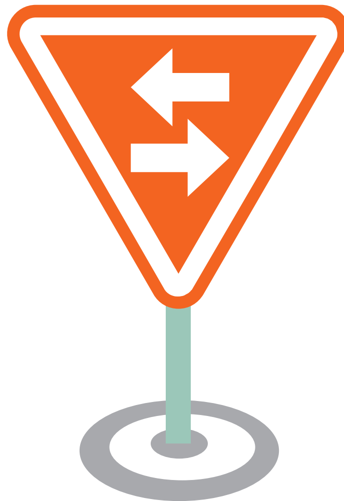

ISSUES IN CROSS-BORDER INCOME FUNDS AND REITS

Corrado Cardarelli

Torys has a long history and considerable experience with cross-border income funds and REITs, having been involved in the development of the first of the modern cross-border business income funds in 2002, as well as in the development shortly thereafter of the analogous "stapled" structures which did away with the income fund (in the case of both U.S. issuers in the U.S. market as well as in the cross-border context).

The cross-border income fund structure involves a Canadian public mutual fund trust that acquires a U.S. entity. The acquisition is structured so that the Canadian income fund normally holds both subordinated debt of and an equity interest in the U.S. entity. For Canadian income tax purposes, the mutual fund trust is not subject to entity-level tax in Canada, whereas the U.S. entity will be subject to taxation in the United States. In addition to the normal expenses and deductions that the U.S. entity may have available to it, the subordinated debt in the structure provides for an interest deduction for U.S. tax purposes, subject to certain rules.

U.S. Considerations

There are four main considerations that the cross-border income fund structure must deal with for U.S. tax purposes. The first is whether a particular debt instrument should be treated as debt or as equity. There are a number of factors that must be considered in making this determination, including that the debt must be on arm's length or market terms. The second relates to the U.S. "earnings stripping" rules, which are the U.S. analogue of the "thin capital" rules in the Canadian tax system.

While not intentionally designed with cross-border income funds in mind, inversion rules present a formidable structuring challenge.

These rules limit the overall annual interest deductions that the U.S. entity may claim in circumstances where debt is owed to a related non-U.S. person. The third consideration relates to U.S. withholding tax on the interest paid across the border to the Canadian income fund. In the past, avoiding withholding tax required reliance on the U.S. "portfolio interest exemption," but amendments to the Canada/U.S. tax treaty caused interest to be generally exempt from withholding tax even if paid to a related person.

Inversions

The fourth and most challenging consideration in cross-border income funds relates to the U.S. "inversion" rules. While not intentionally designed with cross-border income funds in mind, these rules present the biggest structuring challenge. If the U.S. entity were acquired 100% by the income fund for cash at the outset then the inversion rules would not apply. There are a number of commercial reasons, however, why this is often not possible. The former shareholders of the U.S. entity will often end up retaining an interest, typically directly in the U.S. entity. Difficulties arise where the income fund acquires a substantial interest in the U.S. entity but the former shareholders of the U.S. entity retain an interest of over 80% in the U.S. entity, either directly or indirectly.

That situation can occur not only where the former shareholders receive units of the income fund, but also where the former shareholders have an interest in the U.S. entity that is "exchangeable" for units of the income fund or that may otherwise be considered to be an interest that is economically equivalent to units of the income fund. It is important to note that, in determining the 80% threshold, there are rules that disregard units issued in connection with a public offering so that the threshold is easier to go over than it might at first appear.

Recent Cross-Border Developments

In the years that have passed since the first of the cross-border business income funds there have been a number of developments on the Canadian and U.S. income tax fronts that simplified tax planning and structuring. In particular, in the Canadian tax system, certain rules relating to "qualified investments" for tax deferred plans were eliminated, making it easier to make a "direct" investment in the securities of the U.S. entity. Furthermore, the Canada/U.S. treaty was amended to essentially eliminate withholding tax on interest, which also simplified various planning and structuring elements. These two changes are reflected in the more streamlined structures that emerged from 2010 onward.

