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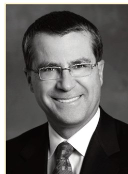
TAX UPDATE

A report on cross-border developments in Canadian tax law



Improving Access to Tax Treaties by Collective Investment Vehicles

By Nigel Johnston

On December 9, 2009, the Organisation of Economic Co-operation and Development (OECD) released a Report containing proposed changes to the Commentary on the OECD Model Tax Convention dealing with the question of the extent to which collective investment vehicles (CIVs or, in Canadian terms, mutual funds) or their investors are entitled to treaty benefits on income received by the CIVs. This note summarizes the Report and its significance to Canadian mutual funds.

For the purposes of the Report, a CIV is a fund that is widely held, invests in a diversified portfolio of securities, and is subject to investor-protection regulation in the country in which it is established. The term includes "fund of funds" that achieve diversification by investing in other CIVs; it does not include private equity funds, hedge funds and REITs. One example of a CIV is a Canadian mutual fund governed by National Instrument 81-102 of the Canadian securities administrators.

The Model Tax Convention is the basis on which approximately 3,000 bilateral tax treaties have been negotiated worldwide. It contains provisions that address the allocation of taxing authority between the Contracting State in which income (interest, dividends and gains) arise and the Contracting State in which the owner of that income is resident (for example, by restricting the rate of withholding tax on interest and dividends imposed by the country in which the income arises).

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The Model Tax Convention does not contain specific rules applicable to CIVs. Therefore, as a general rule, under a tax convention that is based on the Model Tax Convention, a CIV will only be entitled to treaty benefits if it is considered to be a "person" that is a "resident of a Contracting State" and, in the case of interest and dividends, the "beneficial owner" of such income. It is the position of the Canadian mutual fund industry that a Canadian mutual fund trust or mutual fund corporation satisfies each of these requirements and should be entitled to treaty benefits. That is, a trust or corporation is a "person," and is liable to tax on its worldwide income under the *Income Tax Act* (Canada) (*ITA*), although as a practical matter it generally pays no tax by reason of provisions of the *ITA* permitting refunds if appropriate distributions are made to investors, and it is the beneficial owner of such income. In the past, some European countries have taken the position that some or all of these conditions are not satisfied by Canadian mutual funds, although the outcome of bilateral discussions has generally been favourable. The position of Canadian mutual funds can be contrasted with the position of certain European funds (e.g., fonds communs de placement in Luxembourg) that are contractual arrangements under which the condition that the CIV be a "person" is not met and with the position of other structures where the CIV is exempt from tax (and cannot be treated as a "resident of" a Contracting State). From a policy perspective, this is an inappropriate result as economically similar CIVs are afforded different tax treatment.

A complication that arises with respect to the treatment of CIVs is the concern that investors resident in a third country that does not have a treaty with the state in which the income arises will access treaty benefits by investing in a CIV that is resident in a country that does have such a treaty. This would generally not be of concern where the country in which the CIV is resident imposes a material withholding tax on distributions to non-resident investors (as would be the case in the United States, and perhaps to a lesser extent, in Canada) but would be of concern where the country in which the CIV is resident does not impose such a tax (Luxembourg, for example).

The Report proposes additions to the Commentary to the Model Tax Convention to address these concerns.

It contemplates that treaty negotiators expressly address the treatment of CIVs even where it is clear that CIVs of both Contracting States would be entitled to benefits. In such a case, the treaty or an exchange of notes could acknowledge the entitlement of CIVs to treaty benefits.

In other cases, if treaty entitlement would not technically be available, the negotiators should include an express provision in the treaty that a CIV established in a Contracting State be treated, for the purposes of applying the treaty, as if it were an individual resident in the country in which it is established and as if it were the beneficial owner of its income — but only to the extent that "equivalent beneficiaries" are owners of the shares or units of the CIV. "Equivalent beneficiaries" are residents of the country in which the CIV is established, or residents of other countries with which the country in which the income arises has a tax treaty providing for a withholding rate at least as low as that in the treaty under consideration. Countries would need to agree on methods by which the relevant percentages of shares or units of the CIV owned by equivalent beneficiaries could be determined. It is anticipated that further guidance will be forthcoming from the OECD in this regard. The recognition of equivalent beneficiaries is particularly significant for Luxembourg, Ireland and, to a lesser extent, the United Kingdom, which have significant numbers of third-country investors in their funds.

