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HOLDING STRUCTURES FOR CANADIAN INBOUND AND OUTBOUND INVESTMENTS - THE UK OPTION

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The United Kingdom ("**UK**") has completely transformed its corporate tax system over the past seven years, moving more to a territorial basis of taxation. The UK also has one of the lowest corporate tax rates in developed economies, with the main corporate tax rate being reduced to 20% as of April 1, 2015. These developments mean that the UK should now be considered as a holding company jurisdiction for Canadian inbound or outbound transactions.

This paper presents a general discussion of certain tax considerations for structuring Canadian inbound and outbound investments, followed by an examination of the principal features of the UK regime as they apply to a group of companies engaged substantially in trading activities using a UK company as an intermediate holding company.

I. CANADIAN INBOUND INVESTMENTS - GENERAL CONSIDERATIONS

Structuring investments into Canada requires a detailed examination of a myriad of complex tax and commercial issues. Every structure should be tailored for the unique factual circumstances of the particular investment. Nevertheless, there are certain general themes and issues common to Canadian inbound investments.

In general, there are three broad objectives to structuring from a tax perspective:

1. minimizing Canadian and foreign taxes on operational profits;

2. providing for tax-efficient repatriation of profits; and

3. providing for tax-efficient disposition or exit strategies.

Certain Canadian Considerations

General Comments

In considering any inbound investment structure, it is important to determine the specific nature of the investment. Will the investment yield active business income, such as an investment in a working interest, or is the investment more of a passive nature, such as an investment in royalties? The nature of the income will affect both the domestic Canadian tax treatment (e.g. Part I versus Part XIII) and the application of relevant tax treaties.

Similarly, it is important to determine the nature of the investor. Is the investor exempt from income tax

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under Canadian[2] or foreign law or is the investor entitled to an exemption from Canadian tax under an applicable income tax treaty[3]? Tax-exempt investors may have a greater sensitivity to tax leakage in the investment structure, and it may be beneficial to use flow-through vehicles such as partnerships or trusts,[4] or certain international "hybrid" entities.[5] In some cases, a tax-exempt entity making a passive investment together with other investors may not require any significant tax structuring.[6] Some investors, such as certain private equity funds, may have been established for the purpose of investing for a particular timeframe and may expect a liquidity event for the investment within 5-7 years;[7] for such investors, disposition planning may be of greater significance. Similarly, if there are multiple investors or financial partners, commercial issues — such as the desired manner for financing the investment, sharing income, reporting to each other, decision-making, and the ability for one investor to sell its share in the investment (e.g. rights of first refusal) — may have primary importance and the tax structuring may be largely constrained by commercial constraints.

Minimizing Canadian Taxation

A common planning technique to reduce Canadian tax on operational income is to capitalize the Canadian business with debt so that the resulting interest expense may be deducted from Canadian income. This may be particularly useful when the investor is exempt from taxation in its home jurisdiction, such that there is no tax on the interest received. However, in capitalizing the business it is important to carefully consider the source of funds and the mix of debt and equity in light of the Canadian thin capitalization requirements, foreign affiliate dumping rules, transfer pricing requirements, Canadian withholding taxes and available treaty relief.

Reasonable interest paid by a debtor on borrowed money used for the purpose of earning income is generally deductible for Canadian income tax purposes, provided that the interest rate does not exceed an arm's length rate and subject to the thin-capitalization rules. The thin-capitalization rules limit the extent to which certain Canadian taxpayers may deduct interest paid to certain non-residents. Generally, the rules apply to debt owing by a Canadian corporation to a non-resident who holds at least 25% of the Canadian corporation (by votes or value), or a non-resident who does not deal at arm's length with such a shareholder. If the amount of such debt is greater than 1.5 times the equity amount (as defined in subsection 18(5)) of the Canadian corporation, a portion of the interest paid by the Canadian corporation will not be deductible for Canadian tax purposes.[8] The thin-capitalization rules also apply to partnerships of which a Canadian-resident corporation is a member, Canadian-resident trusts and non-resident corporations and trusts that operate through branches in Canada. Furthermore, as a result of legislative amendments from the 2012 federal budget, the non-deductible portion of the interest is deemed to be a dividend that attracts Canadian withholding tax, and the Canadian corporation is liable to remit such withholding tax (however, presumably because the amount of the deemed dividend may not be known until the end of the taxation year, the Canadian corporation is not subject to a late-remittance penalty on top of the liability for the withholding tax).[9]

The thin-capitalization rules contain a subtle timing issue. For the purposes of these rules, the equity amount for a particular taxation year is generally calculated by determining the equity amount at the *beginning* of each calendar month in that year, and calculating the average of all such equity amounts.[10] In contrast, the amount of debt for a particular taxation year is generally calculated by determining the *greatest* amount of debt owing in each calendar month in that year, and calculating the average of all such amounts.[11] Therefore, if capital is contributed midway through a calendar month partially as debt and partially as equity, for that month the debt portion will be included in the thin-capitalization calculation but the equity would not be recognized until the following month. Accordingly, it may be prudent to fund a Canadian subsidiary with equity during (or on the last day of) the month before the month in which the funds may be required and

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contribute the debt during the month in which the funds are required. This practice is even more important now that the thin-capitalization rules not only deny the deduction for interest, but also create a deemed dividend and the associated withholding tax liability.

There is a recent development relating to the thin-capitalization rules which deserves particular attention. In the 2014 federal Canadian budget, the Department of Finance (Canada) ("**Finance**") proposed to expand the so-called "back-to-back loan" rules in an effort to ensure that the thin-capitalization rules are not circumvented through back-to-back loan arrangements. Such an arrangement could exist where, for example, the non-resident parent company makes a loan (the "**first loan**") to an arm's length third party (such as a bank) which is conditional on the third party making a loan to the non-resident parent's Canadian subsidiary. The back-to-back loan rules are intended to ensure that the amount of the first loan is included in the calculation of the amount of debt owing by the Canadian subsidiary to its non-resident parent company for the purposes of the thin-capitalization rules.

The 2014 budget proposals were largely considered by tax practitioners to be overly broad. As originally drafted, the proposals would have essentially considered the non-resident parent company to be making a back-to-back loan where the parent company merely provided the third party lender with security for the Canadian corporation's debt.[12] In particular, the original proposals considered a back-to-back loan arrangement to exist where the non-resident shareholder provided to the third party lender any "interest in property that secures payment" of the loan to the bank and certain other conditions were satisfied.[13] For commercial reasons, in financing transactions it is common for non-resident shareholders of Canadian borrowers to provide security for the loan, and the back-to-back loan proposals created challenges without demonstrating a clear tax policy reason for such a broad and significant change.

On August 29, 2014, Finance released draft legislation which included revisions to the back-to-back loan proposals. The revisions clarified the types of interests in property that the non-resident shareholder must provide to the third party lender in order to trigger the back-to-back rules. Under the revised proposals, the third party lender must now have a "specified right" in property granted by the non-resident shareholder, which is defined to mean a "right to use, mortgage, hypothecate, assign, pledge or in any way encumber, invest, sell or otherwise dispose of, or in any way alienate, the property".[14] This is considerably narrower than an "interest in property that secures payment".

This revision to the back-to-back loan proposals provides greater certainty. Nevertheless, the August 29, 2014 draft legislation has also broadened the back-to-back loan rules in certain other respects. For instance, the draft legislation contains a new clause which provides that the back-to-back rules may apply if it could be reasonably considered that the terms or conditions of a loan made by the third party lender to the Canadian borrower would be different had the third party lender not received a loan from the non-resident shareholder.[15] It therefore remains important to carefully review and consider the back-to-back loan proposals in every situation.

A detailed discussion of the foreign affiliate dumping rules is beyond the scope of this paper.[16] However, when a non-resident is considering an investment in Canada, the foreign affiliate dumping rules and the applicable elections and exemptions should be carefully considered if the Canadian target has or may have investments outside of Canada.

