Cassels

Multi-National Corporations and the Repatriation of Funds

Tera Li Parizeau

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COVID-19 has, and will continue to, disrupt historical revenue and cash management of many multi-national corporate groups. This disruption may necessitate transfers of cash from a corporate member of the group to another corporate member. A parent corporation may need to repatriate cash from foreign subsidiaries for its own requirements, or to redeploy within the corporate group subject to non-tax legal considerations. Any inter-group transfer of funds and the methods chosen will have important multi-jurisdictional tax considerations. The fundamental tax objective will generally be to select a method of transfer which will be as tax-efficient as possible in the particular circumstances. The common methods include dividends, return of corporate capital, capital reorganizations, redemption of shares, repayment of loans, making of loans, and payments of amounts for the provision of goods or services. Also, in some instances, consideration may be given to borrowing funds to make a repatriation of funds.

This comment summarizes the principal Canadian federal tax considerations under the *Income Tax Act* (Canada) (the ITA) of certain common methods of repatriation by a wholly-owned foreign subsidiary to a Canadian parent (Canco Parent), and by a Canadian subsidiary (Canco Subsidiary) to a foreign parent. In some cases, Canco Parent may also be owned by a foreign parent. There will be non-Canadian tax considerations in the jurisdictions of the foreign subsidiary of Canco Parent or the foreign parent of Canco Subsidiary in respect of the repatriation which will influence - if not drive - the planning. In some cases, the transfers may be made most efficiently by one sister corporation to another sister corporation without the need of routing cash through the parent subject to anti-avoidance rules.

Repatriation from Foreign Subsidiary to Canco Parent

The receipt of a dividend by Canco Parent from its foreign subsidiary is subject to a detailed set of rules. The full amount is included in the income of Canco Parent. Canco Parent will be entitled to claim a deduction in computing taxable income in respect of the dividend but subject to detailed rules. The quantum of the deduction will depend upon which notional "surplus account" of the foreign subsidiary, determined under the ITA, the dividend is deemed to be paid or paid out of, and any withholding tax and/or underlying foreign tax paid by the foreign subsidiary (or previously taxed foreign passive income that was included in the income of Canco Parent). Generally, a dividend paid by a foreign subsidiary resident in certain countries which have either a tax convention or a Tax Information Exchange Agreement with Canada and paid out of "active business income" will entitle Canco Parent to a deduction equal to the dividend.

Further, the computation of the relevant surplus accounts of the foreign subsidiary paying the dividend is complex and should be done before the dividend is paid. The calculations will in effect substantiate the amount of the deduction absent which the CRA can deny the deduction.

Another possible strategy of repatriation is for the foreign subsidiary to repay the principal of any loans owing to its Canco Parent. However, the repayment of any loans by the foreign subsidiary may result in increased foreign taxation of its taxable income, if any. If the loan is denominated in foreign currency, a taxable foreign exchange gain (or loss) will generally be realized by Canco Parent.

Moreover, a foreign subsidiary can also make a loan to Canco Parent. This transaction would be subject to a special set of rules called the "upstream loan" rules. Under these rules the amount of the loan may be included in the income of Canco Parent. Detailed planning is required in respect of a loan.

A redemption of shares of the foreign subsidiary by Canco Parent may result in a capital gain (or loss). There may be additional planning to reduce a capital gain such as a filing of an election to elect an amount of the capital gain as a deemed dividend to reduce its capital gain. As mentioned above, dividends received from Canco Parent's foreign subsidiary and included in the income of Canco Parent can potentially be offset by available deductions in computing taxable income of Canco Parent. A capital reorganization of the foreign subsidiary may also facilitate a tax-free return of funds.

Repatriation from Canco Subsidiary to Foreign Parent

The payment of a dividend by Canco Subsidiary will be subject to withholding tax at the rate of 25% subject to reduction under an applicable tax convention. Because of the many changes to Canada's tax treaties, it should be confirmed that treaty benefits are still available.

A reduction of "paid-up capital" under the ITA will not result in Canadian withholding tax but may have other tax consequences. For example, the reduction of paid-up capital may reduce the amount of interest deductible by Canco Subsidiary on a loan from any 25% or greater non-resident shareholder under the thin capitalization rules. The reduction of stated capital will also reduce the tax cost of the shares of Canco Subsidiary which might result in Canadian tax in the future on a sale of such shares in certain situations. Paid-up capital may be very different than stated capital under corporate law or the capital shown on the financial statements.

A repayment of a loan by Canco Subsidiary will reduce the interest deductible and may result in increased Canadian taxation of its taxable income, if any. If the loan is denominated in foreign currency, a taxable foreign exchange gain (or loss) will generally be realized by Canco Subsidiary.

There are several detailed rules applicable where Canco Subsidiary makes loans to a foreign parent. Such loans would avoid the withholding tax which would otherwise result from the payment of a dividend.

However, there will be a tax cost to the making of the loans. In particular, a loan can result in a deemed dividend subject to withholding tax unless certain requirements are satisfied. There are also rules that can impute an amount of interest income to the Canco Subsidiary unless certain exceptions are met. Careful planning is required to ascertain whether this approach will be viable and be more tax efficient than a payment of a dividend.

A redemption of shares of Canco Subsidiary may result in a deemed dividend subject to withholding tax. If a redemption results in a capital gain, the gain may be exempted from tax under the ITA. A capital reorganization may also facilitate a tax-free return of funds.

Optimal Repatriation Strategy

The optimal repatriation strategy will be driven by the relevant facts and circumstances, Canadian and foreign tax considerations, and non-tax legal and business considerations.
