International Taxation: Executive Brief

This executive brief provides an overview of the principal international taxation rules contained in the Income Tax Act (Canada) (Act).¹ These rules typically deal with the taxation of persons that have assets located in, or that carry on activities in, Canada and a foreign country. They are typically categorized as covering either inbound or outbound matters.

Where a person has assets or activities in both Canada and a foreign country, in many instances the person will be subject to double taxation, that is, it will be subject to tax in both Canada and the particular foreign country on the same item of income. Consequently, tax treaties between Canada and that particular foreign country, one of the principal roles of which is to eliminate double taxation, also form an important part of Canada’s international taxation rules.

This brief is divided in two main parts. Part A deals with the principal tax considerations that apply to a non-resident corporation that carries on business activities in Canada either directly through a branch or indirectly through a Canadian subsidiary. Part B then describes the foreign tax credit rules applicable to foreign-source income earned directly by a Canadian-resident corporation and the regime governing the taxation of foreign affiliates and controlled foreign affiliates of a Canadian-resident corporation.

A. International Inbound Taxation

I. Introduction

Three different parts of the Act deal with the taxation of Canadian-source income earned by a corporation that is a non-resident of Canada. Parts I and XIV impose tax on income from a business carried on in Canada, and Part I also imposes tax on capital gains from dispositions of certain types of property.² Part XIII imposes a withholding tax at a rate of 25 percent on the gross amount of certain passive-type income such as dividends, interest, management fees, rent and royalties paid or credited by a resident of Canada to non-resident persons.³

¹ All statutory references herein are to the Act, unless otherwise specified. Every effort has been made to ensure the accuracy of this publication, but the comments are necessarily of a general nature, are for information purposes only, and do not constitute legal advice in any manner whatsoever. Readers are urged to undertake careful analysis on matters of concern and not to rely solely on the text of this publication.

² Subsections 2(3) and 115(1).

³ See, for example, subsection 212(1) and its accompanying provisions.
The Canadian inbound taxation system distinguishes between activities carried on in Canada directly and those carried on indirectly through a Canadian subsidiary. Where a non-resident corporation carries on its business activities directly in Canada, it is generally subject to tax on the business income earned in Canada under Parts I and XIV of the Act, subject to possible relief under a Canadian tax treaty. Where a non-resident corporation carries on its business activities indirectly in Canada, the Canadian subsidiary, by virtue of being incorporated under Canadian law, is deemed to be resident in Canada and is therefore subject to Part I tax on its worldwide income. In addition, the Canadian subsidiary is also required to withhold tax under Part XIII on certain amounts, including dividend distributions, it pays or credits to non-resident persons.

Other than financial institutions, which are subject to special rules in the Act, non-resident corporations rarely carry on business in Canada directly through a branch. Therefore, after a short description of the taxation rules that apply to a Canadian branch of a non-resident corporation, the first part of this brief focuses mainly on the taxation rules that apply to a Canadian subsidiary.

II. Conducting Activities Directly Through a Branch

Under the Act, a non-resident corporation is subject to Part I tax on the taxable income it earns from carrying on business in Canada. The concept of carrying on business in Canada is not specifically defined in the Act. Consequently, this assessment is generally made by reference to the judicial principles developed under the common law and is supplemented by a rule that deems a non-resident person to carry on business in Canada in certain circumstances.

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4 Paragraph 250(4)(a). This deeming rule is subject to subsection 250(5), which provides that where a person is resident in both Canada and another country, the person is deemed not to be resident in Canada if, under the terms of the relevant Canadian tax treaty, the person is resident in the other country and not resident in Canada.

5 Subsection 2(1).

6 Supra note 2.

7 Much of the early jurisprudence on carrying on business comprises UK case law that is generally accepted as being authoritative in Canada. Based on the UK common law principles, Canadian courts have generally considered the location of the operations from which the profits arise and the place where the profit-generating contracts are made to be the two most important factors in determining whether a non-resident corporation is carrying on business in Canada. See, for example, Geigy (Canada) Ltd. v. Commissioner, Social Services Tax, [1969] CTC 79 (BCSC); Cutlers Guild Ltd. v. The Queen, [1981] CTC 115 (FCTD); and The Queen v. Gurd’s Products Company Limited, [1985] 2 CTC 85 (FCA).

8 Section 253 provides that a non-resident person is deemed to be carrying on business in Canada if the non-resident person: (1) produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or part, anything in Canada; (2) solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada or partly in and partly outside Canada; or (3) disposes of certain types of property, including Canadian resource property and real property that is not capital property.
The income or loss of a non-resident corporation from carrying on business in Canada is generally computed for purposes of the Act under the same rules that are applicable to residents of Canada, subject to certain assumptions. More specifically, the income of the non-resident corporation is determined as if it had no income except from the business carried on in Canada, and was allowed no deductions in computing income except those reasonably applicable to the business carried on in Canada.\(^9\)

If the non-resident corporation is a resident of a country that has entered into a tax treaty with Canada and is entitled to the full benefit of that treaty, the non-resident corporation is generally taxable on its business profits earned in Canada only to the extent that such profits are attributable to a Canadian permanent establishment.\(^10\) Canada’s tax treaties typically provide for two broad types of Canadian permanent establishments. The first is the “fixed place of business” type\(^11\) and the second is the “dependent agency” type.\(^12\) The business profits of the permanent establishment are generally computed as if the permanent establishment is a distinct and separate enterprise dealing independently with the non-resident.\(^13\) It is still unsettled under Canadian jurisprudence whether notional transactions can be used to compute profits attributable to a Canadian permanent establishment.\(^14\) However, the adoption of the so-called “authorized OECD approach” by Canada should clarify that there are no substantial limitations on the application of the arm’s-length principle to the computation of profits attributable to a Canadian permanent establishment under Canada’s tax treaties.\(^15\)

In addition to Part I tax, a non-resident corporation that carries on business in Canada is also subject to Part XIV tax, which is generally referred to as branch tax.\(^16\) This tax is designed to ensure that branch profits withdrawn from Canada are subject to the same tax treatment as are net profits of a Canadian

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\(^9\) Paragraph 4(1)(b).

\(^10\) Generally, Article 7(1) of Canada’s tax treaties.

\(^11\) Generally, Article 5(1) of Canada’s tax treaties. Under this provision, the term “permanent establishment” is typically defined as a fixed place of business through which the business of a resident of the other contracting state is wholly or partly carried on.

\(^12\) Generally, Article 5(5) of Canada’s tax treaties. Under this provision, a person acting on behalf of a resident of the other contracting state is generally deemed to be a permanent establishment of that resident if the person has and habitually exercises in Canada the authority to conclude contracts in the name of that resident.

\(^13\) Generally, Article 7(2) of Canada’s tax treaties.

\(^14\) See, for example, *Cudd Pressure Control Inc. v. The Queen*, [1999] 1 CTC 1 (FCA).

\(^15\) In simplified terms, the authorized OECD approach involves the following two steps: (1) hypothesizing the permanent establishment as a “functionally separate enterprise” with its own functions performed, assets used, and risks assumed; and (2) applying, by analogy, the arm’s-length principle (as elaborated in the OECD transfer pricing guidelines) to dealings between this functionally separate enterprise and the enterprise of which it is part. See Organisation for Economic Co-operation and Development, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, December 2006).

\(^16\) Subsection 219(1).
subsidiary repatriated in the form of dividends. The branch tax is levied at the rate of 25 percent on the after-tax earnings of the branch that are not reinvested in Canada. Some Canadian tax treaties explicitly reduce the rate of Part XIV tax. Where a Canadian tax treaty limits the withholding tax rate on dividends paid by a corporation resident in Canada to a resident of the other country, but does not reduce the rate of Part XIV tax, a special rule in the Act reduces the rate of Part XIV tax to the treaty withholding tax rate that would apply to a dividend paid by a corporation resident in Canada to a non-resident corporation that owns all the shares of the corporation resident in Canada. Further, some of Canada’s tax treaties exempt a certain amount of branch profits from Part XIV tax.

