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PRACTITIONERS' CORNER

Using Foreign Holding Companies in Canada

by Jack Bernstein

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In this article, the author examines the use of non-Canadian holding companies to conduct business in Canada. He looks at the history of these entities, the tax risks under current law, and the issues involved in winding up complex holding company structures.

Nonresidents of Canada have often used non-Canadian holding companies to own Canadian investments. Likewise, Canadian multinationals have used non-Canadian holding companies to own global investments. This article addresses both practices, with specific emphasis on the tax risks of maintaining a non-Canadian holding company as well as tax issues involved in winding up holding company structures. This topic is of particular importance because new antiabuse rules in the EU may affect these structures, potentially even rendering them inactive. The rules against treaty shopping proposed by the OECD/G-20's base erosion and profit-shifting project action 6 (treaty abuse) plan may also apply to these entities.

Using Non-Canadian Holding Companies

In the past, popular jurisdictions for holding companies in Canada were Luxembourg, Barbados (a Barbados limited company owned by an international business corporation), the Netherlands, and Cyprus. The use of holding companies in Luxembourg was particularly popular with U.S. funds investing in Canada.

Previously, all share sales in Canada required section 116 clearance certificates under the Income Tax Act and disclosure of all beneficial owners. Holding companies in treaty jurisdictions offered treaty capital gains exemptions, possible reductions in withholding taxes on dividends, and the benefit of a single filer in Canada. For U.S. residents, the holding company may have qualified to check the box, allowing it to be disregarded or be viewed as a partnership for U.S. purposes. Canada later amended its domestic legislation and changed the definition of taxable Canadian property (TCP) not to tax the sale of shares in companies when less than 50 percent of the fair market value of the assets was not real estate, resource properties, or timber rights.[1] Barring specific exceptions, the sale of public company shares by a nonresident who owns less than 25 percent of the shares is also exempt, even if the Canadian company is a real estate, resource, or timber rights company. This is similar to the U.S. system, which taxes a nonresident only on the sale of shares of a real property holding company.

Given these changes, Canada will not tax most nonresidents on the sale of shares, so the need for an intermediary treaty jurisdiction holding company has diminished. The structure is beneficial only if the Canadian investment is TCP and protected by a treaty or if dividends are expected from the Canadian company and a treaty provides for a lower Canadian withholding tax.

Luxembourg remains an attractive location for a holding company because the governing treaty's capital gains exemption extends to all sales of Canadian public shares, even if the company is a resource company or real estate company and the nonresident owns more than 25 percent of the shares. It also covers shares of Canadian real estate companies in which the assets used in the business are also exempt (for example, a

[1]Canadian Department of Finance, 2010 Budget, Budget Plan, at 367 (Mar. 4, 2010).

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hotel, nursing home, freezer plant, or marijuana production company) and shares of less than 10 percent of a Canadian company owning real estate. Luxembourg only had a participating exemption for dividends, which required a minimum 10 percent shareholding in the Canadian company. Cyprus was sometimes used since the tax relief in Cyprus from capital gains, as compared with Luxembourg, didn't require a 10 percent share ownership in a Canadian company.

Although Canada's domestic tax regime may provide relief for capital gains, other than transactions involving TCP, treaty relief may still be sought for dividend withholding tax. Unless a treaty provides relief, Canada will withhold tax at the rate of 25 percent on dividends or deemed dividends paid or payable to a nonresident. Most treaties with Canada reduce the rate of withholding tax to 5 percent if the nonresident is a corporation resident in the treaty country and is the beneficial owner of at least 10 percent of the shares of the Canadian company. The rate of withholding tax under those treaties is typically 15 percent for all other treaty residents of the treaty country. There may be an exemption for withholding on dividends for specified persons and tax-exempt entities. A treaty blocker is useful for a fund structured as a partnership because disclosure of tax information on all partners must be made to the Canada Revenue Agency. This is difficult when other funds have invested in the partnership.

