

The Foreign Affiliate System

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The Legislative Scheme

- Subdivision (i) of Division B of Part I
 - Section 90 – Dividend received inclusion
 - Sections 91 and 92 – FAPI rules
 - Section 93 – Sale of a foreign affiliate
 - Section 93.1 – Shares held by a partnership
 - Section 94 – Non-resident trusts (NRT's)
 - Section 94.1 – Foreign investment entities (FIE's)
 - Section 95 – Definitions, deeming rules, reorganizations and anti-avoidance
- Section 113 – Dividend received deduction (DRD)
- Part LIX of Income Tax Regulations

Complementary Statutory Regimes

- Outbound Non-Resident Indebtedness – Section 17
- Transfer Pricing Rules – Section 247

Both these sections police outbound transactions which threaten the Canadian tax base.

Historical Overview

- 1962 – US introduces Subpart F Rules
- 1966 – Carter Report tabled
- 1969 – White paper released
- 1971 to 1974 – Tax Reform
- 1976 – Foreign affiliate rules come into full force
- 1981 – Budget introduces relieving measures
- 1984 – Offshore fund rules
- 1992 – Auditor General's report
- 1994 – Budget introduces significant modifications
- 1999 – Budget initiative regarding NRT'S and FIE'S

Historical Overview (Cont'd)

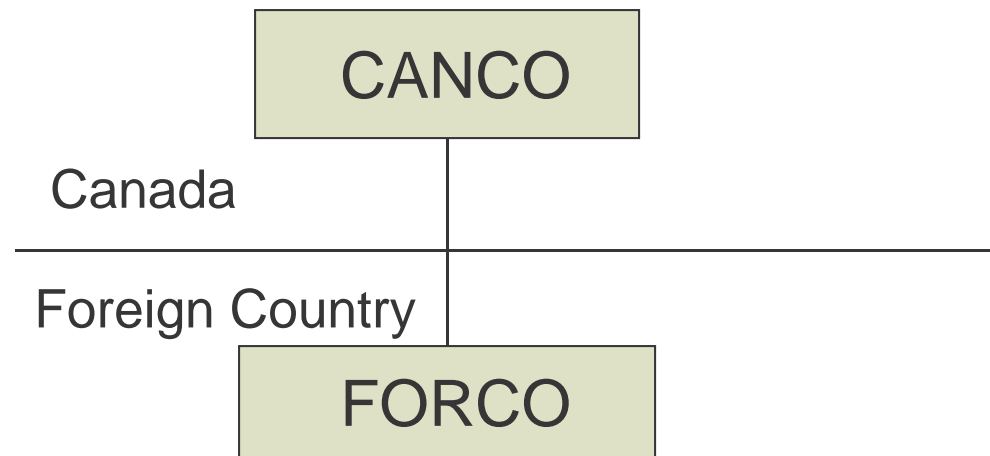
- 2002/2004 – Draft legislation proposing significant changes to Foreign Affiliate Rules
- 2007 – Exempt surplus expansion/TIEA's
- 2008 – Report of Advisory Panel
- 2010 – Budget announces significant (retroactive) changes to NRT and FIE rules

Foreign Investment by Canadians: Foreign Branch or Foreign Entity?

- Foreign Direct Investment: If Canco directly conducts foreign business or investment activities, foreign income or loss therefrom included in computation of Canco's income and taxable income, subject to FTC rules
Exception: Foreign branches of Canadian insurers exempt – subsection 138(2)
- Foreign Indirect Investment: If Canco indirectly carries on foreign business or investment activities through an interposed foreign entity, foreign income or loss not included in computation of Canco's income

Example 1

How and when should Canco recognize income and pay Canadian tax on FORCO's earnings?