A non-resident corporation carrying on business in Canada through a branch is not currently limited by the thin capitalization rules, which are discussed in Part A.III.3(a) of this brief, in computing its income for Canadian tax purposes. The Advisory Panel on Canada’s System of International Taxation recommended in its Final Report that the existing thin capitalization rules be extended to apply to Canadian branches of non-resident corporations.

A branch through which a non-resident corporation carries on business in Canada does not constitute a separate legal person and is therefore ordinarily treated, under general principles, as part of the non-resident corporation for purposes of the Act. Consequently, Part XIII withholding tax generally applies to certain items of Canadian-source passive income paid or credited by a resident of Canada to such non-resident corporation, unless these amounts are reasonably attributable to the business carried on by it through a Canadian permanent establishment, within the meaning assigned by the Act, in which case these amounts are taxed under Part I.

A non-resident corporation that sells its Canadian branch assets may realize a capital gain or a capital loss on the sale. Certain types of properties, including capital property, used by a non-resident

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17 See, for example, Article X(6) of the Convention Between Canada and The United States of America With Respect to Taxes on Income and on Capital (US Treaty), which reduces the rate of Part XIV tax to five percent.

18 Section 219.2.

19 Article X(6)(d) of the US Treaty provides an exemption for the first cumulative $500,000 of otherwise taxable earnings of the Canadian branch.

20 If a non-resident corporation incurs interest-bearing debt in connection with its Canadian branch operations, the debt decreases the branch tax investment allowance, thereby increasing the non-resident corporation’s potential liability for Part XIV tax. See paragraph 808(2)(m) of the Income Tax Regulations (Canada) (Regulations).


22 Regulation 805. Under subsection 212(13.2), for purposes of Part XIII, a non-resident corporation whose principal business is carried on in Canada is deemed to be a person resident in Canada in respect of amounts it pays or credits to another non-resident person where the amounts in question are deductible by the non-resident corporation in computing its taxable income earned in Canada.
corporation in a business carried on in Canada are taxable Canadian property.\(^{23}\) Taxable capital gains resulting from the disposition of the branch assets are generally included in computing the non-resident corporation’s taxable income for Canadian tax purposes, as such properties generally do not constitute treaty-protected property.\(^{24}\) Canada’s tax treaties generally preserve Canada’s right to tax real property situated in Canada and personal property forming part of the business property of a permanent establishment in Canada.\(^{25}\)

Where the non-resident corporation anticipates start-up losses, it may find it advantageous to commence operations in Canada through a branch in order to take advantage of these losses in its home country. When the Canadian branch business becomes profitable, it may be possible for the non-resident corporation to transfer the branch assets to a newly incorporated Canadian subsidiary with no significant Canadian income tax consequences.\(^ {26}\)

### III. Conducting Activities Indirectly Through A Canadian Subsidiary

This part of the brief deals with the following topics associated with a Canadian subsidiary of a non-resident corporation: (1) an overview of the general taxation rules applicable to income earned by the Canadian subsidiary; (2) a discussion of the basic threshold conditions a non-resident corporate shareholder must satisfy in order qualify for relief from double taxation under a Canadian tax treaty; (3) the main considerations relevant to financing the Canadian subsidiary; (4) a discussion of the tax treatment of various forms of profit repatriations by a Canadian subsidiary to a non-resident corporate shareholder; and (5) the general rules applicable when a non-resident corporate shareholder disposes of an investment in the Canadian subsidiary.

#### 1. Basic Framework

As noted earlier, because of its incorporation under Canada law, a Canadian subsidiary is deemed to be resident in Canada for purposes of the Act, and as such, is subject to Part I tax on its worldwide income. The income of the Canadian subsidiary is also generally subject to provincial and/or territorial income tax. The combined federal and provincial/territorial rate of income tax imposed on the Canadian subsidiary varies depending on the provinces and territories in which it conducts business through a permanent establishment, the nature and size of the business activities carried on and other

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\(^{23}\) Paragraph (b) of the definition of “taxable Canadian property” in subsection 248(1).

\(^{24}\) Paragraph 115(1)(b) and the definition of “treaty-protected property” in subsection 248(1). Notice and withholding obligations similar to those discussed in Part A.III.5 of this brief generally apply to a non-resident corporation that disposes of its Canadian branch assets.

\(^{25}\) See, for example, Articles XIII(1) and (2) of the US Treaty.

\(^{26}\) For example, it may be possible for the non-resident corporation to transfer the branch assets to a new Canadian subsidiary on a roll-over basis under subsection 85(1).
tax rate.

Like any Canadian-resident taxpayer, the Canadian subsidiary is required to compute its income for each taxation year in accordance with the specific rules in the Act. For example, the following rules generally apply for purposes of computing the income of the Canadian subsidiary: (1) income includes one-half of a capital gain realized on the disposition of a capital asset;\(^{27}\) (2) one-half of a capital loss may be deducted from the taxable portion of capital gains realized in a taxation year (but not from any other forms of income);\(^{28}\) (3) unused capital losses may be carried back three years and forward indefinitely, subject to certain restrictions in the Act;\(^{29}\) (4) expenses of carrying on business are deductible only to the extent they are reasonable;\(^{30}\) (5) depreciation is generally allowed on a declining balance basis at statutorily prescribed rates in respect of most depreciable property;\(^{31}\) (6) interest expenses on borrowed money used, or an amount payable for property acquired, for an income-earning purpose is generally deductible up to the thin capitalization limit discussed in Part A.III.3(a) of this brief;\(^{32}\) (7) neither federal nor provincial/territorial income tax is deductible in computing income subject to the other level of tax; (8) dividends paid by the Canadian subsidiary are not deductible in computing its income, however, dividends may be received from related Canadian corporations on a tax-free basis;\(^{33}\) (9) dividends on certain classes of preferred shares, or common shares with certain fixed entitlements or limitations, may attract special taxes to either the issuer or the holder (or both) of the shares;\(^{34}\) (10) unused business losses may be carried back and deducted against income in the preceding three years or carried forward for deduction against income in the following twenty years, subject to certain restrictions in the Act;\(^{35}\) and (11) given that there is no tax consolidation in Canada, business losses of the Canadian subsidiary are not available to offset losses of an affiliated company.

Transactions between the Canadian subsidiary and any person with which it does not deal at arm’s length, whether resident in Canada or not, must generally be effected at fair market value.\(^{36}\) Furthermore, the terms and conditions of transactions between the Canadian subsidiary and any non-resident person with which it does not deal at arm’s length must generally be the same as those that

\(^{27}\) Section 38.
\(^{28}\) Paragraph 3(b).
\(^{29}\) Paragraph 111(1)(b).
\(^{30}\) See, for example, section 67.
\(^{31}\) Paragraph 20(1)(a), Part XI and Schedules II to VII of the Regulations.
\(^{32}\) Paragraph 20(1)(c).
\(^{33}\) Subsection 112(1).
\(^{34}\) Parts IV and VI.1.
\(^{35}\) Paragraph 111(1)(a).
\(^{36}\) Subsection 69(1).
would have been made between arm’s-length parties. Certain contemporaneous documentation may also be required under Canada’s transfer pricing rules.

For purposes of the Act, an unlimited liability company (ULC) established under the laws of Alberta, British Columbia or Nova Scotia is characterized as a corporation. A ULC was a popular choice for US-residents that sought to expand into Canada as it can be a hybrid entity in situations where it is treated as a flow-through entity for US tax purposes. This hybrid status allowed for certain advantages, such as the ability to flow start-up losses to its US-resident parent, while avoiding certain issues associated with a branch operation. Notably, however, commencing January 1, 2010, a new provision of the US Treaty will generally deny treaty benefits to a resident of the US on any amount received from a ULC that is disregarded for US tax purposes, thereby undermining the use of ULCs.

2. Treaty Entitlement of the Non-Resident Corporate Shareholder

A non-resident corporation that carries on business activities indirectly in Canada will generally receive amounts, including dividend distributions, from its Canadian subsidiary, that are subject to withholding tax under Part XIII.