Challenges to Holding Company Structures

In *Prévost Car Inc. v. R.*, 2009 FCA 57, a resident of Sweden and a resident of the U.K. formed a Dutch corporation to own the shares of a Canadian company. At that time, the 5 percent Canadian rate of withholding tax on dividends paid to a parent in the Netherlands was less than the rate of Canadian withholding tax to Sweden (15 percent) and less than the rate of Canadian withholding tax to the U.K. (10 percent). Canada challenged the use of the Dutch company, which distributed 90 percent of the dividends received to its shareholders, on the basis that the Dutch company was not the beneficial owner. The court upheld the structure because a positive act of the holding company's board of directors was required to declare and pay dividends. More specifically, the company's deed of incorporation did not mandate the payment of dividends, funds did not automatically flow to shareholders, and funds were available to creditors of the Dutch company until dividends were paid. The court also noted that the holding company was not party to the shareholders' agreement.

Likewise, in *Velcro Canada Inc. v. R.*, 2012 TCC 57, the CRA was unsuccessful in challenging a back-to-back royalty arrangement in which royalties were paid by a Canadian subsidiary to a Dutch parent and then by the Dutch company to its own parent in the Netherlands Antilles. The judge concluded that the Dutch company was the beneficial owner of the royalties, noting that the beneficial ownership tests of possession, use, and risk were met.

A taxpayer also withstood a CRA challenge in *R. v. MIL (Investments) SA*, 2007 FCA 236. The taxpayer, resident in Belize, continued a Cayman holding company to Luxembourg to access the treaty's capital gains exemption. The CRA attacked the structure on the basis of the general antiavoidance rule. The judge disagreed, finding no treaty abuse when the company became a treaty resident in Luxembourg. He mentioned that Canada knew the tax regime in Luxembourg when it signed the bilateral treaty.[2]

Changing Climate

It is arguable that Canada entered into the treaty with Luxembourg not to facilitate bilateral trade but intentionally to encourage nonresidents not residing in a treaty country to invest in Canada through Luxembourg. This would increase investment into Canada. Now, with BEPS, the climate has changed and the use of treaty holding companies is not generally condoned.

Canada has expanded its domestic GAAR to include treaty abuse, but the CRA's GAAR challenge failed in *MIL Investments*. Canada's treaties require that a treaty holding company be the beneficial owner to benefit from reductions in Canadian withholding tax. Nonetheless, the CRA also lost in court in both *Prévost* and *Velcro*. Therefore, Canada wants to adopt a treaty antiabuse rule in its domestic law or sign a multinational treaty including a comprehensive limitation on benefits clause.

Canada has a comprehensive LOB clause with the U.S. and various forms of antiabuse rules in approximately 16 other tax treaties, often included at the request of the treaty partner. Under the LOB clause with the U.S., a derivative benefits provision exempts nonresidents who would have obtained the same treaty benefits had they invested directly. For example, Article XI of the Canada-U.S. tax treaty[3] exempts withholding tax on interest paid to a Canadian resident. The U.S. has no withholding tax on interest paid to a Luxembourg SARL; therefore, a Canadian resident could use that structure to finance its investments in the U.S.

In 2013 Canada proposed the introduction of a special antiabuse rule in the ITA to curtail treaty abuse.[4] Taxpayers were invited to consult on the proposal. In 2014 Canada confirmed its commitment to enacting a domestic anti-treaty-shopping rule that

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[2]Convention Between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital, signed at Luxembourg on September 10, 1999.

[3]Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital, Sept. 26, 1980, as amended by protocols on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

[4]Canadian Department of Finance, ''Treaty Shopping — The Problem and Possible Solutions'' (Aug. 12, 2013).

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would include a major purpose test and a conduit presumption of abuse.[5] However, Canada decided to wait and see the final recommendations of the OECD and BEPS.[6] The 2015 Federal Budget reiterates the Canadian government's commitment to awaiting the conclusion of the BEPS project. The Canadian authorities hope that treaty shopping can be dealt with in a multinational agreement revising all treaties. Otherwise, Canada has stated, it would take 30 years to amend all its treaties.

Today, questions about Canadian tax exposure involving holding company structures center on two issues: central management control and transfer pricing. Unless a treaty (for example, the Canada-U.S. tax treaty) specifically provides that a corporation formed in the other contracting country is resident only in that country, Canadian authorities will attempt to deem the company resident in Canada if de jure (for example, a majority of Canadian resident directors) or de facto (for example, the company follows the instructions of a shareholder resident in Canada) control is exercised in Canada. Transfer pricing rules may pose a challenge to any non-arm's-length payments from Canada to a treaty holding company.