In appropriate circumstances, another technique for generating deductions for Canadian tax purposes involves the Canadian subsidiary paying management fees to a direct or indirect foreign parent corporation. Such fees

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may compensate the parent corporation for performing centralized functions such financial planning and budgeting, accounting, information technology systems, market research, human resources management, emergency management and technical advice. Generally, to be deductible for Canadian tax purposes the amount of such fees must be reasonable in the circumstances and satisfy the "arm's length" principle under Canadian transfer pricing rules. Whether these conditions are satisfied is a question of fact which must be considered on a case-by-case basis, but the Canada Revenue Agency ("**CRA**") generally adopts the OECD's transfer pricing guidelines.[17] As a general principle, it is necessary for the Canadian subsidiary to derive a benefit of economic or commercial value from the parent's activities (in the sense that the Canadian subsidiary would have been willing to perform the activities itself or pay an arm's length third party to perform such activities), and the amount of the fee paid for such activities must be equal to the amount that would be charged in an ordinary commercial dealing between parties acting in their separate interests.[18]

Under Canadian transfer pricing rules, if the amount of interest or management fees paid to a non-arm's length person exceeds that which would have been paid between arm's length persons, the deduction for the excess may be denied and the excess may be deemed to be a dividend that is subject to Canadian withholding tax.[19] In addition, if the amount of the excess exceeds a certain threshold, a penalty may be imposed if the Canadian corporation failed to make "reasonable efforts" to determine and use an arm's length price. Among other things, in order to be considered to have made "reasonable efforts", the Canadian corporation must make or obtain certain records or documents, within six months of its year-end, that contain detailed information relating to the amount of interest or management fees. This generally requires a detailed transfer pricing study, which may result in significant time and expense. Transfer pricing considerations should therefore be considered and addressed early in the structuring process.

Repatriation of Profits

The importance of planning for tax-efficient profit repatriation will depend on the nature of the particular investment. If the investor intends to hold the investment and receive a regular income stream, repatriation planning will be particularly relevant. Similarly, repatriation planning will be particularly relevant where the investor requires regular access to funds for purposes such as debt servicing, paying expenses or distributing profits to its investors. In contrast, if the investor intends to benefit from selling the investment at a gain, there may be a greater emphasis on exit planning considerations rather than profit repatriation. Of course, both types of planning may be relevant and in certain circumstances it may be possible to achieve both objectives.

There are several ways in which profits from Canadian business operations may be repatriated:

1. Interest — Profits may be repatriated in part by paying interest on debt used to capitalize the Canadian business in the manner described above. Interest paid to an arm's length non-resident is generally exempt from Canadian withholding tax provided that the amount is not participating interest.[20] Non-arm's length or participating interest may be subject to Canadian withholding tax at a rate of 25%, subject to reduction under an applicable tax treaty.

2. Management Fees — A Canadian subsidiary may distribute profits in part by paying inter-company management fees in the manner discussed above. Subject to any applicable tax treaties, Canadian withholding tax of 25% applies to management fees other than a reasonable fee paid in respect of a *specific* expense incurred by the non-resident parent for the performance of a service that was for the benefit of the Canadian subsidiary.[21] Many Canadian tax treaties do not specifically address

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management fees; in such treaties, the "business profits" article would apply such that there will generally be no Canadian tax on management fees if the non-resident does not have a permanent establishment in Canada.

3. Dividends — Dividends paid by a Canadian subsidiary to a non-resident shareholder are generally subject to Canadian withholding tax at a rate of 25%. However, subject to anti-avoidance rules, Canadian tax treaties typically reduce the withholding rate to 15%, and in some treaties the rate may be reduced to 5% where the non-resident shareholder holds a significant voting interest (typically 10%) in the Canadian dividend payor.

4. Return of Capital — A Canadian corporation can generally distribute its paid-up capital ("**PUC**") free of Canadian withholding tax, but the shareholder's adjusted cost base in the shares will generally be reduced by the amount of the distribution and a gain may arise if the amount of PUC distributed exceeds the adjusted cost base of the shares.[22] However, there are certain restrictions on the ability of a Canadian public corporation to distribute PUC tax-free.[23]

Because PUC can generally be distributed to a non-resident shareholder free of Canadian tax, it is typically important to maximize the PUC of the Canadian shares held directly by a non-resident. Therefore, when a non-resident is looking to acquire a Canadian target corporation, if the PUC of the shares of the Canadian target corporation is lower than the purchase price, it is common for the non-resident to incorporate a Canadian acquisition corporation and to fund the acquisition corporation with equity or a combination of debt and equity in compliance with the thin capitalization rules. However, if the PUC of the shares of the Canadian target corporation is greater than the purchase price (which could happen when, for example, the target corporation has experienced financial difficulty) the non-resident investor should consider acquiring the target shares directly, rather than through a Canadian acquisition company.[24]

For passive investments in Canada, it is necessary to consider the Canadian tax consequences of the return on the investment. For example, where a non-resident investor receives a royalty, the royalty payment is generally subject to 25% Canadian withholding tax under paragraph 212(1)(d). Canadian tax treaties typically contain an article which reduces the Canadian withholding tax rate on royalties, but the definition of "royalty" for treaty purposes is frequently narrower than the types of payments described in paragraph 212(1)(d). In particular, royalties on production from an oil or gas property may not be a "royalty" as defined for the purpose of a particular treaty, but rather may be considered to be real property situated in Canada such that Canada retains full taxing jurisdiction.[25] In such circumstances, alternative structures should be considered, such as using a Canadian subsidiary to earn the royalties and then repatriating by way of interest or dividends that are eligible for treaty-reduced rates.

As noted, certain payments to a non-resident investor may attract Canadian withholding tax subject to the application of a tax treaty. Where an investor is located in a jurisdiction which does not have a tax treaty with Canada, or which has a treaty that provides less relief than a treaty with another jurisdiction, consideration may be given to interposing a holding corporation in a more favourable treaty jurisdiction. In undertaking any such planning, it is necessary to carefully consider all potential avenues under which such planning may be challenged as improper "treaty shopping". The topic of treaty shopping is complex and nuanced, and other authors have considered the topic in detail.[26] At a high level, it is important to consider the following:

1. The Canadian general anti-avoidance rule ("**GAAR**") — The GAAR was specifically amended (on a retroactive basis) to apply to a misuse or abuse of a tax treaty.[27] However, the CRA has not had great

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success in challenging treaty structures under the GAAR. Courts have generally declined to find a clear tax treaty policy or legislative intent to deny the treaty relief in the cases which have been brought forward. Rather, the courts have typically interpreted the text of treaties as permitting treaty relief when all of the conditions specified in the treaty are satisfied — namely, the recipient of a payment is a "resident" of the foreign jurisdiction within the meaning of the treaty and the person is the beneficial owner of the payment.[28]

2. Treaty specific anti-avoidance/limitation on benefits rules — Perhaps as a response to the Canadian GAAR jurisprudence in the context of tax treaties, in more recent treaty negotiations Finance has sought to include specific anti-avoidance rules in tax treaties. For example, the Canada-Hong Kong tax treaty provides that a resident of Hong Kong is not entitled to a reduced withholding tax rate on dividends paid from Canada if:

> one of the main purposes of any person concerned with an assignment or transfer of the dividend, or with the creation, assignment, acquisition or transfer of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the dividend, is for that resident to obtain the benefits of [the treaty-reduced withholding tax rate].[29]

There are similar "main purpose" rules in the tax treaties with Poland, New Zealand, and the UK, among others, although the scope of the rules vary. For instance, in the Canada-UK Tax Treaty, the rule generally applies if one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid is to take advantage of treaty relief by means of that creation or assignment: Unlike in the Canada-Hong Kong treaty, the UK rule does not expressly extend to the establishment, acquisition or maintenance of an entity or the acquisition of shares.[30]

3. Canadian domestic developments in treaty shopping — The current status of specific domestic anti-treaty shopping rules is not certain. In the 2013 federal budget, Finance announced its intention to consult stakeholders on possible measures to combat structures which it considers to constitute abusive treaty shopping. The consultation paper was released on August 12, 2013, in which the government invited comments on a number of issues including whether treaty-shopping rules should be implemented under Canadian domestic law or by renegotiation of existing treaties, and whether any such rule should adopt a general "main purpose" test or a more specific approach (similar to the detailed limitation on benefits provision in the Canada-US Tax Treaty[31]). In the 2014 federal budget, Finance gave details of its preferred approach: a domestic rule under which a treaty benefit would generally be denied if it is reasonable to conclude that one of the main purposes for undertaking a transaction was to obtain the treaty benefit. Certain commentators have suggested that it is premature for Finance to take legislative action before the Organisation for Economic Co-operation and Development ("**OECD**") has completed its Base Erosion and Profit Shifting ("**BEPS**") initiative,[32] which has been described in detail elsewhere.[33] It appears Finance has acknowledged this criticism, as on August 29, 2014 Finance announced that it will await further work on the BEPS initiative.[34] Accordingly, while these developments should be reviewed closely when considering any treaty-based structure, the details are subject to change. Additionally, to date there has been very little guidance on the extent to which transitional relief may be provided, if at all.