The seemingly adverse development of Canada's "SIFT" rules has not, on its own, had a significant impact on cross-border income funds. The SIFT rules impose an entity-level tax on publicly listed and traded trusts (and partnerships) that is intended to replicate the federal and provincial tax applicable to a Canadian corporation. However, the SIFT rules generally do not apply to an entity that carries on business or owns assets only outside of Canada. While this means that an income fund may acquire a U.S. entity that carries on business or owns assets exclusively in the United States (or outside of Canada), it does create difficulties where the entity may also carry on business or own assets in Canada. As a result, a number of recent income fund IPOs have involved income funds that own interests in exclusively foreign rental properties (outside of Canada and outside of the United States).

The consequence of the income fund being subject to the inversion rules is that the income fund is considered to be a U.S. corporation for U.S. tax purposes. This is problematic in the context of a yield vehicle in the Canadian market since it means that the U.S. entity will have to withhold in accordance with U.S. tax rules on distributions paid to Canadian unitholders. A Canadian unitholder should be entitled to a foreign tax credit in computing its Canadian tax liability for any such U.S. withholding tax. However, the income fund would be subject to U.S. tax on its worldwide income (in the same way as an actual U.S. corporation), which could include the interest income in respect of any subordinated debt it may hold of the U.S. entity.

Addressing Inversion Rules

There is an exception from the inversion rules where the income fund meets the test of having "substantial business activities" in Canada. This test requires more than 25% of the assets, employees and income of the overall enterprise to be located in or derived from Canada. This test is not easy to rely on for cross-border business income trusts since a trust that has "substantial business activities" in Canada would most likely be subject to the SIFT rules on the Canadian tax side.

Some are choosing to take the approach of "embracing" inversion rules, treating the Canadian income fund as a U.S. corporation.

There is, however, another exception to the SIFT rules where the income fund qualifies as a real estate investment trust (REIT) for Canadian tax purposes. Consequently, in the real estate space, it is possible to combine (a) the REIT exception from the SIFT rules for Canadian activities, and (b) the "substantial business activities" exemption from the U.S. inversion rules. This has been done for several recent IPOs involving Canadian REIT vehicles that have rental properties in both the United States and Canada in circumstances where the former U.S. shareholders of the U.S. enterprise continued to have an interest in the U.S. enterprise (i.e., in an "UPREIT" structure involving securities that are "exchangeable" for units of the REIT).

Another approach to the inversion rules in the REIT context is to "embrace inversion." In this case, the Canadian income fund acquires an interest in U.S. rental properties and is "inverted" by design, which means that it is treated as a U.S. corporation for U.S. tax purposes. This allows the Canadian income fund to elect to be treated as a U.S. REIT for U.S. tax purposes. Because it is regarded as a U.S. REIT, the income fund is not subject to U.S. taxation if it distributes essentially all of its earnings to unitholders.

If "embracing" inversion, the income fund will be required to withhold U.S. tax on distributions paid to Canadian unitholders, but it will be able to designate its foreign source earnings (from the U.S. rental properties) to the unitholders so that the

unitholders will be considered to have earned the foreign source income and this will entitle the unitholders to a foreign tax credit for such U.S. withholding tax in computing their Canadian tax liability. As mentioned, the income fund will not be subject to the SIFT rules, primarily because all of the rental properties are located outside of Canada. This kind of planning has been done for several recent IPOs involving Canadian REIT vehicles that have rental properties only in the United States.

Accordingly, notwithstanding the challenges posed by the U.S. inversion rules, there are various structures that may be used in the right circumstances involving cross-border income funds, particularly in the REIT context. It may also be possible to avoid the inversion rules by designing the securities held by the former shareholders of the U.S. entity such that they are not “economically equivalent” to the units of the income fund. It will be interesting to see how approaches to structuring cross-border income funds will evolve in concert with changing rules and dynamics.