Economic substance is becoming a matter of international concern. The European Union has introduced legislation to curb treaty shopping. Likewise, the OECD's BEPS project suggested an LOB clause, which may incorporate a principal purpose test and could also include a separate antiabuse rule. Also, the OECD proposals would require that the treaty holding company have economic substance and business activities concerning the Canadian business. Portfolio management is notably excluded from acceptable business activities. This is contrary to past practice in which nonresidents formed a holding company in Luxembourg to own shares of a Canadian subsidiary and provide portfolio management for other assets of the Luxembourg company. Similarly, in the EU, a company formed solely for receiving dividends may not satisfy the requirement of having valid commercial reasons that reflect economic reality under the recently introduced GAAR in the EU's parent-subsidiary directive, Directive 2015/121/EU. If this test is not met, the holding company is not entitled to the tax benefits.

Applying the Rules in Practice

Meeting Modern Tax Requirements

Unless the Canadian company is wholly owned by the treaty holding company, it is difficult to create business activities in the holding company that relate to the Canadian entity. To take an example from my practice, my associates and I did a tax checkup and successfully reorganized a company to satisfy the BEPS test. Initially, a Dutch holding company owned all the shares of a Canadian company, which itself had global assets but not Canadian assets. The Dutch company had a Canadian director, a Dutch nominee-director, and a branch outside the treaty jurisdiction with employees. As a result of our review and recommendations, a majority of directors now reside in the Netherlands. The branch has been changed to a sister company that receives fees. The CFO and mergers and acquisitions legal team for the global and Canadian business have moved to the Netherlands to work for the Dutch company. We believe that this structure will survive a BEPS challenge since it has a valid commercial reason and its business relates to the Canadian company.

A U.S. corporation forming an unlimited liability company (ULC) in Canada may want to form a blocker in a treaty country (for example, the Netherlands or Luxembourg) to own the ULC. This is because Article IV(7)(b) of the Canada-U.S. tax treaty denies treaty benefits to a Canadian entity that is fiscally transparent for U.S. tax purposes and a corporation for Canadian tax purposes. Although the entity could avoid the adverse effect of Article IV(7)(b) for U.S. shareholders (other than a limited liability company) with proper planning, the easiest solution would be to avoid the Canadian tax treaty by interposing a holding company in the Netherlands or Luxembourg. Then the Canada-U.S. tax treaty would not apply. Although in 2010 the CRA ruled that the GAAR would not apply if a U.S. parent interposed a Dutch company to own a ULC,[7] it has recently indicated that it may apply the GAAR to this situation.

We acted for a large U.S. real estate fund structured as a partnership. The fund proposed to sell a Canadian rental property that it held directly. No treaty relief was available. However, it was necessary to obtain a section 116 clearance certificate under the ITA before or after the sale or the purchaser would be required to withhold 25 or 50 percent of the purchase price (versus the gain). Unfortunately, the application for the section 116 certificate requires tax information on all partners. Given that the U.S. fund had other funds as investors, it was impossible to comply. Thus, the purchaser withheld 50 percent of the purchase price. In this case, the fund should have interposed a single holding company (for example, a Luxembourg SARL that checked the box for U.S. tax) or an LLC to own the real estate. This would have left only one filer for the section 116 clearance certificate, and Canadian tax would have been payable only on the gain, not the total price.

Another file involved a treaty holding company in Luxembourg. If Canada enacts a new treaty antiabuse rule, the company would face tax in Canada on gains

[5]Canadian Department of Finance, 2014 Budget, Budget Plan (Feb. 11, 2014), at 349-357.

[6]Canadian Department of Finance, release, "Department of Finance Consults on Draft Tax Legislation" (Aug. 29, 2014).

[7]CRA Document No. 2009-0343641R3 (Oct. 10, 2009).

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on TCP (more than 25 percent of the shares of a Canadian public company in mining). On our recommendation, the holding company internally sold the shares of the Canadian company to crystallize the accrued gain and increase the tax basis of the shares. There is nothing wrong with taking advantage of current law to bump up the tax cost in anticipation of an adverse change in the law!