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We have noticed more recently that when considering treaty structures, clients are becoming interested not only in the legal analysis and risk of being challenged under treaty-shopping rules, but also the risk of reputational harm to the organization in the event that the organization is perceived as not paying its "fair share" of tax. This is likely driven by the significant media coverage that international tax planning has received in recent months.

Disposition Planning

The primary Canadian income tax consideration relating to the final disposition or exit from an inbound investment is whether the disposition will attract Canadian tax by virtue of being "taxable Canadian property" ("**TCP**"). For instance, if the intention is to develop an investment, go public through an initial public offering and then sell the investment, the investment may not be TCP at the time of disposition if the investor held less than 25% of the shares of the Canadian corporation at all times during the 60-month period preceding the disposition.[35] In such a situation, disposition planning from the outset may be less important. In contrast, if the investment is not expected to be publicly listed at the time of disposition then it may constitute TCP to a particular investor even if the investor holds less than a 25% interest, and there may be significant tax savings by properly planning for the disposition at the time the structure is established.

One strategy for disposition planning involves the use of a holding company in a jurisdiction which has a favourable income tax treaty with Canada. Generally, Canadian tax treaties provide that Canada is entitled to tax gains from the disposition of real property situated in Canada, as well as gains from the disposition of securities of an entity whose value is derived principally from Canadian real property. However, it is well known that tax treaties with certain jurisdictions - such as Luxembourg and the Netherlands - provide that when determining whether an entity's value is derived principally from real property, property through which the business of the entity is carried on is generally excluded in the calculation. The CRA has interpreted this exclusion as applying not only to buildings in which business activities are physically carried on, but also to real property which is actively exploited in the conduct of the business (or held for future exploitation) such as mineral and timber rights.[36]

When relying on a treaty structure for disposition planning, as for repatriation planning it is necessary to carefully consider any potential treaty shopping implications.[37]

Luxembourg and the Netherlands are commonly considered in disposition planning because of the treaty exclusion for immovable property through which the business is carried on, and because of their domestic holding company regimes. The UK is not as commonly considered for a holding company jurisdiction. However, the UK has a domestic holding company regime which provides favourable tax treatment in certain circumstances, as more fully described below. Additionally, the Canada-UK Tax Treaty provides a similar exclusion for immovable property through which the business is carried on, although in the oil and gas exploration and production context, this exclusion may be limited.

In this regard, the gains articles in Canada's tax treaties with Luxembourg and the Netherlands generally provide that Canada can tax gains derived by a resident of Luxembourg or the Netherlands from the disposition of shares forming part of a substantial interest in a Canadian corporation where the value of the shares is derived principally from immovable property situated in Canada. However, for this purpose, the tax treaties with Luxembourg and the Netherlands specifically define "immovable property" to exclude property (other than rental property) in which the business of the enterprise is carried on. There is no apparent distinction drawn between oil and gas interests that are actively exploited and other types of immovable

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property in these tax treaties.

Contrast this to the relevant provisions in the Canada-UK Tax Treaty. Article 13:5 provides that Canada may tax gains from the disposition of shares (other than shares quoted on an approved stock exchange) whose value is derived from immovable property situated in Canada **or** from a right, licence or privilege to explore for, drill for or take petroleum, natural gas or other related hydrocarbons in Canada. For this purpose, Article 13:7(b) provides that, for the purpose of determining whether the value of shares is derived from immovable property, property (other than rental property) in which the business of the enterprise was carried on is to be excluded. The Canada-UK Tax Treaty makes a distinction between certain oil and gas interests and other types of immovable property in the context of Article 13:5 and, while most oil and gas interests would generally be considered to be immovable property, the exclusion in Article 13:7(b) for property in which the business is carried on seemingly does not apply to a right, licence or privilege to explore for, drill for or take petroleum, natural gas or other related hydrocarbons.[38]

Foreign Jurisdiction Considerations

For any particular Canadian inbound investment, it will be important to obtain specific and detailed advice relating to commercial and tax issues in the investor's home jurisdiction and any potential holding company jurisdictions, including how such regimes may interact with Canada and each other.

From a tax perspective, it is generally necessary to consider at least the following:

1. How are payments received from Canada, or from an intermediary holding company jurisdiction, taxed in the investor's jurisdiction? How does the tax treatment change if the payment is a dividend, interest, royalty, management fee or return of capital?

2. How are gains realized from a disposition of the Canadian investment (or from a disposition of an intermediary holding company) taxed?

3. Is the investor exempt from tax on all or a portion of its income under the foreign jurisdiction?

4. What are the applicable anti-avoidance, anti-treaty shopping or transfer pricing provisions?

5. How does the foreign jurisdiction interpret and apply relevant provisions of its tax treaties?

Depending on the result of this analysis, it may become apparent that an intermediary holding company structure through a third jurisdiction would be preferred.

There may also be a variety of non-tax issues which need to be addressed. It is important to not approach the structuring process solely from a tax efficiency perspective, but to obtain broad advice in order to identify relevant commercial issues which may have priority over tax planning. For example, depending on the jurisdiction there may be concerns over economic instability, political risk, or civil unrest which may impact the investor from a financial or reputational perspective. Or the jurisdiction may impose strict foreign exchange controls which may impact how funds are moved within the corporate group and the rates at which currencies may be exchanged. In situations where there may be a risk of a governmental authority discriminating against the investor or expropriating assets, it may be helpful to consider the protections available under applicable bilateral investment treaties.[39]

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Canadian Inbound Investment through the United Kingdom

A typical Canadian inbound investment structure is provided in Figure 1. Such a structure incorporates several of the elements discussed above, including the use of a Canadian corporation ("**Canco**") to maximize cross-border PUC, and the use of an Intermediate Holdco. Foreign Holdco may be inserted in the structure for the purpose of addressing non-Canadian tax issues.

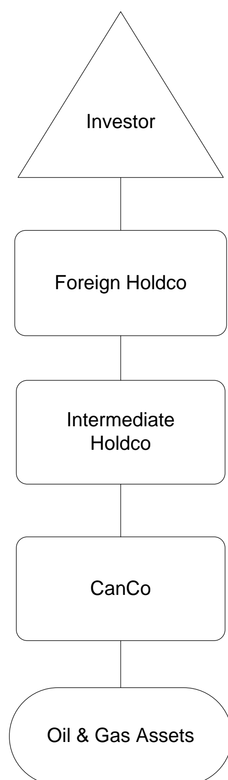

Figure 1 — Typical Canadian Inbound Investment Structure

The following discussion presents certain tax consequences pertaining to this structure assuming that (i) Intermediate Holdco is a resident of the UK for purposes of the Canada-UK Tax Treaty (such company shall be referred to as "**UK Holdco**" in this discussion),[40] (ii) Canco has only one class of common shares outstanding, all of which are owned by UK Holdco, and (iii) Canco is an active trading subsidiary engaged in the exploration, development or production of its Canadian oil and gas assets, and does not own oil and gas assets that are situated in the UK.

Dividends paid from Canco to UK Holdco

Dividends from Canco should be subject to Canadian withholding tax at a maximum rate of 5% under the Canada-UK Tax Treaty, provided that UK Holdco is the beneficial owner of the dividend.[41] The Canada-UK Tax Treaty does not contain a limitation on benefits article, and therefore the ownership of UK Holdco should be immaterial (unless the circumstances are such that UK Holdco does not have beneficial ownership of the dividend). The specific anti-avoidance rule in Article 10:7 of the Canada-UK Tax Treaty will have to be considered in the context of the structure.

Since the dividends are received from a wholly owned subsidiary of UK Holdco, they will be exempt from tax in the UK (whether derived from income or capital profits) provided that (i) UK Holdco has legal and economic

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control of Canco; (ii) the dividend does not give rise to a tax deduction for Canco or any associated entity; (iii) the dividend does not derive from profits made before UK Holdco acquired Canco; and (iv) there are no other unusual circumstances relating to the dividend, such as a person receiving the dividend in place of a payment otherwise due to it, the dividend being compensation for some other arrangement, or the dividend giving a return equivalent to interest.