The Report recognizes that as treaties are bilateral, rather than multi-lateral, some countries would limit benefits to owners of the relevant income that are residents of the country in which the CIV is established rather than adopt the equivalent beneficiary concept.

The Report also contemplates that, if an agreed percentage of interests are owned by equivalent beneficiaries, the Contracting States may agree that the CIV should be entitled to full benefits under the treaty rather than proportional benefits.

In other cases, the Report contemplates that countries may wish to permit CIVs to make claims for treaty relief on behalf of investors that are entitled to such benefits. This could be the case where investors are pension funds that, if they had invested directly, would have been entitled a zero rate of withholding on interest and dividends. It is noted that "transparency" could also be achieved in many cases by using an appropriate investment vehicle such as a limited partnership.

Finally, the Report contemplates that a CIV be treated as entitled to full treaty benefits if the principal class of shares or units of the CIV is listed and regularly traded on a regulated stock exchange in the Contracting State in which the CIV is established. This would address exchange-traded funds.

If adopted, the changes to the Model Tax Convention and resulting changes flowing therefrom should be helpful, or at least not harmful, for the entitlement of Canadian mutual funds to treaty benefits. An interesting question is whether, if Canada's treaty negotiators include an express provision in new treaties addressing CIVs, any negative inferences might arise about earlier treaties that are silent in this regard. We think not, but it is an issue to be considered.

The Report is available on the OECD website *www.oecd.org*. Interested parties are invited to send their comments on the Report electronically (in Word format) to *jeffrey.owens@oecd.org* before January 31, 2010.

Canadian Foreign Affiliates – New Draft Rules

By Marc G. Darmo and Gabrielle M.R. Richards

On December 18, 2009, Canada's Minister of Finance released draft regulations relating to the taxation of Canadian multinationals with foreign affiliates. This release deals with some of the proposals announced in 2001, 2002, 2004 and 2007; not included, however, are the anticipated changes to the foreign affiliate rules for mergers and other reorganizations that were proposed in 2004. These changes will be the subject of a separate release, to be issued in the near future. The public has until February 15, 2010 to provide comments to the Department of Finance.

Summary of Proposed Regulations

The following is a summary of the various proposed provisions of Part LIX of the regulations to the *Income Tax Act:*

1. Partnerships – New section 5908 contains a number of provisions relating to the computation of surplus and deficit accounts of foreign affiliates held by partnerships, including rules to reflect the provisions of section 93.1 of the *Act*. In addition, section 5902 and portions of section 5905 are amended to deal with elections under section 93(1.2) of the *Act* in respect of partnership dispositions of foreign affiliate shares.

2. Foreign Accrual Property Losses (FAPL) – Section 5903 is amended to reflect the three-year carry-back of FAPL and extension of the FAPL carry-forward period from five years to 20 years, effective on the dates previously announced, as well as changes to its computation to reflect paragraph 95(2)(f) of the *Act* and to ensure no duplication of FAPL within a corporate group. New subsection 5907(1.4) ensures that an amount paid by a particular foreign affiliate to another corporation will be considered foreign accrual tax only to the extent that the amount is in respect of an FAPL of a controlled foreign affiliate of a "relevant person or partnership" in respect of a taxpayer.

3. Acquisition of Control and "Bump" Rules – New rules were added to section 5905 to reflect the interaction of the winding-up "bump" under paragraph 88(1)(d) of the *Act* and the computation of foreign-affiliate surplus balances. These rules limit the "bump" to the extent that the Canadian subsidiary being wound up (or vertically amalgamated) has received tax-deductible dividends after the acquisition of control by its Canadian parent out of exempt or taxable surplus earned before the acquisition of control. These rules will apply to windings-up that began, and amalgamations that occurred, after February 27, 2004 — except for those where the acquisition of control occurred after December 18, 2009. In that case, new subsection 5905(5.4) will apply instead (as discussed below).