It is assumed that FORCO is not directly subject to Canadian tax because:

- FORCO is not resident in Canada (subsection 2(1))
- FORCO does not carry on business in Canada (subsection 2(3))
- FORCO does not receive payments subject to Part XIII tax

Basic Tax Policy Issues

1. Canadian Recognition of Foreign Taxes

- Foreign corporate tax paid by foreign entity
- Foreign dividend withholding tax paid by Canco

Inadequate recognition will result in economic double taxation

2. Expatriation of Income

- Canadian residents can shift income from Canada to foreign jurisdiction using an interposed foreign entity

Inadequate surveillance will result in erosion of Canadian tax base

Basic Tax Policy Issues

- Canadian Recognition of Foreign Tax Paid by Foreign Entity
 - Because Canadian corporate tax system does not consolidate global group earnings, no immediate Canadian tax on foreign-source income earned by foreign entity
 - However when foreign entity pays dividend to Canco, dividend fully taxable – Section 90

Basic Tax Policy Issues

- Foreign Tax Recognition (Cont'd)
 - Because net dividend received represents net earnings of foreign entity after foreign corporate and withholding taxes, what recognition, if any, should be given to these foreign taxes paid by foreign entity and Canco respectively?
If no foreign tax recognition, possibility of double taxation
 - Thus, one purpose of foreign affiliate system is alleviating double taxation

Basic Tax Policy Issues

- Expatriation of Income
 - Using mechanism of foreign entity, Canadian resident can arrange its affairs so that investment income, which would otherwise be earned by it, is earned by foreign entity
 - As foreign entity is not resident in Canada, no Canadian tax payable on foreign-source investment income of foreign entity
 - This diversion of investment activity from Canada to foreign base raises important anti-avoidance issue from Canadian perspective

Basic Tax Policy Issues

- Expatriation of Income (Cont'd)
 - As a matter of Canadian tax policy, should a Canadian resident be permitted to organize its affairs so as to defer indefinitely Canadian taxation on investment activity?
 - If income shifted to low-tax jurisdiction, high Canadian tax replaced by low foreign tax
 - Thus, another purpose of foreign affiliate system is preservation of Canadian tax base

Certain Tax Policy Parameters

- Distinction between mobile and immobile activities
- Distinction between treaty and non-treaty jurisdictions – “Designated Treaty Country”
- Tax treaty category extended to include jurisdictions with which Canada has concluded a comprehensive tax information exchange agreement (« TIEA »)
- Primary right of foreign jurisdiction to tax foreign-source income (jurisdiction of source)
- Canada’s secondary right to tax foreign-source income (jurisdiction of residence)
- Increasing importance of bright-line rules

Basic Tax Policy Responses

- Section 113 – Dividend Received Deduction (DRD)
 - Canada will recognize foreign taxes paid on foreign-source income dividended to Canco if dividend recipient is a corporation which holds a significant interest in dividend payor – The concept of “Foreign Affiliate” defines significant interest
- Canada will seek to tax foreign-source investment income as it is earned if Canadian resident or residents control foreign entity which is a Foreign Affiliate—concept of “Controlled Foreign Affiliate”

What is a Foreign Affiliate?

- Entity classification – FA must be a corporation
- FA is corporation not resident in Canada
- Significant interest test – 10%
- Equity percentage
- Direct equity percentage
- Canco's equity percentage in foreign corporation must be not less than 1% and Canco's equity percentage together with equity percentages of related persons must be not less than 10%
- Special Test: "Qualifying Interest" – 10% votes and value test

Manipulation of Foreign Affiliate Status

- Subsection 95(6) – Anti-avoidance rule targets structures affecting foreign affiliate status
- Provision can deem optioned shares to be owned
- Provision can undo acquisition or disposition of shares
- Focus is « principal purpose » of impugned transaction