To be entitled to treaty relief, including relief in respect of Part XIII withholding tax, the non-resident corporation must generally be a resident of a country that has a tax treaty with Canada. A resident for treaty purposes generally means a person who is, under the laws of a particular country, liable to tax in the country by reasons of that person’s domicile, residence, citizenship, place of management, place of incorporation or any similar criterion.

The requirement for treaty residency was examined in the seminal case of *The Queen v. Crown Forest Industries Ltd*. In that case, the Supreme Court of Canada held that a corporation incorporated in the Bahamas, but managed in the US, was not a resident of the US for purposes of the US Treaty. In *obiter dicta*, the Supreme Court commented that the US Treaty was limited to taxpayers “being subject to as comprehensive a tax liability as imposed by a (Contracting) state” and that “in the U.S. and Canada,

37 Canada’s transfer pricing rules are found in section 247. In addition, Article 9 of Canada’s tax treaties often authorize transfer pricing adjustments to reflect arm’s-length terms.
38 Subsection 247(4).
39 Article IV(7)(b) of the US Treaty provides that an amount of income, profit, or gain is not considered to be paid to or derived by a person who is a resident of the US where the person is considered for Canadian tax purposes to have received the amount from an entity that is resident in Canada, but, by reason of the entity being treated as fiscally transparent for US tax purposes, the treatment of the amount for US tax purposes is not the same as its treatment would be if that entity were not treated as fiscally transparent for US tax purposes.
40 Generally, Article 4(1) of Canada’s tax treaties.
41 [1995] 2 CTC 64 (SCC).
such comprehensive taxation is taxation on world-wide income.” The Canada Revenue Agency (CRA) is generally of the view that in order to be “liable to tax” for purposes of the residency article in a Canadian tax treaty, a person must be subject to the most comprehensive form of taxation in the particular country, but that this does not necessarily mean the person must actually pay tax in the particular country.

The fifth protocol (Protocol) to the US Treaty introduced a new reciprocal limitation-on-benefits (LOB) article that requires a resident of the US to satisfy certain additional tests in order to be entitled to claim the benefits provided by Canada under the US Treaty. Generally, a resident of the US is entitled to all the benefits accorded by the US Treaty only if it is a qualifying person, which includes - notably - a company that satisfies a publicly traded test or that is a subsidiary of a public company. A resident of the US who is not a qualifying person may be entitled to treaty benefits with respect to certain items of income under an active business test or a derivative benefits test.

No Canadian tax treaty other than the US Treaty currently includes a full LOB article. In these other tax treaties, there is no other internal rule that would apply to restrict full treaty entitlement. However, the potential application of the general anti-avoidance rule (GAAR) or an implicit treaty anti-abuse rule still needs to be considered, especially in a treaty-shopping situation.

Where the non-resident corporation seeks relief from Part XIII withholding tax under the passive income articles of Canada’s tax treaties, in addition to the treaty residency requirement (and, the case of the US, requirements under the LOB article), the non-resident corporation must also be the beneficial owner of any amounts paid or credited by the Canadian subsidiary. The scope of this beneficial ownership requirement was recently considered in Prévost Car Inc. v. The Queen. In that case, the taxpayer, Prévost, paid dividends to its shareholder, Holding BV, a Dutch holding company, which in turn paid dividends in substantially the same amount to its corporate shareholders, Volvo, a resident of Sweden, and Henlys, a resident of the UK. A shareholders’ agreement between the corporate shareholders of Holding BV provided that not less than 80 percent of the profits of Prévost, Holding BV, and their subsidiaries were to be distributed to Holding BV’s corporate shareholders, unless

42 Ibid. at paragraph 47.
43 See, for example, Income Tax Technical News no. 34, April 27, 2006; and Income Tax Technical News no. 35, February 26, 2007 (ITTN no. 35).
44 Articles XXIX A(2)(c) and (d) of the US Treaty. A resident of the US may also be a qualifying person if it satisfies the ownership and base erosion test under Article XXIX A(2)(e) of the US Treaty.
45 Article XXIX A(3) of the US Treaty.
46 Article XXIX A(4) of the US Treaty.
47 Section 245.
48 [2008] 5 CTC 2306 (TCC); aff’d 2009 FCA 57.
otherwise agreed. Holding BV was not a party to the shareholders’ agreement, but the agreement was referenced in Holding BV’s deed of incorporation.

The Minister of National Revenue (Minister) assessed Prévost under Part XIII on the basis that the beneficial owners of the dividends were the corporate shareholders of Holding BV and not Holding BV itself. The Tax Court of Canada allowed the taxpayer’s appeal. The Court held that the term “beneficial owner” must be interpreted by looking at Canadian domestic law and that the commentary on the dividend article of the 1977 OECD Model Convention was also relevant. In the end, the Court essentially held that Holding BV was the beneficial owner of the dividends paid by Prévost as it was the person who received the dividends for its own use and enjoyment and who assumed the risk and control of the dividends it received. The Court was not prepared to pierce the corporate veil of the corporate dividend recipient unless either the corporation was a conduit for a shareholder and had absolutely no discretion as to the use or application of the funds put through it as conduit or the corporation agreed to act on the shareholder’s behalf, pursuant to that person’s instructions, and without any right to do anything other than what it was instructed to do.

The Federal Court of Appeal dismissed the Minister’s appeal, holding that no palpable or overriding error was shown in the trial judge’s conclusion. In doing so, the Court rejected the Minister’s position that the term “beneficial owner” meant the person who could, in fact, ultimately benefit from the dividends.

3. Financing the Canadian Subsidiary

(a) Thin Capitalization Rules

The debt/equity structure of the Canadian subsidiary is subject to the thin capitalization rules. These rules restrict the deductibility of otherwise deductible interest that is paid or payable by the Canadian subsidiary on outstanding debts to specified non-residents if the amount of these debts exceeds twice the relevant equity of the Canadian subsidiary (a 2:1 debt-to-equity ratio).

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49 In Indofood International Finance Ltd. v. JP Morgan Chase Bank NA London Branch, [2006] EWCA Civ 158, the UK Court of Appeal held that for treaty purposes, the term “beneficial owner” should be given an international fiscal meaning and that a formal owner of income would not be regarded as the beneficial owner of such income unless such person had the full privilege to directly benefit from the income. Notably, in Prévost Car, the Tax Court did not adopt this interpretation; rather, the Court effectively determined whether Holding BV was the beneficial owner of the dividends by reference to whether it was legally obligated to pass those dividends on to it shareholders.

50 Definition of “outstanding debts to specified non-residents” in subsection 18(5).

51 Subsection 18(4).
Generally, for these purposes, a specified non-resident is: (1) a specified non-resident shareholder, that is, a shareholder of the Canadian subsidiary who at that time, either alone or together with non-arm’s-length persons, owns shares of the Canadian subsidiary that either entitle the holders thereof to 25 percent or more of the votes or that represent 25 percent or more of the market value of all of the issued and outstanding shares of the Canadian subsidiary (such shareholder being a specified shareholder) and who is at that time a non-resident person; or (2) a non-resident person who is not dealing at arm’s length with a specified shareholder of the Canadian subsidiary. For the purpose of determining whether either of the foregoing 25 percent thresholds are met, a non-resident shareholder of the Canadian subsidiary, or a person who is not dealing at arm’s length with that non-resident shareholder, is deemed to own any shares that they respectively have the right to acquire, and, any shares that they respectively have the right to require the Canadian subsidiary to redeem (other than those shares held by them) are considered to have been so redeemed.

In calculating the 2:1 debt-to-equity ratio, the debt is the average of all amounts each of which is the greatest total amount of the Canadian subsidiary’s outstanding debt to specified non-residents at any time in a calendar month that ends in the year. Equity is the aggregate of the unconsolidated retained earnings of the Canadian subsidiary, the Canadian subsidiary’s contributed surplus that was contributed by specified non-resident shareholders and the paid-up capital of the shares owned by specified non-resident shareholders. The Canadian subsidiary’s retained earnings are calculated at the beginning of the year. Contributed surplus and paid-up capital are calculated by taking the average of all amounts each of which is the Canadian subsidiary’s contributed surplus or paid-up capital at the beginning of a calendar month that ends in the year. In addition, for the purpose of computing the paid-up capital, shares that are reclassified as debt for accounting purposes continue to be treated as equity.