Other Canadian multinational clients express concern about their offshore holding companies in light of BEPS and the EU requirements for economic substance. For example, the rate of withholding tax may be the same if a corporate taxpayer in Canada owns a European company directly rather than through a Luxembourg company that fails the economic substance test. As a result, we recently continued a Luxembourg SARL to the country of the operating company and then merged the Luxembourg SARL and the operating company to ensure direct ownership by the Canadian parent and simultaneously reduce the withholding tax on dividends.

Changing Complex Corporate Structures

Clients have also asked us to simplify their international tax structure without incurring any tax. In addition to applying our Canadian tax expertise, this requires working with tax counsel in the jurisdictions of both the holding companies and the operating companies.

Assume a Canadian parent has a subsidiary in a favorable tax jurisdiction that in turn owns other companies. It may be possible to dissolve the other companies without Canadian tax if the dissolution qualifies as a designated liquidation and dissolution within the meaning of subsection 95(1) of the ITA. In that case, paragraph 95(2)(e) of the ITA would deem the other companies to dispose of their properties at cost and deem the subsidiary to acquire each property at the same cost. The subsidiary is also deemed to have disposed of its shares in the other companies at cost.

We encountered a structure in which a Canadian company owned a holding company in a non-EU country that owned a subsidiary in the EU. In order to dissolve the subsidiary without triggering tax in the jurisdiction of the subsidiary, the entity needed to move the holding company to an EU country. Because the migration involved a corporate continuance and the continued company had the same legal personality, there was no disposition for Canadian tax purposes or for the jurisdiction where the subsidiary had been resident.

One can dissolve a wholly owned foreign affiliate of a Canadian taxpayer without triggering Canadian tax. The dissolution must be a "qualifying liquidation and dissolution" under subsection 88(3.1) of the ITA. In accordance with subsection 88(3), the foreign affiliate is deemed to dispose of its properties at cost, the Canadian shareholder acquires the properties at cost, and the Canadian shareholder will be deemed to dispose of its shares in the foreign affiliate for proceeds equal to the aggregate cost to the foreign affiliate of all the distributed property.

Moving a subsidiary company's place of residence without triggering Canadian tax is also feasible. A company may reside in a treaty country because of its place of effective management. It may be possible to move the company by changing the place of effective management to another jurisdiction (for example, change the make-up and residency of the board of directors and move the head office). The Canadian parent would not owe Canadian tax on this relocation.

Before a windup, continuance, or merger, it may be commercially prudent to move some redundant assets from an offshore company that is to be wound up to a new offshore company. An exchange of assets for shares in an offshore company may be tax deferred under section 95(2)(c) of the ITA.

In order to avoid Canadian tax, any foreign merger must meet the requirements of section 95(2)(d) of the ITA. A migration followed by a merger or a cross-border merger may be appropriate.

Considerations From Other Jurisdictions

In any restructuring, the client should consult tax advisers in the existing jurisdiction of the holding company and of its subsidiaries to ensure all tax goals may be achieved. Specific wording may be required to meet the rules of another jurisdiction. Also, a tax ruling may be needed to benefit from a tax deferral in another jurisdiction. A minimum holding period could also be necessary. Further, special conditions may apply when there is a transfer of intellectual property if the taxpayer wants to take advantage of a new IP regime. Local counsel can also help the taxpayer decide if assets should be sold or contributed for shares to achieve a tax deferral. Stamp duty is yet another important consideration. Loss carryforwards in the holding company or its subsidiaries and favorable local tax rulings may be other factors to consider.

A liquidation or continuance may also affect consolidated reporting in a jurisdiction, and steps may be required to prevent tax leakages. A corporation that was part of a consolidated group in one country may, following a continuance, become part of a consolidated group in another country. Domestic antiabuse laws in an EU jurisdiction may mean that genuine economic activity is required for a holding company to benefit from the local tax regime.

The implementation of BEPS action plans, the proposed multilateral convention, and the introduction of European GAAR have necessitated a review of existing international structures of multinationals. Adjustments may be required to the corporate structure and to the activities of international holding companies. With careful tax planning, the restructuring may avoid triggering tax and may enable a holding company to benefit from treaty relief. ◆

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