Disposition of Canco Shares

For Canadian tax purposes, if the Canco shares are TCP then the gain realized upon disposition of those shares may be subject to Canadian tax. However, the Canada-UK Tax Treaty would exclude the gain from Canadian tax if the shares are quoted on an approved stock exchange. The treaty exemption for immovable property through which the business is carried on may not be available if Canco's assets consist primarily of rights, licences or privileges to explore for, drill for or take petroleum, natural gas or other related hydrocarbons.

From a UK tax perspective, no UK tax will arise on any gain from the disposition provided that (i) UK Holdco has held the interest in Canco for at least 12 months at the date of disposition; (ii) the profits in Canco have not benefitted from any exemption from tax; (iii) Canco's activities do not include any substantial non-trading activities; and (iv) UK Holdco is a member of a group which is a trading group immediately before and after the disposition. This exemption is known as the substantial shareholding exemption (or SSE). HM Revenue and Customs ("**HMRC**") regards non-trading activities as "substantial" if they account for more than 20% of turnover, company/group assets or employee activities. When applying the test to corporate groups, inter-company transactions such as finance, property, services and employees are disregarded. Because of the requirement that the trading status of the seller continues post sale, the position of a company in wind down requires careful consideration.

UK Controlled Foreign Company Rules

The UK controlled foreign company ("**CFC**") rules generally provide that a UK parent company can be taxed in respect of certain profits earned by a foreign subsidiary if the subsidiary is located in a low tax jurisdiction. The revisions to the UK CFC rules are one of the most significant changes made with a view to ensuring the UK is attractive as a holding company regime. Since Canco is tax resident outside the UK, and is controlled by UK Holdco, Canco is a CFC for the purposes of these rules and therefore needs to fall into an exemption or have no profits which are subject to tax under the CFC regime.

In the case of a Canadian trading company such as Canco, there are a number of exemptions which may apply:

1. There is a safe harbour rule, known as the "white list", which is divided into two sections, with Canada ranking in the section which meets the requirements most easily (the "whiter than white" list). Broadly speaking, the safe harbour rule should apply if all of Canco's income is "subject to tax" in Canada and is not derived from a permanent establishment outside Canada. Additionally, Canco must not be involved in any arrangement which has a main purpose of avoiding UK tax or securing this exemption.

2. Passing the "business profits gateway" — This exemption provides three safe harbours from the CFC rules for a trading company:

    (a) There is no motive to reduce UK taxable profits, with the result of increasing the profits of the CFC and no expectation that, as a result of any arrangement, one or more persons will have reduced liability to tax. As a main purpose test, this can be difficult to apply. The other tests are

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more factual.

(b) There are no UK managed assets or risks: there is no significant management in the UK by Canco or a non-arm's length organization (unless there is a permanent establishment in the UK).

(c) Those assets or risks of Canco which are managed in the UK could be managed effectively commercially by Canco even if it did not have any UK involvement.

3. The CFC rules should not apply to Canco if the level of tax paid in Canada is at least equal to 75% of the tax that would be paid in the UK if the profits were computed in accordance with UK rules.

4. The CFC rules should not apply to Canco if, applying OECD principles as if the activities in the UK were a permanent establishment of Canco, the level of those activities is such that no profit would be ascribed to them (even if this test is not met, only this element of profit will fall into the CFC charge in any event).

There are other exemptions which may apply if the profits of Canco are low, or its profit margin is minimal. Where Canco was acquired by UK Holdco, it has 12 months to meet one of the CFC exemptions.

If the activities carried on by Canco are trading activities managed from Canada, it is unlikely that the CFC rules will apply, unless deliberate tax minimisation strategies have been adopted.

Dividends Paid by UK Holdco to Foreign Holdco

The UK does not impose any withholding tax on dividends paid, and does not tax non-UK resident shareholders in respect of the receipt of such dividends, unless the dividends are attributable to a UK permanent establishment. This is one of the foremost attractions of the UK regime.

Disposition of UK Holdco Shares by Foreign Holdco

The UK does not impose tax on gains realized by non-UK residents, except where they are attributable to certain UK oil and gas interests.

Financing UK Holdco

If UK Holdco's only assets are non-UK companies in respect of which it expects to receive only profits exempt from UK tax, then it is unlikely that funding UK Holdco with debt would be attractive. However, if UK Holdco has UK subsidiaries which are profitable, then it may be attractive to debt fund UK Holdco (subject to normal transfer-pricing and thin capitalization issues), as it may be able to use tax losses generated by interest expense on such borrowings to surrender by way of group relief to those UK subsidiaries to offset their taxable profits on a current year basis only. However, in addition to the normal transfer-pricing and thin capitalization issues, the UK also operates a "world-wide debt cap" to prevent debt being dumped into the UK to a greater extent than is warranted by the overall external borrowings of the relevant group. Under this, if the net debt attributable to the UK exceeds 75% of the gross external debt of the relevant group, then the UK deductions will be restricted. Also, there is a targeted anti-avoidance provision which denies a deduction if the loan is entered into with a tax avoidance purpose.

Interest paid by UK Holdco will attract UK withholding tax at a general rate of 20%, unless the interest is paid

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to a bank carrying on a banking business in the UK, a UK body corporate or a person who qualifies to receive interest at a reduced withholding rate under a tax treaty, or the interest is paid on a "quoted Eurobond".

Financing Canco

The UK tax regime does not contain an exemption for interest received by UK Holdco, and therefore such interest will be subject to tax at the normal UK corporate tax rate (20% as of April 1, 2015). If UK Holdco has equivalent borrowings for which it can obtain tax relief there will be no net UK tax cost, but it is unlikely that funding Canco in this way would be attractive from a UK tax perspective.

Interest paid from Canco to UK Holdco would attract Canadian withholding tax at 10% (pursuant to the Canada-UK Tax Treaty), which further makes debt funding unattractive.

II. CANADIAN OUTBOUND INVESTMENTS - GENERAL CONSIDERATIONS

Certain Canadian Considerations

General Comments

As for Canadian inbound investments, tax structuring considerations for Canadian outbound investments generally relate to the three objectives of minimizing tax on profits, tax-efficient repatriation and tax-efficient disposition planning. In outbound international resource exploration plays, however, disposition planning often has greater significance: junior international exploration companies typically have the ability to find and prove a resource but may not be able to raise the extensive capital required to develop the resource, especially in jurisdictions that do not have an established infrastructure system to facilitate resource production.

Minimizing Canadian Taxation

Canadian enterprises typically engage in significant foreign operations through the use of a foreign subsidiary, rather than carrying on those operations directly (or through a branch). There are several advantages to using a foreign subsidiary, including greater opportunity for deferral of Canadian taxation, greater flexibility for subsequent restructuring transactions, greater commercial liability protection and favourable treatment under foreign commercial law.

A Canadian corporation which carries on foreign operations directly through a foreign branch will be subject to immediate Canadian taxation on income from the foreign operations, subject to any relief available under a tax treaty (typically where there is not a foreign permanent establishment), the foreign tax credit or deduction mechanism[42] and, in the case of foreign resource operations, the use of foreign resource expense pools.[43] If the branch tax in the foreign jurisdiction is greater than Canadian tax rates, then there may not be any Canadian cash tax payable by virtue of the foreign tax credit or deduction. However, for operations in jurisdictions with lower domestic tax rates, the Canadian taxation that may arise on a direct investment could potentially be deferred by using a foreign subsidiary. Nevertheless, using a branch may provide certain benefits. Branches are often easier and less costly to establish and maintain than foreign subsidiaries. Additionally, where start-up losses are anticipated, the losses may be "trapped" if a foreign subsidiary is used, whereas if the losses are incurred by a foreign branch of a Canadian corporation those losses could generally be used to offset other income which may be earned by the Canadian corporation.

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When foreign operations are carried on through a subsidiary of a Canadian corporation, Canadian taxation on the income from such operations can generally be deferred until that income is repatriated to Canada, provided that the income is not considered to be foreign accrual property income ("**FAPI**") earned by a controlled foreign affiliate of the Canadian corporation. A detailed discussion of the Canadian foreign affiliate rules is beyond the scope of this paper.[44] At a high level, the foreign affiliate rules consist of two regimes: the foreign affiliate surplus rules and the FAPI rules. The FAPI rules are intended to prevent Canadian taxation from being deferred by earning certain types of passive/investment income through a foreign subsidiary, since such income can generally be shifted to foreign subsidiaries quite easily. The rules are not intended to create competitive challenges for Canadian enterprises with foreign business operations, and as such, under the foreign affiliate surplus rules, "active business income" earned abroad generally receives favourable treatment and is not subject to immediate Canadian taxation as FAPI.

