Insights:
Transfer Pricing

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Canadian budget clarifies treatment of transfer pricing secondary adjustments and forces multinationals to re-evaluate and better monitor cross-border debt

By Brad Rolph

On March 29, 2012, the Minister of Finance proposed significant changes to Canada's transfer pricing and international tax rules in the federal government's 2012 budget.

Clarifying the treatment of transfer pricing secondary adjustments

Canadian transfer pricing rules allow the Canada Revenue Agency to adjust the prices agreed to between related parties in cross-border transactions if such prices are determined to be non-arm's length. When such "primary" transfer pricing adjustments are made to transactions involving a non-resident shareholder of a Canadian taxpayer, many countries, including Canada, impose a "secondary adjustment" to account for the benefit conferred on the shareholder. Under existing rules, such shareholder benefits are treated as a dividend and are subject to withholding tax unless the cash is repatriated. However, there are no specific provisions in Canada's transfer pricing rules regarding these secondary adjustments. Moreover, the technical basis for assessing such secondary adjustments when the related non-resident is not a shareholder has not been apparent. Based on recommendations made by the Advisory Panel on Canada's System of International Taxation (Advisory Panel), the government has proposed changes to clarify the treatment of secondary adjustments as constructive dividends.

In the budget, the government proposes to amend section 247 of the *Income Tax Act* to confirm that secondary adjustments will be treated as dividends for Part XIII tax purposes. A Canadian corporation subject to a primary adjustment will also be deemed to have paid a dividend to each non-arm's length, non-resident participant in the transaction or series of transactions in proportion to the amount of the primary adjustment that relates to the non-resident regardless of whether the non-resident is a shareholder of the Canadian corporation.

The government also proposes in the budget to clarify that a non-resident is allowed to repatriate to a Canadian corporation that has been subject to a primary adjustment an amount equal to the portion of the primary adjustment that relates to the non-resident consistent with the Canada Revenue Agency's current administrative practice. If the repatriation is made by the non-resident with the concurrence of the Minister of National Revenue no deemed dividend will arise in respect of that non-resident. In addition, no deemed dividend will arise if the non-resident is a controlled foreign affiliate (as defined in subsection 17(15) of the *Income Tax Act*) of the Canadian corporation. In this instance, the benefit conferred on the non-resident is more akin to a capital contribution than a dividend.

This measure will apply to transactions (including transactions that are part of a series of transactions) that occur on or after Budget Day.

Given that most taxpayers avoid the Part XIII tax by repatriating cash under such circumstances, it is not clear to what extent these rules will change existing practice. However, it is ironic that the government in seeking an arm's length outcome deems it necessary to characterize an overpayment/ underpayment to a non-resident that is not a shareholder of the Canadian taxpayer to be a dividend when clearly in an arm's length situation it would not be characterized as such. A better approach may have been to simply impose a penalty if the cash was not repatriated on a timely basis.

Changes to thin capitalization rules

Canada's thin capitalization rules limit the ability of a corporation resident in Canada to deduct interest expense on cross-border, related party debt. Interest expense deductions in such cases are denied if the taxpayer's debt-to-equity ratio exceeds 2:1. In the budget, the government proposes these significant changes to these rules:

- Reducing the debt-to-equity ratio from 2:1 to 1.5:1;
- Expanding the thin capitalization rules to partnerships;
- Treating disallowed interest expense under the thin capitalization rules as dividends for Part XIII withholding tax purposes; and
- Preventing double taxation in certain circumstances where a Canadian-resident corporation borrows money from its controlled foreign affiliate.

Arrangements in place on Budget Day (March 29, 2012) will not be grandfathered. The 1.5:1 ratio will apply to taxation years beginning January 1, 2013 or later. The treatment of disallowed interest as a dividend will apply to taxation years that end on or after March 29, 2012 on a prorated basis as a result applying to interest expense that may have accrued before Budget Day. The partnership rule will apply to taxation years that begin on or after Budget Day.

The thin capitalization rules are in place to protect Canada's tax base from being eroded by excessive interest deductions as a result of capital structures that are skewed toward non-resident, related party debt. The government believed it was necessary to lower the permitted debt/equity ratio after the Advisory Panel observed that Canada's 2:1 ratio was high compared to actual industry ratios in the Canadian economy and high when compared to the ratios allowed by other countries particularly since many other countries apply thin capitalization rules to a broader category of debt.

Under the current rules, any cross-border interest payments that exceed the thin capitalization limit are nondeductible but retain their character and are subject to withholding tax, as interest. Under the Canada-US tax treaty, interest payments are exempt from withholding tax. Under the new rules, the appropriate withholding rates would apply to nondeductible amounts.

The budget also states that the withholding tax on interest that is deemed to be a dividend will be required to be paid at the time that such interest is paid or deemed to be paid. Since interest deductions are not required to be accompanied by any cash payment in the year, special rules are proposed under which the deemed dividend is deemed to be paid immediately before the end of the tax year in question. This will require companies to monitor their interest payments more closely to ensure that withholdings are made on a timely basis, if necessary.

These new thin capitalization rules will force companies with Canadian subsidiaries to review all of their existing cross-border debt structures. It is anticipated that many will need to be restructured before the end of 2012 to better align with the new rules.

Foreign affiliate dumping

In another move to protect the corporate tax base, the government has proposed to implement a measure that will curtail abusive foreign affiliate "dumping" transactions. Foreign affiliate dumping transactions often involve a Canadian subsidiary using borrowed funds to acquire shares of a foreign affiliate from its foreign parent corporation. These transactions are carried out with the expectation that interest paid by the Canadian subsidiary on such borrowed money is deductible in computing income for tax purposes while most dividends received by the Canadian subsidiary on the shares of the foreign affiliate are exempt from taxation.

The government is proposing that, where certain conditions are met, a dividend will be deemed to be paid by a Canadian subsidiary to its foreign parent to the extent of any non-share consideration given by the Canadian subsidiary for the acquisition of the shares of a foreign affiliate. Any deemed dividend will be subject to non-resident withholding tax as reduced by any applicable tax treaty. The government further proposes to disregard the paid-up capital of any shares of the Canadian subsidiary that are given as consideration. This measure effectively extends an existing cross-border surplus stripping rule to cover transactions involving foreign affiliates. This measure will not apply to transactions that meet a "business purpose" test.

This measure will apply to transactions that occur on or after Budget Day, other than transactions that occur before 2013 between parties that deal at arm's length and that are obligated to complete the transaction pursuant to the terms of an agreement in writing between the parties that is entered into before Budget Day.

Recognizing that distinguishing between foreign affiliate dumping transactions and transactions that are undertaken with a view to the legitimate expansion of a Canadian-based business is not straightforward, the government has invited stakeholders to submit comments concerning the details of the proposed "business purpose" test before June 1, 2012.

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