   On an acquisition of control that generally occurs after December 18, 2009, new subsection 5905(5.2) will apply in a manner similar to paragraph 111(4)(c) of the *Act*. It will reduce the exempt surplus balance of the top-tier foreign affiliate to the extent the aggregate of the "tax-free surplus balance" of the affiliate and the adjusted cost base of the shares of the affiliate exceeds the fair market value of the shares at the time of acquisition of control. "Tax-free surplus balance" is generally the aggregate of the exempt surplus of the foreign affiliate and any other foreign affiliates in which it has an interest plus the grossed-up amount of underlying foreign tax (i.e., taxes paid by such foreign affiliates in respect of taxable surplus). A special ordering rule ensures that the adjusted cost base of the shares referred to in the computation under subsection 5905(5.2) is determined after taking into account any adjustments under paragraph 111(4)(c) of the *Act*.

   The new "bump" limitation rules in subsection 5905(5.4) (with amended paragraph 88(1)(d)(ii) of the *Act*) ensure that the "bump" will only be available to the extent the fair market value of the foreign affiliate's shares at the time of acquisition of control exceeds the aggregate of the "tax-free surplus balance" of the affiliate (described above) and the adjusted cost base of the shares of the affiliate immediately before the winding-up. Effectively, if subsection 5905(5.2) has applied to a foreign affiliate on an acquisition of control, no "bump" should be available in respect of the shares of the affiliate on a subsequent winding-up or amalgamation.

4. February 27, 2004 Proposals – A number of features previously introduced to deal with the computation of deficits of foreign affiliates, such as "deficit levitation" rules, "interest push-down" rules and "surplus consolidation" rules, are replaced with a new "fill-in-the-hole" rule, applicable where a share of a foreign affiliate is acquired after December 18, 2009. The rules in new subsection 5905(7.1) to (7.7) will apply to ensure "blocking deficits" are not circumvented; that is, deficits in upper-tier affiliates would need to be filled with surpluses from lower-tier affiliates before the upper-tier affiliate can distribute tax-deductible dividends to its Canadian corporate shareholders. Effectively, the exempt surplus balance of the lower-tier affiliate and the exempt deficit balance of the upper-tier affiliate are reduced, a result comparable to what would have occurred had a dividend been paid by the lower-tier affiliate, immediately before the transactions, from its "tax-free surplus balance" (discussed above), to the extent necessary to "fill the hole" in the upper-tier affiliate. In keeping with the notional dividend concept, the new rules provide for increases in the adjusted cost base of shares of lower-tier affiliates, as if the deemed dividend had been reinvested in shares. These new cost base adjustments are reflected in amendments to the *Act*, in particular, paragraph 53(1)(d) and new subsection 92(1.1).

5. Permanent Establishments – A comprehensive definition of "permanent establishment" is added in section 5906 to ensure a common definition for the foreign affiliate rules.

6. Foreign Oil and Gas Levies – New section 5910 deems certain oil and gas levies to be income taxes paid by a foreign affiliate.

7. Other Changes – The non-taxable portion of gains from the disposition of eligible capital property, and the non-deducted amounts in respect of eligible capital property, are included in "exempt earnings" and "exempt loss." Further, the foreign tax consolidation rules in subsection 5907(1.1) are modified. Finally, consequential changes to the regulations (primarily in section 5907) reflect the amendments that flow from legislation enacted in December 2007, such as the calculation of amounts in particular currencies.

Foreign Affiliate Elections

The Budget 2007 legislation included six individual elections to effect the retroactive application of selected provisions and a revocable "global election" that permitted taxpayers to have all amendments apply retroactively. The deadlines for these elections were extended in June 2008 by 18 months, resulting in a December 31, 2009 deadline for taxpayers with calendar taxation years. This deadline is being maintained in the December 18, 2009 proposals, with the scope of the revocation option being broadened from the global election to include the six individual elections, all of which can now be revoked by the filing-due-date for the taxpayer's taxation year that includes December 14, 2010 (i.e., June 30, 2011 for a taxpayer with a calendar taxation year).

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