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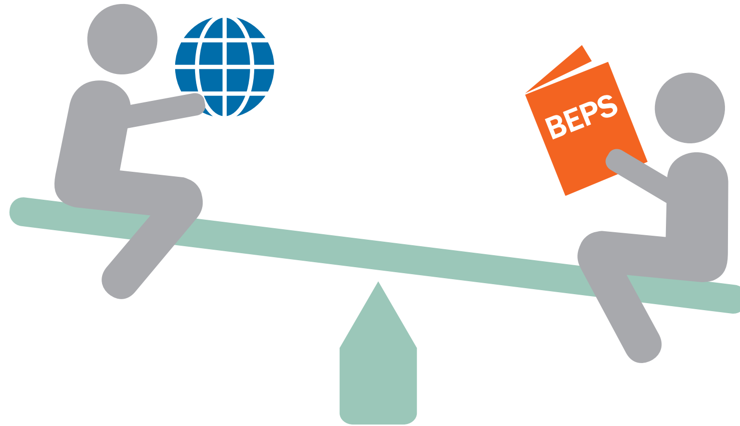

BEPS WILL INCREASE TRANSFER PRICE SCRUTINY

John Tobin

Tax authorities around the globe remain focussed on profit allocation issues. Under the political banner that each corporation should pay "its fair share" of corporate tax, the final reports from the OECD Base Erosion and Profit Shifting (BEPS) working groups that were released in October[1] call for "bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created."[2] The G20 leaders recently endorsed the BEPS Reports and urged timely implementation in all jurisdictions.

The BEPS TP Reports call for changes to domestic law and to treaty provisions and for the negotiation of a multilateral instrument to be finalized in 2016. More immediately, the BEPS TP Reports introduce changes to the OECD Transfer Pricing Guidelines. Canada generally follows the OECD Transfer Pricing Guidelines, and since Canada has been a leading participant in the BEPS project, we anticipate that the CRA will adopt the new guidelines.

Change has arrived, and taxpayers will now need to evaluate their current compliance, adapt to new rules and be ready for additional implementation issues.

Effects of BEPS

Despite the apparent consensus in the BEPS Reports, each country's view of "fair share" will be different. Paying a "fair share" is a difficult concept in a "rule of law" tax system like Canada whose courts have eschewed "substance over form" in their decisions. Yet transfer pricing is inherently about assessing the relative contributions of local legal entities in a global value chain where increasingly global branding and intellectual property substantially contribute. The BEPS TP Reports call for a portion of an organization's global profit to be taxed in jurisdictions in which profit arises (i.e., within the market in which the sale is made) or where contributions are made (i.e., the location of labour, intellectual property or capital) as manifested in risk and the ability to control risk. The BEPS Reports have been criticized for their emphasis on "people" contributions over "capital" contributions and for potentially inappropriately skewing residual returns to "people" functions. While the starting place for review remains the contractual relations between the parties, the BEPS TP Reports call for both greater scrutiny of the conduct of the parties and an analysis of risk and control over risk in determining contribution. Taxpayers will be required to maintain an analysis of the "economically relevant characteristics" of the actual transactions in their local transfer pricing file.

Transfer pricing scrutiny will intensify. Global tax authorities, including, in particular, the CRA, have invested considerable resources in audit infrastructure over the past 10 years and these organizations will continue to audit and propose adjustments. There is a political will to be seen to be assessing tax against multinationals. Adjustments are seen as easy pickings. Almost every audit is going to lead to some adjustment–the rules are too imprecise to be able to predict outcomes with certainty. There are a significant number of ongoing Canadian transfer pricing audits that are slowly grinding through the Competent Authority process and others that are making

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[1] Final Reports of the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Action Plans 1 to 15 released October 5, 2015.

[2] OECD/G20 BEPS Project; "Aligning Transfer Pricing Outcomes with Value Creation," Actions 8-10 Final Reports (BEPS TP Reports).

their way into the courts. Appropriate, timely and fair dispute resolution will continue to be a challenge.