The thin capitalization rules do not apply to debt owed by a Canadian subsidiary to a third-party creditor, whether Canadian or foreign, including a third-party debt that is guaranteed by a related non-resident person. While the Advisory Panel concluded in its Final Report that adding restrictions relating to interest paid on either third-party or guaranteed debt is not advisable at this time, it did recommend reducing the maximum debt-to-equity-ratio from 2:1 to 1.5:1.

Because only the paid-up capital attributable to the shares held by, and surplus contributed by, specified non-resident shareholders qualifies as equity for thin capitalization purposes, a lower-tier Canadian subsidiary will generally not have any relevant equity. As a result, it is generally not advisable for a specified non-resident shareholder to directly finance a lower-tier Canadian subsidiary.

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52 Definition of “specified non-resident shareholder” in subsection 18(5).
53 Definition of “specified shareholder” in subsection 18(5).
54 Paragraphs (c) and (d) of the definition of “specified shareholder” in subsection 18(5).
55 See, for example, CRA document no. 9615465, July 17, 1996.
56 Supra note 21, at 61-65.
If such financing is required, the specified non-resident shareholder should first lend to the upper-tier Canadian subsidiary, which should in turn lend to the lower-tier Canadian subsidiary. The CRA has generally taken the position that the back-to-back loan provision described below does not apply to such internal financing scenarios when the non-resident lender is the parent and grandparent of the two Canadian subsidiaries.  

An anti-avoidance rule prevents a non-resident person from circumventing the thin capitalization rules by financing its Canadian subsidiary through an intermediate lender (i.e., by using back-to-back loans). This rule provides that where a specified non-resident makes a loan (the first loan) to another person on condition that a second loan be made by any person to the Canadian subsidiary, the lesser of the amount of the first loan and the amount of the second loan is deemed to be a debt incurred by the Canadian subsidiary to the specified non-resident who made the first loan.

(b) Interest Withholding Taxes

Under the Act, interest paid or credited by the Canadian subsidiary to a non-resident lender is exempt from withholding tax, provided that the Canadian subsidiary deals at arm's length with the lender and the interest is not participating debt interest. Participating debt interest is interest that is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class or series of shares of the capital stock of the Canadian subsidiary.

Interest paid or credited by the Canadian subsidiary to a non-resident lender with which it does not deal at arm's length is subject to withholding tax at a rate of 25 percent unless the rate is reduced under the provisions of a tax treaty between Canada and the country where the non-resident lender is resident. For example, where the related non-resident lender is resident in the US and entitled to the

57 The CRA has indicated that subsection 18(6) does not apply in back-to-back situations where the following three conditions are satisfied: (1) the first loan and the second loan are in the same amount; (2) the interest earned on the second loan exceeds the interest paid on the first loan; and (3) the specified non-resident shareholder has de jure control over each of the Canadian subsidiary corporations. See, for example, Income Tax Technical News no. 15, December 18, 1998.

58 Subsection 18(6).

59 In Compagnie Minière Québec Cartier v. MNR, [1984] CTC 2408 (TCC), the Court held that the term “credits” requires more than an accounting entry; an amount must be “made available to” the non-resident person. The CRA considers an amount to be “credited” only where the amount is set aside and unconditionally available to the non-resident person. See paragraph 5 of Information Circular 77-16R4 “Non-Resident Income Tax,” May 11, 1992.

60 Paragraph 212(1)(b).

61 Definition of “participating debt interest” in subsection 212(3).
full benefit of the US Treaty,\textsuperscript{62} the withholding tax rate is reduced to four percent for interest paid or credited in 2009 and then to nil starting in 2010.\textsuperscript{63} Where the related non-resident is resident in another treaty country, the withholding tax rate is generally reduced to 10 percent under the relevant tax treaty.

Given that withholding tax is payable only when interest is paid or credited rather than as it accrues, deferring payments of interest payable in 2009 to 2010 will result in a reduction of the withholding tax rate from four percent to nil where the related non-resident lender is resident in the US and entitled to the full benefit of the US Treaty. This unpaid interest should still generally be deductible by the Canadian subsidiary on an accrual basis. However, this deductible interest owing to the related non-resident lender must be paid before the end of the second taxation year following the taxation year in which it was deducted by the Canadian subsidiary. If not paid by that time, the unpaid interest will be added to income of the Canadian subsidiary in the third year following the taxation year in which it was deducted unless an election is filed to deem the payment of interest to have been made by the Canadian subsidiary and loaned back by the non-resident lender.\textsuperscript{64}

\textbf{(c) Guarantee Fees}

The Canadian subsidiary will frequently have its debt guaranteed by a non-resident entity within the same corporate group. Any guarantee fee paid by the Canadian subsidiary to a non-resident guarantor is deemed to be a payment of interest on the debt for purposes of Part XIII.\textsuperscript{65} Where the guarantee fee is paid to a non-arm’s-length non-resident guarantor, the guarantee fee is deemed to be a payment of interest to a non-arm’s-length person. As a result, the payment is subject to Part XIII withholding tax at a rate of 25 percent, even if the interest payable on the loan is exempt from such withholding tax.

Where the Canadian subsidiary pays a guarantee fee to a non-arm’s-length guarantor that is resident in the US and entitled to the full benefit of the US Treaty, the guarantee fee is exempt from withholding tax under the other income article of the US Treaty.\textsuperscript{66} Where the Canadian subsidiary pays a guarantee fee to a non-arm’s-length guarantor that is resident in another treaty country, the guarantee fee is generally subject to the reduced withholding tax rate for interest under the relevant tax treaty.\textsuperscript{67}

\begin{footnotesize}
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\item As discussed in Part A.III.2 of this brief, Article XXIX A, the new LOB article, imposes additional tests on residents of the US that must be satisfied before such residents are entitled to the benefits provided by Canada under the US Treaty.
\item Article 27(3)(d) of the Protocol and Article X(1) of the US Treaty.
\item Subsection 78(1).
\item Subsection 214(15).
\item Article XXII(4) of the US Treaty.
\item Article 11 of Canada’s tax treaties generally define the term “interest” to include items of income that are deemed to be interest under Canadian domestic law, thereby encompassing guarantee fees.
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(d) **Foreign Exchange Gains or Losses**

The Canadian subsidiary will generally make a foreign exchange gain or sustain a foreign exchange loss on the repayment of a loan denominated in a foreign currency. The character of the foreign exchange gain or loss as on income or capital account will follow that of the borrowing represented by the loan. While the case law is still somewhat unsettled, more importance has been attached to the degree of permanence of the funding than to the use of the borrowed funds to determine the character of the loan. Thus, as a general proposition, where the borrowing of the Canadian subsidiary is not temporary or short-term but rather is part of the Canadian subsidiary’s permanent capital, such borrowing is generally considered to be on capital account, and any foreign exchange gain or loss realized or sustained in connection with such a borrowing is also on capital account.

(e) **Financing Structures**

A foreign multinational will generally seek to finance its Canadian subsidiary on a tax-effective basis. The tax objective of most inbound financing structures is to achieve a tax deduction for interest payments in both Canada and the relevant foreign country, without any immediate offsetting inclusion in the relevant foreign country.

US multinationals often use hybrid entity planning as the cornerstone for financing their Canadian subsidiaries. The Protocol to the US Treaty introduced two new rules, with a delayed effective date of January 1, 2010, that target some of these financing structures.

The first rule in the US Treaty will generally deny treaty benefits to the US-resident members of a so-called reverse hybrid partnership, namely, a partnership organized under the laws of a Canadian province that elects to be treated as a Canadian corporation for US tax purposes. These reverse

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68 Under the new calculating currency rules in section 261, a taxpayer is generally required to determine its Canadian tax results using the Canadian dollar as the calculating currency. However, in certain circumstances, these rules permit Canadian-resident corporations to elect to instead use a foreign currency as the calculating currency for Canadian tax purposes.