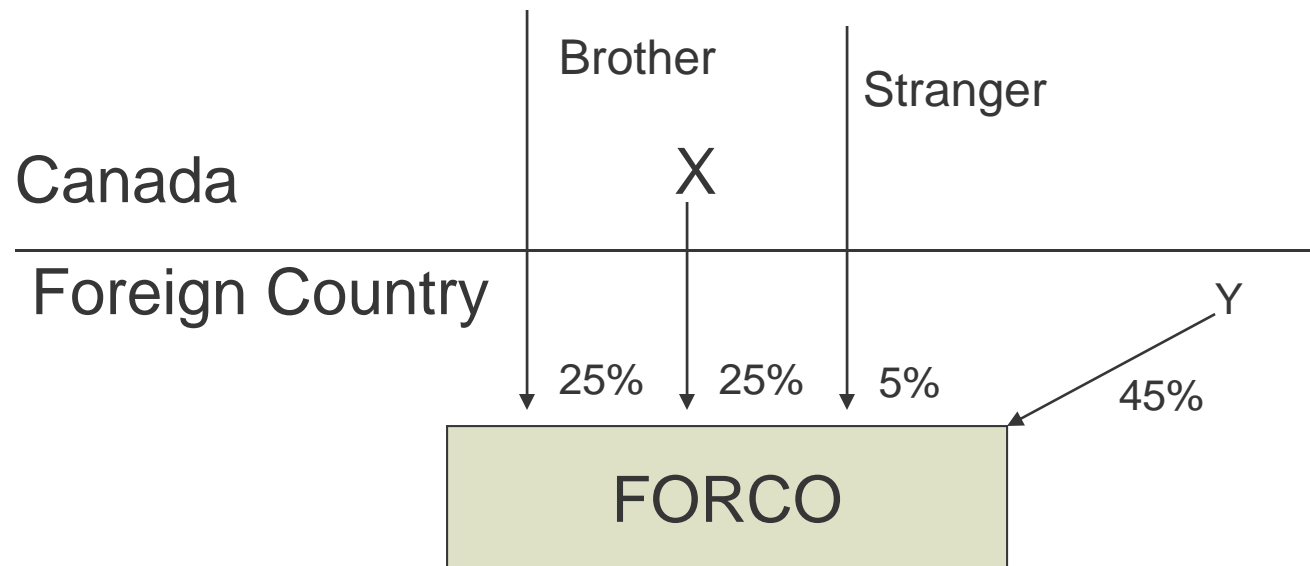
Subsection 95(6) – Application

- Provision limited to sections 91-93.1 and 95 (proposed)
- CRA prefers provision to GAAR as basis of assessment because test thought less exigent
- Case law on meaning of provision:
Univar – 2005 TCC – taxpayer victory

What is a Controlled Foreign Affiliate?

- CFA is FA either controlled by the taxpayer, or an FA which could be controlled by the taxpayer if the taxpayer owned all shares owned by
 - Taxpayer
 - Person or persons with whom Taxpayer does not deal at arm's length;
 - Any set of not more than four persons resident in Canada (the "relevant shareholders"), other than the Taxpayer and persons not dealing at arm's length with the Taxpayer
 - Person or persons with whom relevant shareholders do not deal at arm's length
- "Control" determined in accordance with de jure standard: Buckerfield's, 1957 Ex. Ct., Duha 1998 SCC

Example 2



Facts:

X and his brother do not deal at arm's length

Stranger deals at arm's length with X and his brother

Y is a non-resident of Canada who deals at arm's length with X, his brother and Stranger

Analysis:

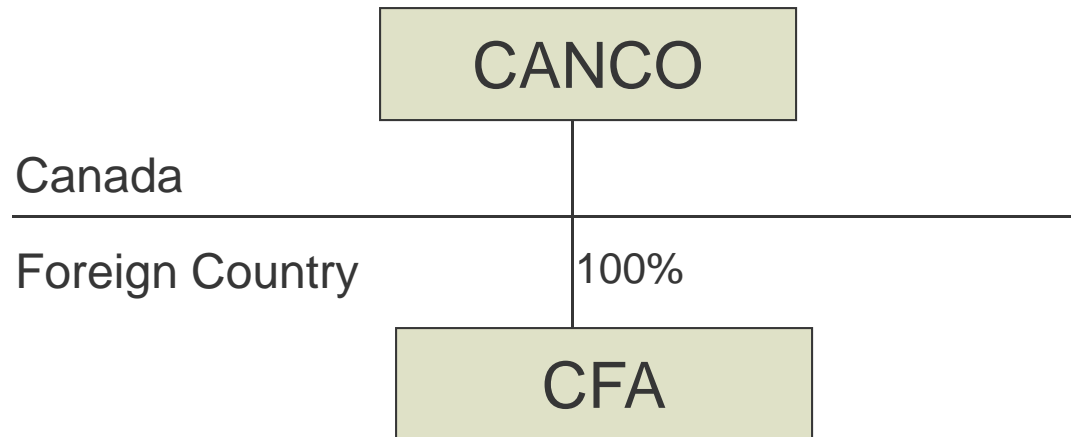
FORCO is a CFA of both X and his brother