Disputes will be inevitable. Despite the clear statements from the Supreme Court of Canada in *Canada v. GlaxoSmithKline*[3] that as long as pricing is within the range of observed comparables, the pricing will be considered to meet the arm's length standard, in practice, disputes will arise over the selection of methods, the identification of the comparables, the adjustments to be made to comparables and whether (and to what extent) the surrounding facts and circumstances need to be taken into account to derive appropriate pricing. All of this will be analyzed by a government auditor usually with little industry experience and in reliance upon position papers crafted by CRA economists. The BEPS TP Reports will further increase reliance on economic analysis.

Almost every audit is going to lead to some adjustment–the rules are too imprecise to be able to predict outcomes with certainty.

The recent BEPS TP Reports will add additional complexity and confusion and which has a negative implication for multinationals through additional exposure upon audit. The BEPS Reports promulgate a risk approach to pricing largely to combat transfer pricing for global products where brand name is important, where multiple teams contribute and where failures are part of the development process. Under that approach, pricing is based on what risks exist and which entity is in the best position to address the risk (i.e., mitigate it, avoid it or absorb it). Data supporting this approach likely do not exist currently, and that rubric will allow multiple approaches from the CRA, leading to increased risk of adjustment. As this risk approach militates toward people functions, it is likely to result in significant interviews of functional staff, and will require greater tracking of people data.

The result will be an increased workload on tax managers in multinational organizations first in compliance and second in defense of the inevitable audits and tax assessments from tax authorities both at home and abroad who seek to collect additional tax. A transfer pricing audit from the CRA will be one of the most expensive and most arduous processes a multinational in Canada will face.

Experience in Canada suggests that resolving transfer pricing issues will be long and difficult. Companies that have outstanding assessments will need to be able to address the implications of a long process. Once an assessment is issued, a large corporation must pay 50% of the tax assessed and file a notice of objection to continue to dispute the assessment regardless of whether dispute follows the Competent

[3] 2012 SCC 3.

Authority or court process. This has an immediate effect on cash flow. It also creates disclosure issues for public companies. We increasingly see transfer pricing as a significant issue in due diligence in corporate finance and M&A transactions. Finally, the pace of change within organizations will affect the ability to contest an assessment. People change, memories fade, and business units are restructured. By the time staff are interviewed they are more focussed on what they do now than able to remember long ago strategies.

Be Prepared: Audit Planning

Good advocacy is key to achieving optimal transfer pricing outcomes. Like any dispute resolution method, "prepare, prepare, prepare." Below are considerations to keep in mind both in advance of and in response to an audit.

Have a plan

At the beginning of an audit, a detailed strategic plan will help address potential issues, including marshalling of documents, and planning for site visits, presentations and submissions.

Paperwork

Review your documents (legal contracts) and analysis (transfer pricing reviews, comparables and transfer pricing studies) on an ongoing regular basis. Prepare your staff to be interviewed, know what they will say and how they will say it. Prepare your files for audit; protect privilege.

Be consistent

Know how affiliates in other countries are addressing issues in their new country-by-country reporting.

Know your deadlines

Treaties have different coming-into-force provisions, and foreign law may not be as clear as to when notices have to be given.

Options

Consider possible approaches—lobbying, audit submissions, court challenges, Competent Authority, advance pricing agreements, and multijurisdictional simultaneous audit and other multijurisdictional resolution.

Transfer pricing remains at its heart an allocation methodology. Its goal, from a government perspective, is to deliver on corporate tax revenues. This inherently raises double taxation issues and so the domestic audit in many cases quickly leads to Competent Authority processes bilaterally and increasingly to multilateral dispute resolution. This allocation aspect and the use of Competent Authority process takes the audit away from the domestic court process and away from the potential for a principles-based resolution. The nature of negotiation between government tax authorities is more likely to result in compromise than principled outcomes leading to less predictable outcomes.

We are increasingly seeing transfer pricing loom larger in due diligence in corporate finance and M&A transactions.