69 See, for example, *Shell Canada Limited v. The Queen*, [1999] 4 CTC 313 (SCC).

70 See, for example, *Beauchamp v. F.W. Woolworth plc.*, [1990] 1 AC 478 (HL); *The European Investment Trust Co. Ltd. v. Jackson (HM Inspector of Taxes)*, (1932), 18 TC 1 (UK CA); *Canadian SKF Ltd. v MNR* 66 DTC 140 (TAB); and *Bennett & White Co. Ltd. v. MNR*, [1949] CTC 1 (SCC).

71 Article IV(7)(a) of the US Treaty provides that an amount of income, profit, or gain is not considered to be paid to or derived by a person who is a resident of the US where the person is considered for Canadian tax purposes to have derived the amount through an entity that is not a resident of the US but, by reason of that entity not being treated as fiscally transparent for US tax purposes, the treatment of the amount for US tax purposes is not the same as its treatment would be if the amount had been derived directly by that person.
hybrid partnerships, with US-resident members, have been the key building block for certain “synthetic NRO” financing structures.\(^\text{72}\)

In a basic structure involving a reverse hybrid partnership, a US corporation (USco) uses borrowed money to make a capital contribution in respect of its 99.9 percent interest in the partnership. In turn, the reverse hybrid partnership uses the funds to make an interest-bearing loan to the Canadian subsidiary, which uses the loan proceeds for general business purposes.

For US tax purposes, the objective is to ensure that USco is entitled to deduct the interest it pays on the money it borrowed to make the partnership contribution without being subject to tax on accrual basis on its share of the interest income earned by the reverse hybrid partnership on the loan to the Canadian subsidiary.

For Canadian tax purposes, subject to the possible application of the thin capitalization rules, the interest paid by the Canadian subsidiary on the loan from the reverse hybrid partnership is deductible in computing income. Given that the reverse hybrid partnership is not a Canadian partnership within the meaning of the Act, it is deemed, in respect of the interest payments received from the Canadian subsidiary, to be a non-resident person for purposes of Part XIII.\(^\text{73}\) Therefore, since Part XIII withholding tax applies to interest paid by the Canadian subsidiary to the reverse hybrid partnership, the viability of the structure currently relies to a large extent on obtaining the treaty-reduced withholding tax rate on the interest paid to the partnership.\(^\text{74}\) When the first rule introduced by the Protocol comes into effect in 2010, the full 25 percent Part XIII withholding tax rate will apply to the interest payments made by the Canadian subsidiary, thereby making this structure unattractive.

The second rule, as set out in note 39, will generally deny treaty benefits to a resident of the US on any amount received from a ULC that is disregarded for US tax purposes. A newer generation of financing structures in which ULCs were interposed between a reverse hybrid partnership and the US-resident members had become increasingly popular in the last several years. These newer financing

\(^{72}\) The structure is referred to as a “synthetic NRO” structure because it results in tax consequences similar to those of non-resident-owned investment corporation (NRO) structures that were used prior to the repeal of the special status accorded to NROs.

\(^{73}\) Paragraph 212(13.1)(c) and the definition of “Canadian partnership” in section 102.

\(^{74}\) The longstanding position of the CRA was to look through the reverse hybrid partnership to grant treaty benefits to the US-resident partners on amounts received by the reverse hybrid partnership. However, starting in 2003, the CRA announced that it was reconsidering its position because it appeared at odds with paragraph 6.2 of the commentary on article 1 of the OECD Model Convention. See, for example, CRA document no. 2003-0039051E5, January 26, 2004; CRA document no. 2004-0072381C6, June 17, 2004; and CRA document no. 2004-0102471C6, November 25, 2004. The announcement that the CRA was reconsidering its withholding tax position resulted in this type of structure losing much of its popularity and being largely replaced by a newer generation of synthetic NRO structures to which Article IV(7)(b) of the US Treaty will apply, as discussed below.
structures displaced the Canadian interest withholding tax liability at the level of the payments made by the ULCs.

In the typical structure involving a ULC, USco uses borrowed money to make an interest-bearing loan to, and invest in equity of, a ULC in a ratio that complies with the thin capitalization rules. In turn, the ULC uses the funds to make a capital contribution in respect of its 99.9 percent interest in a reverse hybrid partnership. The reverse hybrid partnership uses the partnership contributions to make an interest-bearing loan to, and invest in equity of, the Canadian subsidiary in the same ratio that USco acquired debt and equity of the ULC and the Canadian subsidiary uses the loan proceeds for general business purposes.

For US tax purposes, the objective is the same as in the earlier structure, that is, to ensure that USco is entitled to obtain an interest deduction on the borrowed money without any immediate offsetting income inclusion with respect to the interest income earned by the reverse hybrid partnership.

For Canadian tax purposes, the interest paid by the Canadian subsidiary on the loan from the reverse hybrid partnership is deductible. Interest income earned by the reverse hybrid partnership is allocated to the ULC to the extent of its limited partnership interest. However, the interest paid by the ULC on the loan from USco is deductible against such interest income. In contrast to the earlier structure, because the reverse hybrid partnership is a Canadian partnership, Part XIII withholding tax does not apply to the interest paid by the Canadian subsidiary to the partnership. The interest paid by the ULC to USco is currently subject to the reduced withholding tax rate under the US Treaty.

When the second rule in the US Treaty comes into effect in 2010, the full 25 percent Part XIII withholding tax rate will apply to the interest payments made by the ULC to USco, thereby undermining the viability of the structure. As a consequence, there is now a trend towards the use of entities that are disregarded for US tax purposes and that are formed in a favourable treaty country, such as the Netherlands or Luxembourg, as a replacement of, or as a holding company for, ULCs, in a new generation of reverse hybrid partnership structures.

The new residence rules for fiscally transparent entities introduced by the Protocol to the US Treaty have also resulted in a renewed interest in certain hybrid instruments, which are instruments that are characterized as equity for US tax purposes and as debt for Canadian tax purposes, as the key building block for financing the Canadian subsidiary of a US multinational. While hybrid instruments have been around for a long time, they have typically lacked the popularity of hybrid entity planning.

There are several ways in which a hybrid instrument financing may be structured. One of the more common is to couple a loan from a US related-party lender with a forward subscription agreement for shares of the Canadian subsidiary with the objective of ensuring that, for US tax purposes, the two instruments are integrated and characterized as equity. The Canadian subsidiary pays interest on the loan by either directly or indirectly issuing shares of its capital stock so that, for US tax purposes, the
US related-party lender is considered to receive a non-taxable stock dividend from the Canadian subsidiary.

For Canadian tax purposes, the loan and the subscription agreement are characterized as separate instruments according to their legal substance. Thus, the advance made under the loan is characterized as debt and the associated interest paid by the Canadian subsidiary is deductible. Subject to the application of the LOB article, under the US Treaty, the interest paid by the Canadian subsidiary to the US related-party lender is subject to a four percent withholding tax rate in 2009 and then exempted from withholding tax starting in 2010.

4. Repatriation of Profits

(a) Dividend Payments

Dividends paid or credited by the Canadian subsidiary to a non-resident shareholder are subject to Part XIII withholding tax at a rate of 25 percent unless the rate is reduced under the provisions of a tax treaty between Canada and the country where the non-resident shareholder is resident. Canada’s tax treaties generally reduce the withholding tax rate on dividends to 15 percent. If the shareholder is a corporation and certain ownership requirements are met, the withholding tax rate is generally further reduced to 10 percent or five percent. The ownership requirements for the preferential dividend withholding tax rate vary considerably in Canada’s tax treaties. For example, under the US Treaty, a US-resident corporate shareholder will qualify for the preferential dividend withholding tax rate of five percent if it owns at least 10 percent of the voting stock of the Canadian subsidiary.

(b) Return of Paid-Up Capital

In addition to paying dividends on the shares issued to a non-resident shareholder, the Canadian subsidiary could return paid-up capital to the non-resident shareholder without Canadian withholding tax. The paid-up capital of shares is the paid-up capital of the shares for corporate law purposes (for example, the corporate stated capital) as adjusted by various provisions of the Act.