In order for Canadian income tax to be deferred on active business income of a foreign subsidiary, it is critically important that the subsidiary not be considered to be a resident of Canada for tax purposes. The place of residence of a corporation incorporated outside of Canada is a question of fact based on where its central management and control actually resides.[45] In determining the location of a corporation's central management and control, the focus is generally on the place where strategic decisions are made, not general day-to-day management and operational decisions. When the board of directors actually make company decisions (as opposed to acting under the dictates of an outsider), an important factor is the location of the meetings of the board of directors, and it is good practice to ensure that all directors' meetings are physically held in the foreign jurisdiction[46] and clearly documented as such. However, because the location of central management and control is a question of fact, no one factor is determinative and it is generally advisable to structure the foreign activities in order to locate as much "substance" as possible in the foreign jurisdiction in order to establish a strong nexus to that jurisdiction. Some examples of substance include storing the corporation's minute book, seal and financial records in the foreign jurisdiction, and locating the company's bank accounts and signing officers in the foreign jurisdiction. Increasing the substance in the foreign jurisdiction may also help address Canadian or foreign treaty-shopping rules.

In practice, there is a risk that decisions relating to the business of the foreign subsidiary will actually be made in Canada, especially where the key personnel in respect of the foreign business are also Canadian-resident directors or officers of the Canadian parent corporation. Such decisions could lead to a conclusion that the central management and control of the foreign subsidiary is actually located in Canada. Consideration may be given to formally documenting an inter-company management or technical services agreement under which the Canadian parent corporation provides certain management or technical services to the foreign subsidiary. Such an agreement may support an argument that the activities in Canada are activities of the Canadian parent relating to the services it is providing, rather than activities of the foreign subsidiary. However, such an agreement will need to be carefully drafted to ensure that the agreement does not go as far as to grant the Canadian parent *de facto* control of the foreign subsidiary; the agreement should not effectively remove the powers of the directors of the foreign subsidiary to manage the foreign business. As a starting point, the decision for the foreign subsidiary to enter into the agreement should be made at a meeting of the subsidiary's directors physically held in the foreign jurisdiction, and to the extent possible local directors or officers of the subsidiary should be responsible for receiving and reviewing the services provided by the Canadian parent. Additionally, it will be necessary to consider Canadian and foreign transfer pricing requirements in respect of the fees to be paid by the foreign subsidiary for the management and technical services, if any.

Using a foreign subsidiary may provide other benefits in addition to potentially allowing for deferral of

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Canadian taxes. Using a foreign subsidiary may provide greater flexibility for subsequent restructuring which may be desired, since where foreign assets are held directly by a branch it can be quite difficult or impossible to transfer the assets to a foreign subsidiary without triggering Canadian tax consequences.[47] Foreign subsidiaries may also provide greater commercial liability protection, such that assets of the Canadian parent may not be available to creditors of the foreign subsidiary. Furthermore, some jurisdictions may provide tax, commercial or regulatory advantages to companies locally incorporated in those jurisdictions, or may allow certain activities (such as resource development) to be performed only by local companies.

Repatriation of Profits

As noted above, the Canadian foreign affiliate surplus rules are the second component of Canada's foreign affiliate system. The surplus rules address how distributions from foreign affiliates of Canadian corporations are to be taxed in Canada. Accordingly, in repatriating income from outbound investments the surplus rules are the primary rules to be considered from a Canadian perspective.

At a high level,[48] distributions[49] from foreign affiliates to Canadian corporations are taxed based on the type of surplus account from which the distribution is considered (or deemed) to be made. Income earned by a foreign affiliate is allocated to a particular type of surplus account based on whether the income is "active business income", whether that income is earned in a "designated treaty country" and whether the foreign affiliate is resident in a designated treaty country. In a multi-tier structure, distributions from a lower-tier foreign affiliate to an upper-tier foreign affiliate generally cause the surplus accounts of the lower-tier affiliate to flow up to the upper-tier affiliate and be available for distribution to the Canadian parent.

The definition of "active business income" is central to the surplus regime. Generally, active business income includes income from most business operations, and certain inter-company payments which may otherwise be considered to be property income.[50] Certain types of business income are specifically excluded from active business income, typically in circumstances where the business is highly mobile and therefore capable of being easily moved outside Canada and avoiding Canadian taxation.[51] Such excluded businesses include businesses with the principle purpose of earning property income (an investment business), except for certain types of investment businesses which employ more than five full-time employees.[52]

For the purposes of the surplus rules, a "designated treaty country" is generally a country with which Canada has a comprehensive double tax treaty or tax information exchange agreement ("**TIEA**") that has entered into force.[53] The concept of designated treaty country was expanded in 2008 to include TIEA countries, and this change has resulted in new planning opportunities particularly as certain TIEA jurisdictions may have relatively low domestic tax rates.

A Canadian corporation can generally receive a distribution of "exempt surplus" from a foreign affiliate free of Canadian tax.[54] Exempt surplus generally includes active business income earned in a designated treaty country, provided that the foreign affiliate is a resident of a designated treaty country within the meaning of the relevant tax treaty or TIEA.[55] Similarly, 50% of a capital gain realized by a foreign affiliate is generally included in exempt surplus, other than certain gains from the disposition of shares of another foreign affiliate or a partnership interest. Where the capital gain arises on the disposition of active business assets used in a designated treaty country, the entire portion of the gain is generally included in exempt surplus.[56]

When a foreign affiliate repatriates "taxable surplus", the amount is generally subject to Canadian tax in the hands of the Canadian parent corporation, but a deduction is provided on account of the underlying foreign tax paid by the foreign affiliate in respect of the amount and any foreign withholding tax applicable to the

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distribution.[57] As a result, distributions out of taxable surplus are generally subject to Canadian tax only to the extent that the foreign taxes are less than Canadian corporate taxes. A foreign affiliate's taxable surplus generally includes active business income that is not included in exempt surplus (because the business is not carried on in a designated treaty country or because the affiliate is not a resident of a designated treaty country); property income (FAPI); and 50% of capital gains other than (i) gains fully included in exempt surplus (e.g. gains from active business assets used in a designated treaty country), and (ii) gains from the disposition of shares of another foreign affiliate or a partnership interest (provided substantially all of the value of the other affiliate or partnership is attributable to gains from active business assets used in a designated treaty country).[58]

The "hybrid surplus" account is a relatively new concept which applies to capital gains realized by a foreign affiliate on the disposition of shares of another foreign affiliate or interests in a partnership where substantially all of the value of the other affiliate or partnership is attributable to gains from active business assets used in a designated treaty country. Before the hybrid surplus concept was introduced, a portion of such a gain was allocated to the exempt surplus and taxable surplus accounts. Now, the full amount of such gain is generally allocated to the hybrid surplus account, such that the taxable and non-taxable portions of the gain are now effectively required to be distributed together. When a Canadian corporation receives a distribution out of hybrid surplus, one-half of the amount is included in income and, similar to taxable surplus distributions, a deduction is provided on account of underlying foreign tax paid by the foreign affiliate and any foreign withholding tax applicable to the distribution.[59]

Where a foreign affiliate has balances in multiple types of surplus accounts, distributions are generally paid first out of exempt surplus, then hybrid surplus and taxable surplus.[60] In certain circumstances an election may be made for the distribution to be paid in a different order, which could be beneficial if, for example, the Canadian parent corporation has loss carryovers which might otherwise expire and desires to receive taxable or hybrid surplus in order to use up the losses.[61] Any distribution in excess of the surplus accounts is analogous to a return of capital: such a distribution is considered to be paid out of the residual "pre-acquisition surplus" account, and the distribution is not subject to Canadian tax but the Canadian corporation's adjusted cost base in the foreign affiliate shares is reduced, which may give rise to a capital gain.[62] An election may be available to deem a distribution to be made out of the pre-acquisition surplus account even if there is a balance in other surplus accounts; such election essentially allows the Canadian corporation to receive a tax-free return of capital with the adjusted cost base of the foreign affiliate shares serving as a proxy for the amount of capital.[63]

Disposition Planning

If it is anticipated that an outbound investment may be sold as a going concern, it is common to use a multi-tier subsidiary structure under which a top-tier foreign holding company holds shares of the lower-tier foreign operating company. Provided that the operating company is carrying on an active business, if the shares of the operating company are sold the gain realized by the top-tier holding company would generally be included in its hybrid surplus and would not be subject to Canadian tax until the amount is distributed to the Canadian parent. Such funds could remain outside Canada and be re-invested by the holding company in other active business ventures without attracting current Canadian tax. A multi-tier structure also allows greater flexibility for subsequent restructuring transactions which may be desired.