FORCO is not an FA of Stranger, and therefore cannot be a CFA of Stranger

Imputation of FAPI

- If Canadian resident holds an interest in CFA, foreign accrual property income (“FAPI”) of CFA imputed to Canadian resident on proportionate basis – Subsection 91(1)
- Income inclusion reduced by amount of income treated as taxed at appropriate level – Subsection 91(4)
 - Foreign accrual tax applicable to FAPI (FATA)
 - Relevant tax factor
 - FATA multiplied by relevant tax factor to yield deductible offset against income inclusion

Example 3



FAPI 1000

FATA 100

FATA X relevant tax factor = $100 \times \frac{1}{0.38} = 263$

Gross FAPI income = 1000

FATA gross-up = $\frac{263}{1}$

Net FAPI income = 737

CANCO includes \$737. of net FAPI in computing its income from Canadian tax purposes (*i.e.* the portion of the income which Canada considers untaxed by Canadian standards)

Imputation of FAPI

- If dividend received is traceable to taxable surplus, deductible offset avoids possible double taxation of already-taxed FAPI – Subsection 91(5)

ACB Adjustment: Canco's Shares in CFA

- Subsection 92(1): timing issue
- Net FAPI inclusion added to ACB of shares of CFA held by Canco so as to avoid double-taxation upon subsequent disposition of shares
- If prior to any disposition of shares of CFA, CFA pays dividend traceable to taxable surplus to Canco, then Canco must reduce basis

What is FAPI?

- FAPI is largely passive investment income of FA
- Definition of FAPI in subsection 95(1)
- FAPI is net amount
- FAPI is computed under Canadian tax rules – paragraphs 95(2)(f) and (f.11)

Essential Components of FAPI

- Income from property
- Income from businesses other than active businesses
- Taxable capital gains from dispositions of property, other than excluded property
- Income from non-qualifying businesses (certain business income sourced in non-treaty/non-TIEA jurisdictions)

Deductions in Computing FAPI

- Losses from property
- Losses from businesses other than active businesses
- Allowable capital losses from dispositions of property other than excluded property
- Losses from non-qualifying businesses
- Deductibility of allowable capital losses not restricted to taxable capital gains

Amounts Not Included in Computing FAPI

- Interaffiliate dividends – Transmogrification of active business income to investment income avoided
- Capital gains and capital losses accruing prior to time at which foreign entity becomes FA disregarded – paragraph 95(2)(f.1)

Foreign Accrual Property Loss (“FAPL”)

- If net FAPI is negative, Regulation 5903 provides that FAPL may be carried back three years and forward seven years

Income from Property Statutorily Defined

- Income from property, classically speaking
- Income from adventure or concern in the nature of trade (reversal of normal rule)
- Income from investment business (defined concept)
- Income from property does not include income from active business or income from business other than inactive business

What is Investment Business?

- Investment business of FA means business the principal purpose of which is to derive income from property or profits from disposition of investment property **unless** business is conducted principally with persons with whom FA deals at arm's length, AND
 - Business is a regulated financial businessOR
 - Business is development of real estate for sale, lending of money, leasing or licensing of property or insurance or reinsurance of risksAND
 - FA employs more than five employees full-time in active conduct of business

What is Investment Property?

- Definition inclusive
- Shares which are not excluded property
- Partnership interests which are not excluded property
- Trust interests which are not excluded property
- Indebtedness or annuities
- Commodities or commodities futures traded on exchanges
- Currency
- Real estate
- Resource properties
- Interests in other entities or funds
- Interests or options in respect of any of the foregoing

What is Excluded Property?