We expect the scope of influence of transfer pricing on corporate decision-making will continue to broaden. Amid the current dynamics of the international landscape, businesses should establish and maintain plans and processes that allow for nimble response to change.

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U.S. REAL ESTATE DEVELOPMENT: MEZZANINE FINANCING BY NON-U.S. PERSONS

James Guadiana, Ari Feder

U.S. real estate development projects are generally conducted in the form of a joint venture or partnership for U.S. tax reasons. The players in such an operation include the developer and the equity investor, both of whom are partners in the partnership, and lenders, both senior and mezzanine lenders. While mezzanine lenders are often U.S.-based, foreign investors are increasingly seeking to make such loans.

Portfolio Interest Exemption

In the case of foreign mezzanine lenders who are residents of countries that do not have income tax treaties with the United States (or are not entitled to treaty benefits by reason of failing to qualify under the limitation on benefits provision in the applicable treaty of the country of residence), interest derived from U.S. sources would typically be taxable at 30% unless another exemption can be relied on. The portfolio interest exemption set forth in sections 871(h) and 882(c) of the U.S. Tax Code is usually looked to in these cases.

To qualify for this exemption, the following principal requirements, among others, must be satisfied:

(i) the documentation evidencing the loan must have certain registration language (this is a relatively simple requirement);

(ii) the mezzanine lender must provide the partnership with a Form W-8BEN-E certifying ownership by a non-U.S. person; and

(iii) the holder of the loan instrument must not be a "10% owner."

Requirement (iii) is most often the reason for this exemption being unavailable. Specifically, mezzanine lenders often seek "equity kickers." Thus, in addition to earning interest on the underlying debt, mezzanine lenders often negotiate with the borrower to receive partnership units and/or warrants to acquire such units.

What is 10% Ownership?

In cases where a loan is made by a foreign person (for example, a Cayman corporation making a loan to a Delaware corporation), 10% ownership is tested on the basis of voting power. However, where the loan is being made to a partnership instead of a corporation, the 10% ownership test would be based on the lender's interest in the partnership's capital or profits. As mentioned, 10% ownership of partnership units by the lender will disqualify portfolio interest treatment.

In determining 10% ownership, certain attribution of ownership rules apply for purposes of determining whether the person making the loan is to be treated as a 10% owner. For example, if the Cayman corporate lender were owned by a related entity that was acquiring partnership units in that partnership, that ownership interest could be attributed to the lender and the exemption would be lost. Also, an option to acquire such an ownership interest held by the lender itself would be treated as exercised for this purpose. Thus, the lender's having a conversion right into a 10% ownership interest would suffer the loss of the portfolio interest exemption.

Interestingly, a partnership interest attributed to the option holder under the option attribution rule is not attributed further to or from a partnership, estate, trust, or corporation. Thus, the portfolio interest exemption should not be denied the lender if the option were held by a different entity than the one that holds the loan. For example, if the option were issued to an affiliate of the lender, such as a parent or brother-sister company, the potential ownership interest in the partnership represented by the option held by the affiliate should not be attributed to the lender. Obviously, in structuring these transactions, care must be taken in making certain that the related entity holding the option is treated as its beneficial owner and not the agent of the lender.

Under the option attribution rule, a partnership interest attributed to an option holder is not attributed further to or from a partnership, estate, trust or corporation.

Treasury Regulations recently adopted and related to “noncompensatory options” also need to be taken into account. Essentially, these regulations could treat certain options not yet exercised as having been exercised. If this were to occur, the plan described in the preceding paragraphs would not work, since we would not be dealing with options but with actual partnership interests.

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WE CAN DEDUCT. WE CAN HEDGE. WE'RE DOING IT MORE AND MORE.

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This past year saw a flurry of cases, transactions and Canada Revenue Agency (CRA) interpretations dealing with interest deductibility and hedging. Some present new planning opportunities by expanding conventional boundaries or by rejecting restrictive CRA interpretations. Others serve to muddle rather than clarify the law in these important areas.