However, the benefits of a multi-tier structure must be weighed against the initial and ongoing costs of establishing and maintaining the structure, and in certain circumstances the complexity of a multi-tier structure may not be justified. Where the foreign operating company is held directly by the Canadian parent,

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the gain arising upon the sale of the operating company would generally be subject to immediate taxation in Canada. Nevertheless, if the operating company would have been able to make a distribution to the Canadian parent out of a surplus account immediately prior to the sale, the Canadian parent may generally elect to recharacterize the proceeds of disposition as a dividend paid out of the operating company's surplus accounts.[64] Such an election would be particularly beneficial where the operating company has undistributed exempt surplus.

Subsection 85.1(3) may provide a mechanism for forming a multi-tier structure if such a structure is not established from the outset of the outbound investment. Subsection 85.1(3) generally provides that shares of a foreign affiliate may be transferred to another foreign affiliate on a tax-deferred basis (from a Canadian tax perspective). However, if the transfer is part of a series of transactions or events for the purpose of disposing of the shares of the lower-tier subsidiary, subsection 85.1(3) may not apply.[65] Because this is a question of fact, the analysis may be uncertain, particularly given the broad meaning that "series of transactions" has received in recent jurisprudence.[66]

Foreign Jurisdiction Considerations

As with inbound investments, it is important to obtain specific and detailed advice for Canadian outbound investments. Although the present focus is on tax concerns, non-tax issues may also be important and should be carefully considered with reference to the particular jurisdictions involved.[67]

From a tax perspective, the following matters should be examined among others:

1. How is business and investment income taxed in the foreign operating jurisdiction? Is there a preference for operating as a branch or through a foreign subsidiary?

2. How does the jurisdiction tax gains realized on assets or shares of companies located in the jurisdiction?

3. What withholding taxes apply to amounts paid out of the operating jurisdiction?

4. For any foreign intermediary holding jurisdictions being considered:

   (a) How are dividends, interest and gains taxed when received by the holding company?

   (b) What withholding taxes apply to amounts paid out of the intermediary jurisdiction?

   (c) How are tax treaties interpreted and applied in all relevant jurisdictions?

The relevant issues are highly contextual and must be addressed on a case-by-case basis. As one example, some jurisdictions may impose tax upon a sale of resource property assets located in that jurisdiction, but may not impose tax upon shares of a company that holds such assets. In such a case, it may be advantageous to acquire and develop such assets through a subsidiary company to facilitate exit planning.

Canadian Outbound Investment through the United Kingdom

A typical Canadian outbound investment structure is provided in Figure 2. Such a structure incorporates several of the elements discussed above, including the use of a top-tier subsidiary ("**Foreign Holdco**") and the potential for tax treaty relief on payments from the Foreign Opcos to Foreign Holdco.

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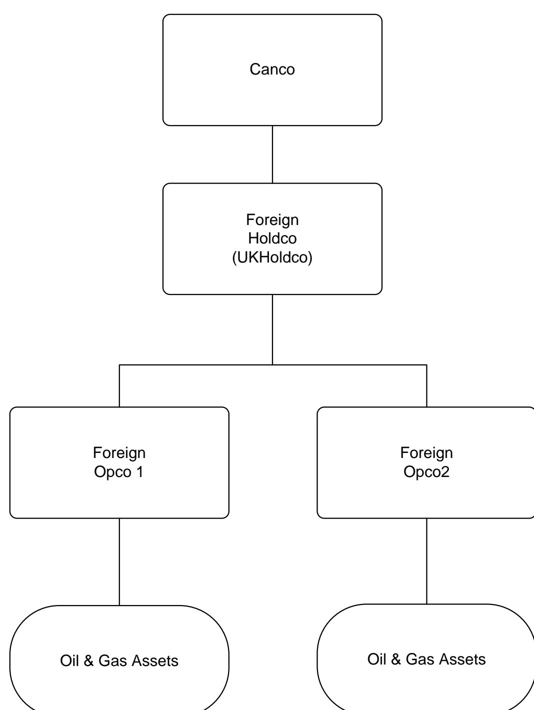

Figure 2 — Typical Canadian Outbound Investment Structure

The following discussion presents the tax consequences pertaining to this structure assuming that (i) Foreign Holdco is a resident of the UK for purposes of the Canada-UK Tax Treaty (such company shall be referred to as "**UK Holdco**" in this discussion),[68] (ii) each Foreign Opco has only one class of common shares outstanding, all of which are owned by UK Holdco, and (iii) each Foreign Opco is an active trading subsidiary engaged in the exploration, development or production of its oil and gas assets, which are assumed to be non-UK based.

Dividends paid from Foreign Opco to UK Holdco

The amount of withholding tax applicable to dividends from a Foreign Opco will depend on where the Foreign Opco is resident, but the UK has a good network of tax treaties that would likely reduce the withholding tax rate. Additionally, under the EU Parent Subsidiary Directive, after an initial holding period dividends can normally be paid between an EU parent and subsidiary without any withholding tax or liability to tax in that paying jurisdiction for UK Holdco. If a tax treaty is being relied on, any limitation on benefit and beneficial ownership requirements will need to be considered.

The UK tax applicable to UK Holdco in respect of the receipt of a dividend from Foreign Opco would be the same as in the inbound case (see discussion above under the heading "Dividends paid from Canco to UK Holdco").

Disposition of Foreign Opco Shares

The UK tax applicable to UK Holdco in respect of the disposition of Foreign Opco shares would be the same as in the inbound case (see discussion above under the heading "Disposition of Canco Shares"). The jurisdiction in which Foreign Opco is incorporated, carries on business or holds assets may impose additional taxes, subject to the application of a tax treaty.

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UK Controlled Foreign Company Rules

The UK CFC rules should apply in the same manner as in the inbound case, except that the "white list" safe harbour rule will depend on where Foreign Opco is resident.

Dividends paid by UK Holdco to Canco

As described above in the inbound case, the UK does not impose any withholding tax on dividends paid, nor tax on shareholders in respect of the receipt of such dividends, unless the dividends are attributable to a UK permanent establishment.

Canadian income tax may apply to Canco in respect of the receipt of a dividend from UK Holdco, depending on whether the dividend is considered to be paid out of exempt surplus, taxable surplus or hybrid surplus and the extent of any underlying foreign tax.

Disposition of UK Holdco Shares by Canco

As described above in the inbound case, the UK does not impose tax on gains realized by non-UK residents unless the gains are attributable to oil and gas assets located in the UK or the UK continental shelf. This includes gains from the disposition of shares of a company whose value is attributable to such oil and gas assets; however, UK tax will not apply if the shares are quoted on a recognized stock exchange (which does not include the Alternative Investment Market).

Financing UK Holdco

For the reasons given in relation to the inbound position, it is unlikely to be desirable to fund UK Holdco with debt unless it has other UK operations. Interest paid to Canco would attract 10% UK withholding tax under the Canada-UK Tax Treaty.

Financing Foreign Opco with Debt

For the reasons given in relation to the inbound structure, financing Foreign Opco with debt from UK Holdco is not likely to be attractive. The withholding tax position would depend on the local rules applicable to Foreign Opco and the terms of any tax treaty between the UK and the country of residence of Foreign Opco, including any limitation on benefit articles or other limitations which may restrict treaty relief.

OTHER UNITED KINGDOM CONSIDERATIONS

The following is a summary of some additional features of the UK tax and legal systems which may be relevant in considering the UK for a Canadian inbound or outbound investment.

Loss Carry Forwards

If trading losses are made in the UK, these can be carried forward indefinitely against profits from the same trade, provided there is not both a major change in ownership and a major change in the nature or conduct of the trade.

Permanent Establishments

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A UK resident company is normally taxed on its worldwide income and gains. However, it is now possible for certain permanent establishments to be taxed on a territorial basis, if the relevant company so elects.

