Surprise! Foreign Affiliate Dumping Rules Coming to a Private Business Near You

Kenneth Keung CA, CPA (CO, USA), CFP, LLB, MTAX, TEP and Kim G C Moody FCPA, FCA, TEP
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The Foreign Affiliate Dumping ("FAD") rules, contained in section 212.3 of the Income Tax Act (the "Act"), are 10 pages of the Act that many Canadian advisors of private enterprises could safely staple together and never open since its introduction in 2012. Well, as of March 19, 2019, these staples need to come off. Similar to the Government's recent legislative approach to perceived abuses of subsection 55(2), the small business deduction regime, and income splitting for family shareholders of private businesses, the Government introduced – as part of its 2019 federal Budget – a similarly heavy-handed legislative "fix" to the FAD rules that appears to go beyond addressing the perceived abuses. (For a general overview of the 2019 Federal Budget, read our budget blog). The purpose of this blog is to highlight how these proposed amendments could broaden the reach of the FAD rules to family businesses and the potential consequences of their application.

The FAD rules (both existing and proposed) are very complicated the details of which are beyond the scope of this blog. The objective of the FAD rules is to prevent foreign enterprises from using Canadian corporations as intermediaries to invest in entities outside of Canada. Canadian corporations caught within these rules are deemed to have notionally repatriated funds to their foreign parent upon such an investment, causing a reduction of paid-up capital (PUC) or triggering of Canadian Part XIII withholding tax on a deemed dividend amount. Under existing rules, the FAD rules only apply to a corporation resident in Canada ("CRIC") that (i) is controlled by a non-resident corporation and (ii) has made an investment in a foreign affiliate. Generally speaking, a foreign affiliate is a non-resident corporation in which the CRIC owns 10% or more. This type of 'sandwich' structure is typically not found within the private enterprise universe where CRICs are typically controlled by individuals and trusts. As a result, the existing FAD rules seldom have application for advisors in this space and, hence, they were safe to staple through section 212.3 of the Act.

The 2019 federal Budget documents state the Government's concern that the policy objective of the FAD rules can be circumvented when CRICs are controlled by a non-resident individual or trust. Therefore, effective for transactions or events that occur on or after March 19, 2019, the application of the FAD rules is extended to CRICs that are controlled by:

- A non-resident individual;
- A non-resident trust; or
- A group of persons that do not deal with each other at arm's length, comprising any combination of non-resident corporations, non-resident individuals and non-resident trusts

So far, these amendments appear reasonable and we can somewhat agree with the underlying policy rationale (although we think the existing version of the FAD was limited to CRICs controlled by foreign corporations for the exact reason of restricting these complicated rules to only multi-national enterprises). However, the amendments didn't end there. To pre-empt attempts to plan around the rules, a new deeming rule is proposed so that for purposes of the FAD rules, in determining whether two persons are related to each other or whether any person is controlled by any other person, it will be as if:

- Each trust is a corporation having issued a single class of voting shares;
- Each beneficiary under a trust owns a pro-rata number of these notional voting shares based on the proportionate fair market value of their beneficiary's interest; and
- Generally speaking, if the trust is a discretionary trust, each beneficiary would be deemed to own all such notional voting shares

This means, starting March 19, 2019, a CRIC that is controlled by a discretionary Canadian resident trust with one or more non-resident beneficiaries would potentially trigger the FAD rules at any time the CRIC makes an investment in a foreign affiliate. An "investment" in a foreign affiliate is very broadly defined, and it includes both equity and debt contributions amongst other types of transactions.

In other words, under the Budget amendments, FAD could apply in fairly common family enterprise situations such as:

1. A Canadian individual controls a Canadian corporation but who has since become a non-resident of Canada;
2. A Canadian trust controls a Canadian corporation and its trustee has since departed Canada, resulting in central management and control of the trust leaving Canada and thus making the trust a non-resident trust;
3. A Canadian resident discretionary family trust that controls a Canadian corporation and has one beneficiary who is a non-resident of Canada, even if no distribution is intended for that beneficiary in the foreseeable future; and
4. A deceased left control – by automatic operation of law upon death – of a Canadian corporation to his / her Estate (note that an estate is a trust for tax purposes), and the executor of the Estate has discretion in respect of a non-resident beneficiary's share of income or capital of the Estate.