- Property of FA used or held principally for purpose of gaining or producing income from an active business
- Shares of FA if all or substantially all its property is excluded property
- Amount income from which is income from an active business (actual or recharacterized)

What is Income from an Active Business?

- Income from business, classically speaking
- Defined to **include** incidental business income
- Defined to **exclude** income from property, income from an inactive business and income from a non-qualifying business

Income from Inactive Business/Base Erosion Rules

- A series of statutory provisions deem certain types of business income to be income from a business other than an inactive business, and hence FAPI, **unless** more than 90% of the gross revenue of business is derived from transactions with persons with whom FA deals at arm's length; purpose of rules is to prevent erosion of Canadian tax base
- These deeming rules catch the following types of business income:
 - Income from sale of property – Paragraph 95(2) (a.1)
 - Income from insurance – Paragraph 95(2)(a.2)
 - Income from Canadian debt and lease obligations – Paragraph 95(2)(a.3)
 - Income from partnership debt and lease obligations – Paragraph 95(2)(a.4)

Income from Inactive Business (Cont'd)

Inactive business rules inspired by series of tax cases:

- Irving Oil 1991 FCA
- Consolidated Bathurst 1987 FCA
- Canada Trustco 1999 FCTD

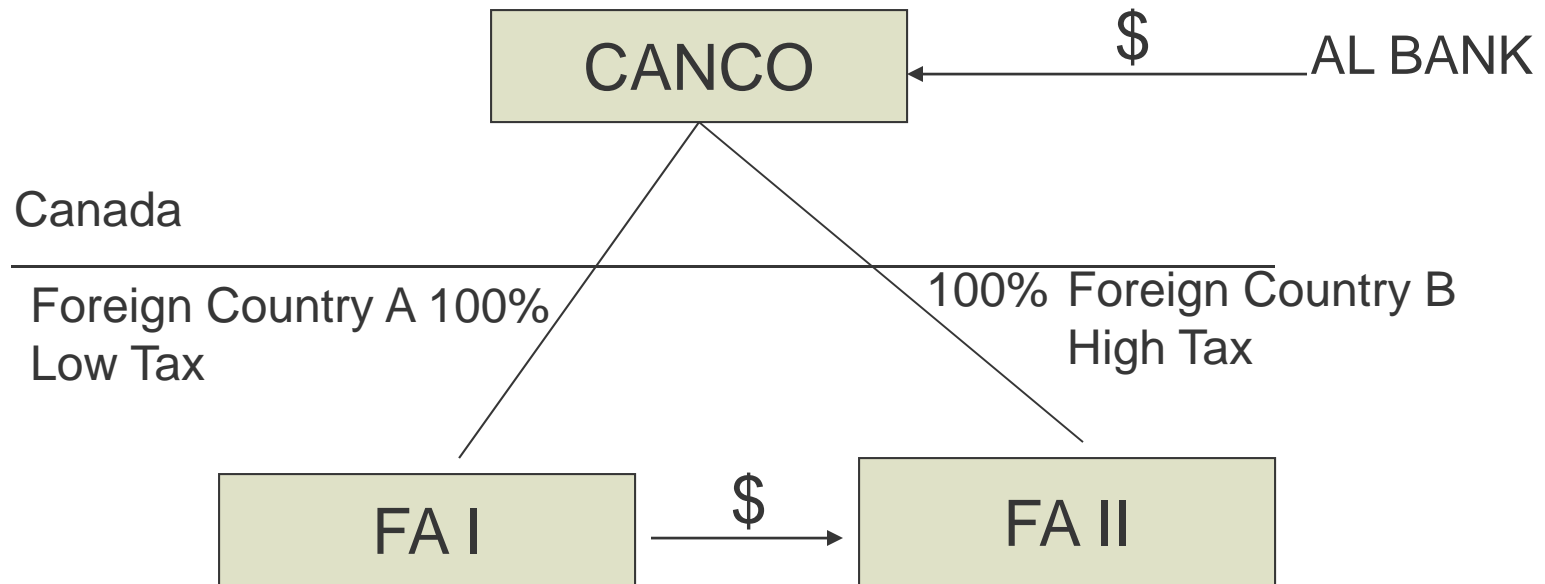
Recharacterization of FAPI as Active Business Income