The Canadian subsidiary may return paid-up capital to a non-resident shareholder by way of a reduction of the paid-up capital of the shares held by the non-resident shareholder. The adjusted cost base of the shares is reduced on a dollar-for-dollar basis by all payments received by the non-resident shareholder that are not treated as deemed dividends. In this context, given that the shares of the

75 Subsection 212(2).
76 Article X(2)(a) of the US Treaty.
77 Definition of “paid-up capital” in subsection 89(1).
78 Subparagraph 53(2)(a)(ii).
Canadian subsidiary will generally constitute capital property and taxable Canadian property\(^{79}\) to the non-resident shareholder, the shareholder will realize a capital gain if the adjusted cost base of shares become a negative amount.\(^{80}\) Exceptionally, a return of paid-up capital by this method to a holder of term preferred shares\(^{81}\) of the Canadian subsidiary is deemed to be a dividend unless the non-resident shareholder did not acquire the shares in the ordinary course of the business carried on by such holder.\(^{82}\)

The Canadian subsidiary may also return paid-up capital to a non-resident shareholder by redeeming or otherwise acquiring or cancelling its shares. In this case, the proceeds of disposition of the shares is reduced by the amount of any deemed dividend resulting, as noted below, from any amount paid by the Canadian subsidiary in excess of the paid-up capital of the shares.

Under either method of returning paid-up capital, any amount paid to the non-resident shareholder in excess of the paid-up capital of the shares is generally deemed to be a dividend paid by the Canadian subsidiary\(^{83}\) that is subject to Part XIII withholding tax at a rate of 25 percent\(^{84}\) unless the rate is reduced under the provisions of a tax treaty between Canada and the country where the non-resident shareholder is resident.\(^{85}\) Also, under either method, where the non-resident shareholder disposes of, or is deemed to dispose of, shares of the Canadian subsidiary (which, as described above, will generally be capital property and taxable Canadian property), the non-resident corporation is subject to the same tax consequences as those described in Part A.III.5 of this brief.

\[(c)\] Shareholder Loan

The Act contains a number of rules designed to discourage the repatriation of profits by a Canadian subsidiary to a non-resident shareholder in the form of a loan. Generally, when a non-resident

\(^{79}\) Paragraph (d) of the definition of “taxable Canadian property” in subsection 248(1) includes “a share of the capital stock of a corporation resident in Canada ...that is not listed on a designated stock exchange.”

\(^{80}\) Subsection 40(3). Under paragraph 53(1)(a), the amount of the deemed gain under subsection 40(3) is added to the adjusted cost base of the shares so that the adjusted cost base is reset at nil.

\(^{81}\) The definition of “term preferred share” in subsection 248(1) encompasses two principal types of shares. The first type, in general terms, has one or more debt-like features such as a right of the holder to cause the share to be redeemed, acquired or cancelled. The second type is a share owned by a corporation described in the definition of “specified financial institution” in subsection 248(1) (or by a corporation that is controlled by one or more such corporations or that is related to such a corporation).

\(^{82}\) Subsection 84(4.2).

\(^{83}\) Subsections 84(3) and (4).

\(^{84}\) Subsection 214(3).

\(^{85}\) Article 10 of Canada’s tax treaties generally define the term “dividend” to include items of income assimilated to or treated in the same way as income from shares under Canadian domestic law.
shareholder of the Canadian subsidiary (or a person connected to that shareholder) receives a loan from, or has become indebted to, the Canadian subsidiary, the amount of the loan or indebtedness is deemed to be a dividend paid by the Canadian subsidiary. The deemed dividend is subject to Part XIII withholding tax at a rate of 25 percent unless the rate is reduced under the provisions of a tax treaty between Canada and the country where the non-resident shareholder is resident. When the loan or indebtedness is repaid, other than as part of a series of loans and repayments, the non-resident person may apply for a refund of the Part XIII withholding tax.

One important exception to this rule is provided where the loan or indebtedness is repaid within one year after the end of the non-resident’s taxation year in which the loan was made or indebtedness arose, unless the repayment was part of a series of loans or other transactions and repayments.

If the loan owing by the non-resident shareholder to the Canadian subsidiary is outstanding for more than one year and the interest charged on it is not reasonable, the Canadian subsidiary may be required to include in income an amount of interest on the loan calculated using a prescribed rate. This interest imputation rule does not apply if the loan is subject to the deemed dividend treatment described above. Therefore, if the loan is outstanding for more than one year but is repaid before the end of the taxation year following the year in which the loan was made, the Canadian subsidiary may be deemed to have interest income to the extent the prescribed rate interest exceeds the actual interest on the loan.

5. Disposition of an Investment in the Canadian Subsidiary

A non-resident shareholder who disposes of shares of the Canadian subsidiary will generally realize a capital gain or capital loss on the disposition as these shares typically constitute capital property and taxable Canadian property to the non-resident shareholder. However, any taxable capital gain resulting from the disposition of the shares is not included in computing the non-resident shareholder’s income for Canadian tax purposes if the shares constitute treaty-protected property. The shares of the Canadian subsidiary are generally treaty-protected property where the gain from the disposition of

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86 Subsections 15(2) and 214(3).
87 Subsection 227(6.1).
88 Subsection 15(2.6).
89 Subsection 17(1), which is discussed in more detail in Part B.III.2(a) of this brief.
90 Subsection 17(7).
91 Supra note 79. As an exception to this general rule, section 212.1 deems in certain circumstances what would otherwise be capital gain from the disposition of shares to be a dividend subject to Part XIII withholding tax.
92 Supra note 24.
such property, would, because of an applicable Canadian tax treaty, be exempt from Canadian income tax.  

A non-resident shareholder who is resident in the US and entitled to the full benefit of the US Treaty will generally be exempt from Part I tax in respect of a gain realized on the disposition of the shares of the Canadian subsidiary where the value of such shares is not derived principally from real property situated in Canada.

Notice and withholding obligations generally apply to the non-resident shareholder who disposes of shares of the Canadian subsidiary unless the shares are excluded property. Excluded property includes property that is, at the time of the disposition, treaty-exempt property. The shares of the Canadian subsidiary are treaty-exempt property if, at the time of the disposition, the non-resident shareholder is exempt from tax on any gain from disposing of the shares because of a Canadian tax treaty. Where the non-resident shareholder and the purchaser are related, within the meaning of the Act, the purchaser must also provide a notice to the Minister setting out certain information in respect of the disposition.

Where the shares of the Canadian subsidiary are not excluded property, the purchaser of the shares is entitled to withhold 25 percent of the purchase price unless the non-resident shareholder obtains a certificate from the Minister in respect of the disposition. The non-resident shareholder must provide the Minister with certain information and either pay tax or furnish acceptable security in order to obtain the certificate. The non-resident shareholder may provide this information to the Minister before the disposition occurs, but otherwise must provide it not later than 10 days after the disposition.

The decision of *MIL (Investments) SA v. The Queen* provides an interesting example of a situation where a non-resident vendor moved its residence from a non-treaty country into a treaty country prior to disposing of shares and realizing a gain that would have otherwise been a taxable transaction in Canada. More specifically, in that case, the taxpayer was a Cayman Islands company that continued into Luxembourg prior to disposing of shares of a Canadian public corporation. The taxpayer realized a

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93 Supra note 24.
94 Article XIII(4) of the US Treaty.
95 Paragraph 116(6)(a).
96 Paragraph 116(6.1)(a).
97 Paragraph 116(6.1)(b).
98 Subsection 116(5).
99 Subsections 116(1) and (3).
100 Subsections 116(2) and (4).
101 [2006] 5 CTC 2552 (TCC); aff’d [2007] 4 CTC 235 (FCA).
capital gain on the disposition of the shares and claimed an exemption from Canadian tax on this gain under Article 13 of the Canada-Luxembourg tax treaty. The main issue before the Tax Court of Canada was whether GAAR applied by virtue of the taxpayer’s change in residence. After concluding that there had been no avoidance transactions for purposes of GAAR, the Tax Court held in *obiter dicta* that there was in any event no abusive tax avoidance under the Canada-Luxembourg tax treaty. The Tax Court then held that there was no anti-abuse rule inherent in the Canada-Luxembourg tax treaty.102

The Federal Court of Appeal summarily dismissed the appeal of the Minister, holding that it was unlikely that the trial judge’s conclusion was the result of a palpable and overriding error. The Federal Court of Appeal was in any event unable to see in the provisions of the Act and the Canada-Luxembourg tax treaty any support for the argument that the tax benefit obtained by the taxpayer was a misuse or abuse of the object and purpose of any of those provisions.