Interest Deductibility

TDL Group Co. v. The Queen[1]

This March 6, 2015 decision of the Tax Court of Canada deals with the deductibility of interest on funds borrowed to subscribe for common shares. Unfortunately, in this case, both the facts and the law seem to get confused.

The taxpayer, TDL Group Co., was part of the Tim Horton's group, which was owned by Wendy's International Inc. TDL borrowed money from a U.S. affiliate and used the proceeds to subscribe for additional common shares of its existing wholly owned subsidiary, Tim Donut U.S. Limited, Inc. Tim's U.S. used the proceeds of the share subscription to make a non-interest-bearing loan to Wendy's, the indirect parent of both it and TDL. After this structure had been in place for about seven months, Tim's U.S. contributed the receivable from Wendy's to a wholly owned subsidiary and the receivable was refinanced into an interest-bearing note. The Minister of National Revenue denied a deduction for the interest expense incurred by TDL during the seven-month period during which the loan to Wendy's bore no interest.

The Court agreed with the Minister, denying a deduction for the interest at issue. With no dispute about the direct use of the borrowed funds, the only issue was whether the common shares of Tim's U.S. were acquired for the purpose of earning non-exempt income. The Court found that the purpose test must be applied at the time the investment was made. As a result the issue became whether "it [could] be said that the Appellant had the reasonable expectation to earn income; either immediate or future dividend income or even increased capital gains as a result of the purchase of shares at the time of such purchase."

The Court found that TDL had no such reasonable expectation. The Court found that there was no expectation at the time of the share subscription that Tim's U.S. would be in a financial position to pay dividends in the short term, and that the 10-year plan for Tim's U.S. did not contemplate the payment of dividends. These findings create uncertainty about the period of time over which a company's dividend-paying capacity should be assessed for interest deductibility purposes, as well as narrowly construing dividend-paying capacity by ignoring the possibility of borrowing to distribute retained earnings. The Court also discounted evidence that the non-interest-bearing loan was replaced by an interest-bearing loan and that the proceeds of the interest-bearing loan were intended to be used to fund store expansion in the U.S., instead concluding that, at the time of the share subscription, the only intended use of the subscription proceeds was to make a non-interest-bearing loan to Wendy's. These factual findings are difficult to understand, and also appear to reflect the application of a different legal test than the one set out at the beginning

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[1] [2015] 4 C.T.C. 2122 (T.C.C.), under appeal.

of the reasons. In particular, in finding that “the sole purpose. . .being to facilitate an interest free loan to Wendy’s,” the Court seemed to focus on the purpose of the series of transactions, rather the purpose of the use of the borrowed funds by TDL. Hopefully, the Federal Court of Appeal will straighten this one out.

Basket “C” Transactions

The last year saw two important developments—one a CRA interpretation and the other a transaction—in the effort to design instruments that both support an interest deduction for Canadian income tax purposes and achieve partial equity treatment for rating agency purposes (known as Basket “C” Equity Treatment from Moody’s and “Intermediate Equity Credit” from S&P).

The CRA interpretation[2] considered whether mandatorily convertible notes with a 60-year term would constitute “borrowed money,” permitting a deduction for interest on the notes.[3] On a bankruptcy or insolvency of the issuer, the notes, together with any accrued interest, would be automatically and mandatorily converted into a fixed number of fixed-rate preferred shares and the notes would be extinguished. While the CRA provided general comments, indicating it could come to a definitive conclusion only in the context of an advance tax ruling, its comments should comfort taxpayers who might consider applying for a ruling where the taxpayer is in good financial condition and the prospect of financial collapse is remote. Basically, the CRA said the mandatory conversion clause would not keep the notes from being considered borrowed money as long as the events giving rise to the conversion (such as bankruptcy or insolvency) are “remote and would occur only in extraordinary circumstances” and are beyond the control of the issuer.