- Certain statutory provisions recharacterize income of FA which would otherwise be FAPI as active business income
 - Subparagraph 95(2)(a)(i) – Special purpose FA related to another FA carrying on an active business – e.g. income of leasing subsidiary of foreign bank otherwise treated as investment business income

Recharacterization of FAPI as Active Business Income

- Subparagraph 95(2)(a)(ii) – Certain interaffiliate payments – FAI carries on active business, FAI borrows money from FAII, interest paid by FAI to FAII (which otherwise might be FAPI to FAII), will be recharacterized as active business income to FAII to the extent interest is deductible in computing the active business income of FAI – Status of FAII as foreign affiliate determined under “Qualifying Interest” test
- “Double dip” financings

Example 4: « Double Dip » Financing



1. Canco borrows \$ at interest from arm's length Canadian bank, AL Bank
2. Canco uses borrowed \$ to purchase shares of FA I and deducts related interest expense under paragraph 20(1)(c) - « First Dip »
3. FA I lends \$ at interest to FA II; interest earned by FA I lightly taxed in Country A and recharacterized by Canada as ABI (no FAPI imputation) and potentially paid to Canco as tax-free dividends
4. FA II deducts interest expense related to FA I loan under Country B tax law – « Second Dip »
5. Country A and Country B withholding taxes may erode « Double Dip »

Certain Non-Recognition Rules

- Various non-recognition rules may apply to transactions involving foreign affiliates
 - Subsection 85.1(5) – Foreign share-for-foreign share exchange
 - Section 51 – Convertible property
 - Section 86 – Exchange of shares by a shareholder in course of reorganization of capital

Certain Non-Recognition Rules

- Non-recognition provisions which specifically target foreign affiliates
 - Subsection 85.1(3) – Canco transfers shares of FAI to FAII – Anti-avoidance provision denies non-recognition treatment if transfer occurs as part of a series of transactions involving sale of FAI to arm's length purchaser
 - Subsections 87(8), (8.1) – Foreign Mergers
 - Paragraph 95(2)(c) – FAI transfers shares of FAII to FAIII
 - Paragraphs 95(2)(d), (d.1) – Merger involving foreign affiliates
 - Paragraphs 95(2)(e), (e.1) – Winding-up of foreign affiliate
 - Subsection 88(3) – Winding-up of foreign affiliate into Canco

Certain Non-Recognition Rules

- These various provisions to be carefully scrutinized, in particular as to whether (1) non-recognition treatment is total or partial, and (2) boot is permissible
- Pending amendments/comfort letters

Treatment of Dividends Received by Canadian Resident Corporation from Foreign Affiliate

- Essential issue is recognition of foreign taxes paid by both dividend payor and dividend recipient as offset for Canadian tax purposes
- Foreign taxes paid by dividend payor – Underlying foreign taxes applicable
- Foreign taxes paid by dividend recipient – Foreign withholding tax

Surplus Accounts

- Exempt surplus – Exemption method – No Canadian Tax
- Taxable surplus – Credit method – Foreign Tax “credited”
- Pre-acquisition surplus – ABC reductions

Four Categories of Income

	Treaty Countries	Non-Treaty Countries
Active Business Income	(1) EXEMPT SURPLUS (no Canadian tax if treaty country residence and source)	(2) TAXABLE SURPLUS (taxed upon dividend distribution)
Investment Income (FAPI)	(3) TAXABLE SURPLUS (taxed immediately if CFA)	(4) TAXABLE SURPLUS (taxed immediately if CFA)

What is Exempt Surplus?