Using Canada as an intermediary jurisdiction for foreign affiliate investments is likely not the motivation behind the above situations, but for all the above situations, FAD could apply if the Canadian corporation makes any investment in a foreign affiliate. It should be noted that the FAD rules will only apply prospectively, so historical investments in foreign affiliates made prior to March 19, 2019 will not be caught.

Under the existing FAD regime, even if the FAD rules apply, cash tax outlay is often not triggered because the FAD rules provide that the deemed dividend that would otherwise arise (and attract Part XIII withholding tax) can be offset against the PUC of the shares of the CRIC. In other words, a CRIC may choose to suppress their PUC of their issued shares rather than pay a withholding tax on the amount of the investment in a foreign affiliate. With typical multi-national inbound corporate structures, sufficient PUC is often available for this purpose. In contrast, in the private business context, high PUC shares are rare because private businesses are primarily built with sweat equity and because any available PUC would likely have been withdrawn as soon as excess funds were available. This means that if the FAD rules apply, the likely result will be a 25% Part XIII tax liability (subject to potential reduction by way of an applicable tax treaty as discussed below) based on the gross amount of the investment in the foreign affiliate. The lowest tier treaty-reduced withholding rates are generally never available when the foreign controller is an individual or a trust (e.g. if FAD applies under any of the four situations described earlier, the applicable Part XIII withholding tax rate is 15% on the gross amount of the investment in a foreign affiliate; compare that to 5% if the foreign controller was a corporation).

An exception to FAD that may be available is the "more closely connected business activities" exception. The purpose of this exception is to prevent FAD from applying in circumstances where there are substantive business reasons for the CRIC to make the investment in the foreign affiliate. To meet

the exception, the Act requires that the CRIC "demonstrate" that it meets all three of the following conditions:

1. The business activities carried on by the foreign affiliate are, at the investment time and are expected to remain, more closely connected to the business activities carried on in Canada by the CRIC (or by other non-arm's length Canadian corporations) than to the business activities carried on by any non-arm's length non-resident person;
2. The officers of the CRIC exercised the principal decision-making authority in respect of the investment, and a majority of those officers were resident and working principally in Canada at the investment time (or in a country of a "connected affiliate" – meaning a controlled foreign affiliate who carries on business activities that are at least as closely connected to those of the foreign affiliate in question as the business activities carried on in Canada by the CRIC are to that foreign affiliate); and
3. At the investment time, it is reasonable to expect that (i) the officers of the CRIC will exercise ongoing principal decision-making authority in respect of the investment, (ii) a majority of those officers will be resident and working principally in Canada or a country of a connected affiliate, and (iii) the performance evaluation and compensation of the officers of the CRIC will be based on the results of the operations of the foreign affiliate to a greater extent than will be the performance evaluation and compensation of any officers of a non-arm's length non-resident corporation (other than the foreign affiliate).

To put it mildly, placing the burden of "demonstrating" the fulfilment of these complex conditions to a family business is inappropriate, especially one that falls accidentally into the proposed FAD regime. Also, if the key decision maker of the business no longer resides in Canada or in a country of a connected affiliate, the exception above will likely not be met. Furthermore, meeting the tests may technically be impossible for private businesses who do not have another non-resident corporation (besides the foreign affiliate) in their organizational structure! For example, how is it possible to prove test #1 – that the business activities carried on by the foreign affiliate are more closely connected to the business activities carried on in Canada by the CRIC than to the business activities carried on by any non-arm's length non-resident person – or test #3 -that the performance evaluation and compensation of the officers of the CRIC will be based on the results of the foreign affiliate to a greater extent than the same for officers of a non-arm's length corporation non-resident corporation -, when no such non-resident corporation exists?

The "more closely connected business activities" exception is also not available where the investment in the foreign affiliate consists of shares that do not fully participate in the profits and appreciation of the foreign affiliate (unless the foreign affiliate is wholly owned by the CRIC). It is very common for third-party investors to acquire shares or units that have limited or custom participation rights in an entity. To the extent the size of the investment is sufficient to make the foreign investee a foreign affiliate (again, >10% generally), the more closely connected business activities exception won't be available, and the FAD rules may apply to trigger a Part XIII withholding tax if the CRIC falls under these proposed rules.

We are barely scratching the surface of the FAD rules in this brief blog, but we hope we impress on you that the FAD rules are now required reading even you practice solely in the private enterprise space. May the FAD be with you; and remove that staple from those 10 pages of the Act.