**B. International Outbound Taxation**

**I. Introduction**

The Act contains a number of rules designed to tax foreign-source income earned by Canadian-resident corporations. The Canadian outbound taxation system distinguishes between foreign activities carried on directly and those carried on indirectly through a foreign intermediary. If the Canadian-resident corporation conducts its business activities directly, the corporation is subject to Part I tax on its worldwide income,103 including any foreign-source income, and the principal tax considerations are whether relief from any double taxation of the foreign-source income is available under the terms of a Canadian tax treaty or the foreign tax credit rules.

If the Canadian-resident corporation conducts its business activities indirectly through a foreign intermediary, the tax treatment of the foreign-source income varies depending on a number of factors, including: (1) whether the intermediary is a corporation, a trust or a partnership; (2) the ownership interest of the Canadian-resident corporation in the intermediary; (3) the type of income earned by the intermediary; (4) the country in which intermediary carries on its activities; and (5) the timing of the repatriation of the foreign-source income by the intermediary.

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102 The Tax Court rejected the CRA’s position that the 2003 revisions to the commentary to Article 1 of the OECD Model Convention supported the existence of such a rule for the purposes of the Canada-Luxembourg tax treaty. In interpreting the tax treaty, the Court did not accord much weight to interpretive aids, such as the 2003 revisions, that were published after the tax treaty was concluded. In doing so, the Court appeared to leave open the question of whether the result would have been different if the tax treaty was one that was concluded in or after 2003. In any event, the 2003 revisions make it clear that such a rule should not be applied lightly, and only where the impugned transaction is contrary to the object and spirit of the tax treaty.  

103 *Supra* note 5.
The foreign affiliate (FA) rules govern the Canadian tax treatment of earnings of, and distributions from, a foreign intermediary that is an FA of a Canadian-resident taxpayer. These rules have two main components. The first component consists of the foreign accrual property income (FAPI) rules, which is an anti-deferral regime that applies in respect of “passive” income earned by an FA that is also a controlled foreign affiliate (CFA) of the Canadian-resident taxpayer. More specifically, this anti-deferral regime applies to ensure that FAPI of a CFA is subject to Part I tax in the hands of its Canadian-resident shareholder on an annual accrual basis, irrespective of whether such income is distributed by the CFA. The second component of the FA rules consists of the surplus rules, which govern the tax treatment of dividends received by a Canadian-resident corporate shareholder from an FA. Generally, under these rules, a dividend that is paid from active business income of an FA that is resident in, and which carries on business in, a designated treaty country is exempt from Canadian tax, while a dividend paid from active business income of an FA arising in other circumstances, and from FAPI, must be included in income, but relief is provided for any underlying foreign tax, and any withholding tax paid by the Canadian-resident corporate shareholder, on the dividend.

The Act contains two other anti-deferral regimes that govern the Canadian tax treatment of income earned by foreign intermediaries that are not otherwise subject to the FAPI rules. The first anti-deferral regime applies to certain non-resident trusts\(^{104}\) and the second applies in respect of certain investments in offshore investment funds.\(^{105}\) The non-resident trust regime generally applies where a non-resident trust acquires property from a person resident in Canada and the trust has a Canadian-resident beneficiary. If those conditions are met and the non-resident trust is discretionary, the non-resident trust is deemed to be a person resident in Canada and is subject to Part I tax on its taxable income earned in Canada and on any FAPI. If, however, the non-resident trust is not discretionary, the trust is deemed to be a CFA of any beneficiary whose beneficial interest in the trust is not less than 10 percent of the aggregate of the fair market value of all beneficial interests in the trust. Consequently, where such beneficiary is a resident of Canada, the beneficiary is then subject to Part I tax on its share of FAPI of the non-resident trust on an annual accrual basis. The offshore investment fund regime generally applies where a taxpayer holds an interest in an entity that is not resident or situated in Canada whose value is derived from certain portfolio investments and one of the main reasons for the investment in the entity is to significantly reduce or defer the Part I tax that otherwise would have applied in respect of the income from those investments had such income been earned directly by the taxpayer. If those conditions are met and the taxpayer is a resident of Canada, the taxpayer is subject to Part I tax on an imputed income amount equal to the amount of the designated cost of the investment in the offshore investment fund at the end of each month multiplied by a prescribed rate of interest, less the actual amount of income from the offshore investment fund.

\(^{104}\) Section 94.
\(^{105}\) Section 94.1.
Former Bill C-10\textsuperscript{106} contained proposals to replace the non-resident trust rules and the offshore investment fund rules with the new non-resident trust (NRT) rules and the foreign investment entity (FIE) rules, respectively. The NRT and FIE rules have a much broader scope than the existing rules and were proposed to generally apply in respect of taxation years commencing after 2006. Given that former Bill C-10 was not passed before the 39\textsuperscript{th} Parliament was dissolved in September 2008, the legislative amendments in this bill must be reintroduced by Parliament in order to be enacted. Notably, in the 2009 Federal Budget, the Government stated that it will review the NRT and FIE proposals in light of the recommendations made by the Advisory Panel in its Final Report\textsuperscript{107} before proceeding with measures in this area. Consequently, the status of the proposed NRT and FIE rules at the time of writing is uncertain.

The remainder of this part of the brief provides an overview of the foreign tax credit rules and the FA rules.

\textbf{II. Conducting Activities Directly: The Foreign Tax Credit Rules}

As described above, if a Canadian-resident corporation carries on business in a foreign country, the corporation is subject to Part I tax on the foreign-source business income and such income may also be subject to tax in the foreign country. When such double taxation occurs, relief may be available under the foreign tax credit rules in the Act or under the elimination of double taxation article of a tax treaty between Canada and the country where the business is carried on.\textsuperscript{108}

There are two foreign tax credits available under the Act: one in respect of taxes relating to property (or non-business) income sourced from a foreign country\textsuperscript{109} and the other in respect of taxes relating to

\\textsuperscript{106} Bill C-10, Income Tax Amendments Act, 2006, 2\textsuperscript{nd} Session, 39\textsuperscript{th} Parliament, 2007.
\textsuperscript{107} Supra note 21, at 34-39.
\textsuperscript{108} As discussed in Part A.II of this brief, if a Canadian-resident corporation carries on business in a country with which Canada has entered into a tax treaty, and it is entitled to the full benefit of that treaty, the corporation is generally only taxable on its business income earned in a foreign country to the extent that such profits are attributable to a permanent establishment in that country. Where the Canadian-resident corporation carries on business through a permanent establishment in the foreign country, relief from double taxation may nonetheless be available under the foreign tax credit rules in the Act or under the elimination of double taxation article of a tax treaty between Canada and the country where the business is carried on.
\textsuperscript{109} Subsection 126(1) and the definition of “non-business-income tax” in subsection 126(7). Notably, a non-business income tax credit is not available where the Canadian-resident taxpayer is a corporation and the foreign tax is paid in respect of income from a share of an FA. As a result, for example, a Canadian-resident corporation is not entitled to claim a foreign tax credit for foreign withholding tax paid in respect of a dividend from an FA. As discussed in Part B.III.4(c) of this brief, a Canadian-resident corporation is generally entitled to claim a deduction in computing taxable income under paragraph 113(1)(c) in respect of such foreign withholding tax.
a business carried on by the Canadian-resident taxpayer in a foreign country. In order to qualify for either foreign tax credit, the tax in question must be paid by the Canadian-resident taxpayer to a foreign government and either the basis of taxation in the foreign country must be substantially similar to that of Canada (i.e., the tax must either be levied on net income or profits or be similar to Part XIII withholding tax) or the tax must be specifically identified in the elimination of double taxation article of the tax treaty between Canada and the particular foreign country.