Stamp Duty

The UK applies stamp duty on share transfers and on property transactions. The UK is increasingly seeking to tax UK residential property in the hands of non-residents. It is common to choose a non-UK incorporated but UK tax resident company to avoid the stamp duty. There is a relief from stamp duty available for certain intra-group transactions.

Employees

Unlike corporate level taxes, individual taxes and social security contributions in the UK are still at relatively high levels. The top rate of tax on income (with few reliefs) is 45%, and on capital gains it is 28%. Social taxes are at 12% for individuals (2% above a certain level of income) and 13.8% for employers (on salaries and benefits).

A statutory residence test now makes it easier to determine the point at which visitors to the UK become tax resident.

Tax Stability

The current corporation tax regime was the result of a degree of cross-party consensus, so fundamental change is not expected even if there is a change of government in the UK. However, the UK is still in a deficit position, and so a tax rate increase cannot be ruled out. However, for a company such as a UK Holdco contemplated in this paper, a rate rise may have no impact, since their income and gains are largely exempt from tax, and this exemption seems even less likely to change.

Patent Box Regime

The UK wishes to attract technology heavy activities to the UK, and so has introduced the patent box structure which offers a lower rate of tax on certain income derived from European patents.

Oil and Gas Regime

The UK offers a favourable tax regime for higher risk oil and gas operations, and has recently clarified the tax treatment of the compulsory decommissioning regime. Companies can enter into contracts with government which set down what the tax position for that company will be. This means that security for these obligations can now be provided on an after-tax basis.

CFC Finance Company

Within the CFC regime there is a special regime for offshore finance companies providing for a lower rate of tax applying to profits which come within the scope of the rules.

Exit Taxes

On ceasing to be UK resident, a company is deemed to dispose of all its capital assets, loan relationships, intangibles and derivatives at market value. In order to comply with EU rules, the resultant tax charge can be

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deferred for a period of time. If the assets owned by the company qualify for the SSE, no tax liability should arise in respect of shares in subsidiaries of the company unless that regime has changed before the exit.

In some cases, notification has to be given to the UK Treasury that a company is ceasing to be UK resident.

Anti-Avoidance and Disclosure Regime

The UK has focussed heavily on anti-avoidance over recent times, and as a result the UK has a general anti-abuse rule (less stringent than a general anti-avoidance rule), and many of its more favourable tax regimes are controlled by specific targeted anti-avoidance rules. In addition, advance notice has to be given in relation to tax avoidance schemes.

Tax Rulings

No formal tax ruling system exists, but larger companies now have Customer Relation Managers within the UK tax authority, and informal discussions are part of the function of the Customer Relation Managers. There are non-statutory clearances available in some cases, but in general there is less interchange between taxpayers and HMRC than might be seen in other jurisdictions such as Luxembourg or the Netherlands. Advance pricing arrangements are available.

BEPS

The UK is an active participant in the BEPS process, and has published some guidance on how it views the action points affecting the UK. The UK system is already compliant in some respects (for example, the dividend exemption does not apply if the payer can obtain a tax deduction for the dividend and the patent box regime has substance requirements). In general, it is expected that the UK will not act to pre-empt BEPS outcomes, and will only act if there is international action more generally. Having said this, HMRC have recently imposed a statutory limitation on deductions for intra-group charterhire payments for bareboat charters of drilling rigs and accommodation platforms, even where the rate being paid has been signed off under an advance pricing arrangement as a market rate. As a result, if the UK perceives significant tax leakage it may act unilaterally. However, in general the UK is not viewed as a tax haven.

Value Added Taxes

A detailed discussion of UK VAT is beyond the scope of this paper. As holding companies do not carry on an active business in EU terms, there may be some non-recoverable VAT if there is not a wider UK group. However, the amounts should not be significant.

Common Law

The UK operates a common law based system, which is more similar to the Canadian legal system model (outside of Quebec civil law) than other jurisdictions which may be used for holding companies.

Corporate law

UK company law is relatively straightforward and should not impose constraints, especially where UK Holdco is not a public limited company.

Non Sterling Accounts

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It is generally possible to maintain financial accounts in currencies other than sterling, and to use these currencies as the basis for tax on income (and capital gains in some circumstances).

Anti-bribery and Corruption Rules

The UK has stringent rules in this area (for example, facilitation payments are not permitted); whether the rules would apply to a UK Holdco which is non-UK incorporated but UK tax resident only by virtue of director meetings being held in the UK should be reviewed if this is a concern.

CONCLUSION

The recently transformed UK tax system provides a number of advantages which are well understood and which facilitate certain planning objectives typically considered for holding companies used in Canadian inbound and outbound investment. Although no particular structure or holding company jurisdiction will work in all circumstances and the use of a UK holding company may not always be appropriate, the UK should now be considered among the list of possible holding company jurisdictions by Canadian practitioners.

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1 The authors wish to greatly thank Robert Joseph of Norton Rose Fulbright Canada LLP for his invaluable assistance in preparing this paper.
2 For example, a person exempt from tax pursuant to the *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1 (the "**ITA**"), s. 149(1). Unless otherwise indicated, all statutory references in this paper are to the ITA.
3 For example, certain US tax-exempt organizations may be entitled to an exemption from Canadian tax on certain Canadian source income by virtue of Article 21 of *The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital*, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (the "**Canada-US Tax Treaty**").
4 For Canadian tax purposes, partnerships are not taxpayers in their own right, but rather they generally compute their income under Canadian taxation principles and then allocate that income to their partners under ITA s. 96. Similarly, although trusts are taxpayers, if a trust's income for a taxation year is paid or payable to a beneficiary the trust is generally not liable for tax and, with certain designations, the nature of the income may be flowed through to the beneficiary: ITA ss. 104(6)(b), (13) and (19)-(22).
5 For a recent discussion of planning with hybrid entities and instruments, see Corrado Cardarelli and Peter Keenan, "Planning Around the Anti-Hybrid Rules in the Canada-US Tax Treaty", draft paper presented to the Canadian Tax Foundation's 65th Tax Conference, 2013.
6 The tax-exempt entity may not be subject to Canadian income tax by virtue of a tax treaty (*supra* note 3), or the Part XIII tax on the passive investment may be significantly reduced by a Canadian tax treaty. Further, where there are multiple investors such that the particular investor holds less than 25%, there may not be any Canadian tax on the disposition of the investment as the investment may not constitute taxable Canadian property: see text below at note 35.
7 Craig Maurice, "Private Equity Investments in the Oil & Gas Sector" 26 *Canadian Pet. Tax J.* (2013) at 3:2.
8 ITA s. 18(4).
9 ITA ss. 214(16), 212(2), 215(6) and 227(8.5).
10 ITA s. 18(5)"equity amount".
11 ITA s. 18(4)(a)(i).
12 Steve Suarez, "Canada's Problematic Proposed New Loan Rules", *Tax Notes Int'l,* May 5, 2014, p. 441.
13 Proposed ITA s. 18(6), pursuant to the *Notice of Ways and Means Motion to Amend the Income Tax Act and Other Tax Legislation* (Ottawa: Department of Finance, February 11, 2014) at clause 37(2).
14 Proposed ITA s. 18(5)"specified right", pursuant to the *Legislative Proposals Relating to Income Tax and Sales Tax* (Ottawa: Department of Finance, August 29, 2014) (the "**August 29, 2014 Legislative Proposals**") at clause 4(3).
15 Proposed ITA s. 18(6)(c)(i)(D), pursuant to the August 29, 2014 Legislative Proposals, *ibid*.
16 ITA s. 212.3. For detailed analysis (excluding discussion of the August 16, 2013 proposed amendments and the revisions to such proposals in the August 29, 2014 Legislative Proposals, *ibid*.), see Angelo Nikolakakis and Penelope Woolford, "Foreign Affiliate Dumping," *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013) 26:1.
17 Canada Revenue Agency Information Circular IC 87-2R, *International Transfer Pricing* (September 27, 1999).