The transaction involves trust notes issued in the principal amount of US$750 million by TransCanada Trust. TransCanada Trust is a unit trust whose sole voting beneficiary is TransCanada PipeLines Limited (TCPL); the trust notes are unsecured and subordinated with a 60-year term bearing fixed interest for the first 10 years and redeemable at par after 10 years.

The trust notes were structured explicitly with the intention of achieving Basket ‘‘C’’ and ‘‘Intermediate Equity Credit’’ status. In particular, on a bankruptcy or insolvency event, the trust notes are to be automatically and mandatorily exchanged for a fixed number of fixed-rate preferred shares of TCPL. In addition, TCPL and its parent

[2] CRA document number 2014-0563351E5, dated May 25, 2015.

[3] The requirement for “borrowed money” is thought to impose a more onerous test than merely needing an instrument to constitute debt. “Borrowed money” suggests an obligation to repay the amount advanced, while debt can represent a promise to repay a lesser amount.

corporation provided an undertaking to refrain from paying dividends on their preferred shares should interest not be paid on the trust notes when required, and holders are required to invest interest received on their trust notes in preferred shares of TCPL should TCPL or its parent not pay dividends on their preferred shares.

TransCanada Trust used the proceeds from issuing the notes to acquire notes of TCPL. It is expected that TCPL is entitled to deduct interest on these notes and that there is no material amount of tax in TransCanada Trust.

Hedge Transactions

Character Issues

George Weston Limited v. The Queen[4]

This Tax Court of Canada case involved the character (i.e., income or capital account) of approximately C$316 million received on the termination of a cross-currency swap. The decision affirmed the taxpayer's capital treatment of the receipt, firmly rejecting CRA's administrative position that a derivative cannot be linked to an investment in a subsidiary for tax purposes without there being some intention to sell that investment.

In 2001, George Weston Limited (GWL), through a subsidiary, acquired a baking business in the U.S., increasing its net investment in "USD Operations" from approximately US$800 million to over US$2 billion. Foreign exchange adjustments translating this amount to Canadian dollars in the preparation of consolidated financial statements were reflected in GWL's currency translation account (CTA). GWL was concerned about a strengthening in the Canadian dollar, which would erode its consolidated equity and decrease its debt-equity ratio. GWL gave evidence that this could in turn reduce its credit rating, violate loan covenants or cause a reduction in its stock price. Accordingly, following the acquisition, GWL entered into a number of cross-currency swaps to hedge its net investment in USD Operations. By 2003, with the Canadian dollar having appreciated, GWL determined that its currency risk was waning and terminated the swaps with the counterparties. GWL reported the resulting termination payments on capital account and the Minister assessed them on income account.

The Court found that the swaps were on capital account, and that the proceeds received on termination were also on capital account. Citing an earlier case and commentary, the Court stated that "a transaction is a hedge where the party to it genuinely has assets or liabilities exposed to market fluctuations, while speculation

[4] [2015] 4 C.T.C. 2010 (T.C.C.).

is ‘the degree to which a hedger engages in derivatives transactions with a notional value in excess of its actual risk exposure.’” The Court found GWL to be hedging, not speculating, although was not clear as to what in its view was being hedged (the direct shares owned by GWL, GWL’s indirect investment in its subsidiaries or its equity as a whole). Importantly, the Court was not troubled by the fact that the USD Operations were carried out by subsidiaries and not directly by GWL and rejected the notion that GWL could only hedge a transaction, i.e., a proposed sale.

Capital treatment is not always desired, at least not at the inception of a swap when the contract is as likely to yield a loss as a gain.

The case should make it easier for taxpayers to achieve hedge treatment for tax purposes where that is desired, although the Court’s lack of clarity about what precise risk it thought was being hedged introduces some uncertainty. Capital treatment is not always desired, at least not at the inception of a swap when the contract is as likely to yield a loss as a gain.

Rollovers

Two recent CRA documents consider the treatment of derivatives in the context of the tax-deferred rollover of property under subsection 85(1). One dealt with the tax treatment to the transferor and the other to the transferee.