- Active business income earned by FA resident in designated treaty country sourced in either (1) in a designated treaty country or (2) Canada
- Tax-free portion of capital gains (net of foreign tax)
- 2007 Budget extended exempt surplus treatment to active business income earned in non-treaty countries if Tax Information Exchange Agreement (“TIEA”) is in force or under negotiation
- Income from a non-qualifying business to be added to FAPI
- Significant tax policy change: presumption of foreign tax replaced as principal criterion by active business nature of income

What is Designated Treaty Country?

- Country with which Canada has contracted “comprehensive” tax treaty
- Residence of FA determined under tax treaty, not Canadian rules
- Certain exclusions – special tax regimes

WHAT IS A TIEA?

- TIEA = comprehensive exchange of information agreement
- OECD model information convention
- Access to information *sine qua non* to exemption treatment – Canada can audit legitimacy of taxpayer characterization

What is Taxable Surplus?

- Active business income which is not exempt earnings
- FAPI of FA
- Taxable portion of capital gains

What is Pre-Acquisition Surplus?

- Dividends not sourced to either exempt surplus or taxable surplus are considered to be paid as pre-acquisition surplus
- Appellation can sometimes be misnomer *e.g.* dividends sourced to appraisal surplus

Basic Scheme - DRD

- Dividends are considered to be paid firstly from exempt surplus, secondly taxable surplus and lastly from pre-acquisitions surplus
- All dividends included in income of Canco – Section 90
- Dividends traced to exempt surplus are fully deductible – Paragraph 113(1)(a)

Basic Scheme

- Portion of dividends traced to taxable surplus, which is considered as fully taxed by Canadian standards, is deductible – Paragraphs 113(1)(b) and 113(1)(c)
 - Approach similar to computation of FAPI – Underlying foreign tax applicable multiplied by relevant tax factor
- Dividends traced to pre-acquisition surplus are fully deductible, but go to reduce ACB of shares of dividend payor held by Canco– Paragraph 113(1)(d), subsection 92(2), subparagraph 53(2)(b)(i)

Sale of a Foreign Affiliate – Section 93 Election

- When Canco sells FA, Canco can electively choose to treat part of its proceeds of disposition as deemed dividend – this recharacterization may be tax advantageous to Canco because of Canadian tax treatment of deemed dividend
- In this way, Canco can gain beneficial Canadian tax treatment even if it is minority shareholder of FA and therefore cannot cause FA to pay an actual dividend
- Rule automatic in case of sale of foreign affiliate by another foreign affiliate
- Analogy to « safe income » dividends not recharacterized under subsection 55(2)

Interest Deductibility

- Interest on borrowed money used by Canco to acquire common shares of FA generally deductible by Canadian parent, even if anticipated dividends are attributable to exempt surplus: paragraph 20(1)(c)
- 2007 Budget proposed restriction on deductibility of Canadian interest expense if “double dip”, effective 2012
- 2009 Budget reversed 2007 Budget proposal

Other Issues

- Foreign Exchange
 - « Calculating currency » definition in subsection 95(1)
 - Gains and losses from excluded property and income from active business (actual or recharacterized) computed using calculating currency: paragraph 95(2)(f.12)
 - Canadian currency used to compute other items, e.g. FAPI: paragraph 95(2)(f.14)
- Surplus Multiplication: Pending Amendments

Advisory Panel Recommendations

- Exemption system broadened to cover all foreign ABI of FA's
- Exemption system extended to capital gains on dispositions of shares of FA's which are excluded property
- Base erosion rules critiqued
- Finance not yet committed to making these changes

Foreign Reporting Obligation – Section 233.4

- Annual filing requirement
- Due Diligence exception
- Penalties (consider carefully)

Parallel Systems

- NRT rules address tax leakage which would otherwise arise if taxpayers use trust structures
- FIE rules address tax leakage which would otherwise arise if taxpayers made investments in foreign entities which are not controlled foreign affiliates and the value of those investments derives primarily from investment property – “one of the main reasons” test
- Pending amendments on FIE rules (Budget 2010)
- Advisory panel on NRT rules (Budget 2010)
- Draft legislation August 27, 2010