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18 *Ibid*. at paras. 152-171.
19 ITA ss. 247(12)-(15).
20 ITA s. 212(1)(b).
21 ITA ss. 212(1)(a) and 212(4). The Canada Revenue Agency is of the view that for the exception in subsection 212(4) to apply, the specific expense must be explicit and identifiable, and must not include a mark-up or profit element: Canada Revenue Agency, Interpretation Bulletin IT-468R, "Management or administration fees paid to non-residents" (December 29, 1989) at para. 8.
22 ITA ss. 84(4); 53(2)(a)(ii) and 40(3).
23 ITA s. 84(4.1). It is common in the context of an inbound acquisition of a public corporation to file an election for the target corporation to cease to be a public corporation for Canadian tax purposes to ensure that the restriction in ss. 84(4.1) will not limit the ability to return capital following the acquisition. The election should be filed after the shares of the target corporation are delisted and prior to the target corporation amalgamating with the Canadian acquisition corporation.
24 In general, PUC of lower-tier shares in a Canadian corporate group is not a helpful attribute as funds can generally be moved among Canadian corporations by way of dividends deductible under subsection 112(1), and a distribution of PUC by a lower-tier corporation does not impact the PUC of the shares of the higher-tier corporation. Furthermore, tax planning to move lower-tier PUC to the top-tier shares may be considered abusive within the meaning of the general anti-avoidance rule in ITA s.245: see *Copthorne Holdings Ltd. v. R.*, 2011 SCC 63.
25 For example, in *The Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980, October 16, 1985, May 7, 2003 and July 21, 2014 (not yet in force) (the "**Canada-UK Tax Treaty**"), a "royalty" is defined in Article 12:4 as including certain payments in respect of tangible or intangible *personal* property, not real property. Article 6:2 provides that for treaty purposes, "real property" takes its meaning from Canadian domestic law, and section 5 of the *Income Tax Conventions Interpretation Act*, R.S.C. 1985, c. I-4 ("**ITCIA**"), generally provides that real property in Canada includes any right to an amount computed by reference to production from natural resources in Canada. Article 6:2 further provides that real property includes rights computed by reference to the amount or value of production from natural resources.
26 See, for example, Robert Couzin, "A Few Thoughts on Treaty Shopping" (2013) 61(3) *Canadian Tax Journal*, 671.
27 ITA s. 245(4)(a)(iv); ITCIA, *supra* note 25, s. 4.1.
28 *MIL (Investments) S.A. v. R.*, 2007 FCA 236; *Velcro Canada Inc. v. R.*, 2012 TCC 57 ("***Velcro***"); *Prevost Car Inc. v. R.*, 2009 FCA 57 ("***Prevost Car***"); *Garron Family Trust v. R.*, 2010 FCA 309 at para. 90, aff'd 2012 SCC 14.
29 Article 10:7 of the *Agreement Between the Government of Canada and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income*, signed at Hong Kong on November 11, 2012. For further discussion, see Joyce Lee & James W. Radelet, "Canada-Hong Kong Income Tax Agreement", *2013 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2013) 6:1 at 6:19-6:22.
30 Canada-UK Tax Treaty, *supra* note 25, art. 10:7.
31 Canada-US Tax Treaty, *supra* note 3, art. XXIX-A.
32 This was a common view among several of the submissions made in respect of the August 12, 2013 consultation paper: see Joel Nitikman, Shawn Porter and Carrie Smit, "Department of Finance Consultation Paper and Submissions" (presentation delivered at *Treaty Shopping: Anticipating Developments in Canada and Internationally*, conference presented jointly by the International Fiscal Association and the Canadian Tax Foundation), February 3, 2014.
33 See the paper by Gordon Zittlau and Ivan Williams presented at this conference.
34 Department of Finance News Release 2014-113, "Department of Finance Consults on Draft Tax Legislation" (August 29, 2014), available online: <http://www.fin.gc.ca/n14/14-113-eng.asp>.
35 Notwithstanding paragraph (e) of the definition of "taxable Canadian property" in subsection 248(1), even where these conditions are satisfied the investment may constitute TCP if a "deemed TCP" rule applies, e.g. ITA ss. 51(1)(f), 85(1)(i), 85.1(1)(a), 87(4).
36 CRA doc. 9506785, "Property — in which business of company carried on" (August 29, 1995); CRA doc. 9703965, "Shares deriving value from immovable property" (June 12, 1997); CRA doc. 2000-0015753, "Article 13—Canada-Netherlands Treaty" (2000).
37 See text above at note 26.
38 In the context of Article 13:7(b) of the Canada-UK Tax Treaty, the CRA has expressed the view that property referred to in Article 13:4 is distinguished from immovable property. See CRA doc. 9629635, "Look-through provisions in Article 13 United Kingdom treaty" (May 14, 1997) and CRA doc. 9233205, "Article XIII-7(B) of U.K. convention" (November 6, 1992).
39 See, e.g., John W. Boscariol, "Considering the Role of Trade and Investment Treaties in Tax Disputes," *Report of Proceedings of Fifty-Eighth Tax Conference*, 2006 Conference Report (Toronto: Canadian Tax Foundation, 2007), 19:1.
40 For UK Holdco to be a resident of the UK for treaty purposes, generally UK Holdco must be incorporated in the UK and have its central management and control located in the UK. Central management and control is generally the type of control exercised by the board of directors of a company (provided it is that body which makes the strategic decisions in relation to the company), and thus a

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company will normally be tax resident in the UK if the board of directors hold their meetings there and the actual decisions relating to the company are taken at those meetings: see text below at note 45.
41 Canada-UK Tax Treaty, *supra* note 25, art. 10:2; *Velcro*, *supra* note 28; *Prevost Car*, *supra* note 28.
42 ITA ss. 20(12), 126.
43 Foreign resource expenses are generally expenses incurred outside of Canada which would be included in Canadian oil and gas property expense, Canadian development expense or Canadian exploration expense if incurred in Canada: ITA s. 66.21(1)"foreign resource expense". Foreign resource expense pools are tracked on a country-by-country basis, and generally permit a minimum 10% annual deduction on a declining-balance basis and a maximum deduction of 30% if sufficient foreign income is earned: ITA s. 66.21(4). Expenses incurred in taxation years ending before 2001 are generally considered foreign exploration and development expense: ITA s. 66(4).
44 For detailed discussion of the foreign affiliate rules, see Angelo Nikolakakis, *Taxation of Foreign Affiliates*, looseleaf (Toronto: Thomson Canada); Drew Morier and Raj Juneja, "Foreign Affiliates: An Updated Primer", *Report of Proceedings of the Sixty-Fourth Tax Conference, 2012 Conference Report* (Toronto: Canadian Tax Foundation, 2013) 28:1.
45 *De Beers Consolidated Mines, Ltd. v. Howe* (1906), 5 T.C. 198 (H.L.).
46 In order for the foreign subsidiary to not be a Canadian resident such that the subsidiary is not subject to Canadian taxation on its worldwide income, it would be sufficient for the central management and control to be located anywhere other than Canada. However, for the subsidiary's income from businesses in a designated treaty country to constitute "exempt surplus", the subsidiary must also be resident in a designated treaty country and this typically requires the central management and control to be located in that country.
47 One possibility is to consider using a farm-in to dilute the branch in favour of the subsidiary. However, such a transaction is relatively complex and may trigger foreign tax consequences.
48 See *supra* note 44.
49 Historically, there was some uncertainty in determining whether a distribution would be considered a return of capital, a dividend or some other form of distribution. Recently enacted subsection 90(2) largely resolves these difficulties by generally deeming *pro rata* distributions from foreign corporation to be dividends for Canadian tax purposes such that the foreign affiliate surplus regime is engaged.
50 ITA ss. 95(1)"active business", 95(2)(a).
51 ITA ss. 95(2)(a.1)-(a.4).
52 ITA s. 95(1)"investment business".
53 *Income Tax Regulations*, C.R.C. c. 945 ("**ITR**"), s. 5907(11). In certain circumstances a country may be a designated treaty country before the tax treaty or TIEA has entered into force: ITR ss. 5907(11.1), (11.11)
54 ITA s. 113(1)(a).
55 ITR ss. 5907(11.2); 5907(1)"exempt earnings"(d).
56 ITR s. 5907(1)"exempt earnings"(a).
57 ITA ss. 90(1), 113(1)(a), 113(1)(b).
58 ITR s. 5907(1)"taxable earnings".
59 ITA ss. 90(1), 113(1)(a.1).
60 ITR s. 5901(1).
61 ITR ss. 5900(2), 5901(1.1).
62 ITA ss. 113(1)(d), 92(2), 53(1)(b).
63 ITR s. 5901(2)(b).
64 ITA s. 93(1).
65 ITA s. 85.1(4).
66 See, e.g., *Copthorne*, *supra* note 24; *Groupe Honco Inc. v. R.*, 2013 FCA 128.
67 See discussion in the text above at note 39.
68 See *supra* note 40.

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