One of the documents involved a taxpayer that had entered into cross-currency swaps involving Canadian and U.S. dollars.[5] While the swaps appear to have been entered into in connection with an issuance of U.S. dollar notes, the technical interpretation presumes the swaps are on income account. The interpretation addressed whether the swaps, which were “in-the-money” for the taxpayer, constitute “inventory” for purposes of their being transferred to a subsidiary for shares on a tax-deferred rollover basis. The CRA concluded that the swaps were inventory, and as such eligible for rollover treatment, as their cost or value would be relevant in the computation of the taxpayer’s income.

The other document, from 2014, addresses the treatment to a subsidiary of a gain it realized on forward contracts received on a rollover transaction.[6] In the scenario considered by the CRA, a parent corporation entered into a series of foreign currency forward contracts to hedge senior U.S. dollar notes it had issued. The parent transferred the forward contracts to a wholly owned subsidiary for shares on a tax-deferred rollover basis under subsection 85(1). The forward contracts were

[5] CRA document number 2014-0544651I7, dated January 29, 2015.

[6] CRA document number 2013-0500891I7, dated March 5, 2014.

then terminated and the subsidiary reported its gains on the forward contracts as capital gains, which it sheltered with its own capital losses. The CRA agreed with the subsidiary that its gains on the forward contracts were on capital account on the basis that the forward contracts had been held by the parent on capital account since they were linked to a capital debt obligation of the parent and maintained that character in the hands of the subsidiary. The CRA reached this conclusion even though the contracts could not have been a hedge for the subsidiary.

Timing Issues

Kruger Inc. v. The Queen[7]

This case involves the timing of the recognition of gains and losses on option contracts held on income account. The taxpayer reported gains and losses using the mark-to-market method (i.e., reporting and gains and losses annually) whereas the Minister assessed on the basis that gains and losses could be recognized only when realized (i.e., when the contracts expired or were closed out).

The mark-to-market method is used by financial institutions who are subject to express rules that require marking in certain circumstances and who are otherwise permitted by the CRA to use the method.

Kruger's core business was the manufacturing of newsprint, coated paper products and tissue paper. It was the third-largest newsprint company in North America and also operated a lumber business selling to the U.S. market. Since most of its sales were outside Canada, approximately 75% of its accounts receivable were in U.S. dollars. Kruger also carried on a business of speculating in foreign currency options that was separate from its other businesses (and was not hedging its accounts payable or receivable). It was a leading trader of option contracts in Québec and had experienced traders. It entered into a large number of contracts and the amounts of the contracts were significant. Kruger claimed a loss of $91 million from its business of trading in derivatives in its 1998 taxation year, stemming from marking to market its foreign currency option contracts in that year.

The Court denied mark-to-market losses on option contracts written by Kruger, finding that Kruger had to follow the realization method in recognizing losses from those contracts. There is not much by way of reasons for this conclusion, other than to say that mark-to-market reporting could require a taxpayer to report gains "where there is no clear statutory language requiring him or her to do so" and that the realization principle "is basic to Canadian tax law." It appears that the Court

[7] [2015] 5 C.T.C. 2006 (T.C.C.), under appeal.

was troubled somewhat by the variation in valuations in the contracts among the different financial institutions. The Court did, however, allow Kruger to recognize mark-to-market losses on the contracts that it had purchased (as opposed to written) on the basis that those contracts were inventory to Kruger and could be recorded at the lower of cost and value.

The mark-to-market method is used by financial institutions who are subject to express rules that require marking in certain circumstances and who are otherwise permitted by the CRA to use the method. Mark-to-market is also sometimes used by taxpayers who are not financial institutions. *Kruger* creates uncertainty for these taxpayers. We will have to wait until the appeal to see if the result stands or can be better explained. We understand that the grounds of appeal include that the Court should have attempted to determine whether the mark-to-market method resulted in an accurate picture of the taxpayer's income for the year, rather than merely applying the realization principle as a rule of law.

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