Separate non-business and business foreign tax credits must be claimed in respect of taxes paid to each foreign country and an ordering rule provides that non-business foreign tax credits must be claimed before business foreign tax credits. A foreign tax credit may not exceed the Canadian-resident taxpayer’s Part I tax otherwise payable for the year on the net income from sources in the particular foreign country. Unused non-business foreign tax credits in a particular taxation year may not be carried forward or back; however, a Canadian-resident corporation can elect to increase its taxable income in order to use these credits. Unused business foreign tax credits in a particular taxation year may be carried forward ten years or carried back three years.

The foreign tax credits under the Act can be claimed by a Canadian-resident corporation that carries on business in foreign country that does not have a tax treaty with Canada. Where the Canadian-resident corporation carries on business in a treaty country, the elimination of double taxation article generally permits a Canadian-resident taxpayer who derives profits, income or gains arising in the particular foreign country to deduct an amount equal to the income tax paid in the foreign country from the taxpayer’s Part I tax payable in respect of such profit, income or gain. The foregoing foreign tax credit is typically subject to the laws of Canada (i.e., the foreign tax credit rules in the Act) and any subsequent modifications to those provisions, provided that the modification does not affect the general principle of those rules as they read at the time the particular treaty was entered into.

In essence, the elimination of double taxation article incorporates by reference the foreign tax credit rules in the Act. It provides for an independent treaty credit only where a subsequent amendment to the foreign tax credit rules in the Act affects the general principle of these rules at the time the particular tax treaty entered into force. In such a case, the elimination of double taxation article

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110 Subsection 126(2) and the definition of “business-income tax” in subsection 126(7).
112 Section 110.5. The amount added to taxable income under section 110.5 also increases the Canadian-resident corporation’s non-capital loss for the year, which can then be applied in other taxation years in accordance with the normal loss-carryover rules in section 111. Alternatively, a Canadian-resident corporation may claim non-business foreign tax as a deduction in computing income under subsection 20(12). As with the non-business foreign tax credit, a Canadian-resident corporation is not entitled to this deduction where the foreign tax is paid in respect of income from a share of an FA.
113 See, for example, Article XXIV(2) of the US Treaty.
would essentially allow for treaty relief under the more favourable rules in effect under the Act at the
time the tax treaty entered into force.

Finally, the elimination of double taxation article contains an important sourcing rule that directly
impacts the application of the foreign tax credit rules in the Act. More specifically, the rule generally
provides that profits, income or gains that are taxed in the other treaty country will be deemed to
arise from sources in that other country. This sourcing rule is intended to preclude the possibility that
an item of income, although taxable in the other country, is not considered to be creditable on the
basis that its source is considered under the sourcing rules in the Act to be in Canada or in a third
country. For example, under the US Treaty, business profits of a Canadian-resident corporation are
deemed to arise in the US only if such profits may be taxed in the US under the terms of the US
Treaty.  

III. Conducting Activities Indirectly: The Foreign Affiliate Rules

As described above, the FA rules have two main components: the FAPI rules and the surplus rules. This
part of the brief deals with the following topics associated with the FA rules: (1) the definition of
“foreign affiliate” and “controlled foreign affiliate”; (2) the main provisions relevant to financing FAs;
(3) the rules relating to the attribution of FAPI of a CFA; (4) the surplus rules applicable when an FA
repatriates profits to a Canadian-resident corporation; and (5) the general rules applicable when a
Canadian-resident corporation disposes of an investment in an FA.

The FA rules are principally found in sections 90 to 95 (other than sections 94 and 94.1), section 113
and Part LIX of the Regulations. Bill C-28, which received royal assent on December 14, 2007,
implemented extensive amendments to these rules, including amendments to various definitions,
amendments to the income recharacterization rules in paragraph 95(2)(a) and the introduction of new
rules relating to tax information exchange agreements (TIEAs). More recently, Bill C-10, which
received royal assent on March 12, 2009, introduced new rules for computing income and gains of an FA
and expanded the definition of designated treaty country to include TIEA countries. Notably, Bill C-10
also repealed section 18.2, which was included in Bill C-28, and which otherwise was to apply to limit
the deductibility of interest incurred after 2011 in respect of certain double-dip financing structures
through FAs.  

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114 Article XXIV(3) of the US Treaty.
115 Bill C-28, Budget and Economic Statement Implementation Act, 2007, SC 2007, c. 35. The amendments in this bill have various
coming into force dates.
116 Bill C-10, Budget Implementation Act, 2009, SC 2009, c. 2. The amendments in this bill have various coming into force dates.
117 As part of the 2007 Federal Budget, the Government introduced rules to deny the deduction of interest on borrowed money
used to finance FAs. Notably, in response to concerns expressed by the tax and business communities relating to the 2007 Federal
As of the time of writing, there are also a number of proposed amendments to the FA rules, including:

(i) February 27, 2004 draft legislation: Many of the technical amendments in this legislative package were subsequently included in Bill C-28. Notably, however, the so-called suspended surplus and FAPI loss rules, and amendments to various provisions governing FA reorganizations, remain outstanding. The suspended surplus and FAPI loss rules are designed to suspend the creation of exempt surplus, and the recognition of FAPI losses, respectively, on internal dispositions of property until such time as the property is disposed of to a third party.

(ii) Former Bill C-10: This bill contained amendments to the FA rules that were consequential to the introduction of the NRT and FIE rules and that included measures regarding the interaction of the FIE rules with the FA rules. \(^{118}\)

Another significant development in the FA area is the Panel’s *Final Report*. Chapter 4 of the *Final Report* is devoted to outbound taxation and the Panel made seven recommendations to improve aspects of the FA rules, including a recommendation to broaden the existing surplus rules to exempt all dividends sourced from active business income from Part I tax. In the 2009 Federal Budget, the Government indicated that it would consider the Panel’s recommendations relating to FAs before proceeding with the remaining proposals in the February 2004 draft legislation, as modified to take into account comments received to date. Aside from this specific announcement, the Government indicated that it is studying the remaining recommendations in the *Final Report*. Consequently, additional changes to the FA rules are likely forthcoming.

1. **Definition of “Foreign Affiliate” and “Controlled Foreign Affiliate”**

The FAPI rules apply only in respect of income of a CFA of a Canadian-resident taxpayer and the surplus rules apply only in respect of dividends paid by an FA to a Canadian-resident corporation. An FA of a Canadian-resident taxpayer is defined to mean a non-resident corporation in which the taxpayer’s equity percentage is not less than one percent and the total equity percentages of the taxpayer, together with each person related to the taxpayer, is not less than 10 percent. \(^{119}\)

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\(^{118}\) These proposed amendments are not discussed in this brief.

\(^{119}\) Definition of “foreign affiliate” in subsection 95(1). Where shares are owned by a partnership, subsection 93.1(1) provides that each member of the partnership is deemed to own a number of the shares based on the relative fair market value of the member’s interest in the partnership. This rule applies for purposes of determining whether a non-resident corporation is an FA of a Canadian-resident corporation and certain other enumerated sections.
A CFA of a Canadian-resident taxpayer is defined to include an FA that is controlled by the taxpayer.\footnote{120} A CFA of a Canadian-resident taxpayer also includes an FA that, under an hypothetical control test, \textit{would be} controlled by the taxpayer \textit{if} such taxpayer owned all the shares of the FA that are owned by: (1) the taxpayer; (2) each person who does not deal at arm’s length with the taxpayer; (3) each of not more than four persons resident in Canada, other than persons described in items (1) and (2); and (4) each person who does not deal at arm’s length with persons described in item (3).\footnote{121} “Control” for purposes of the CFA definition means \textit{de jure} control, which has been interpreted to mean “the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.”\footnote{122}

The following is an overview of specific matters relevant in determining whether a foreign intermediary is an FA and a CFA of a Canadian-resident taxpayer.

\begin{itemize}
\item \textit{Entity Characterization}
\end{itemize}

Given that one is typically dealing with an entity formed under the laws of a foreign jurisdiction, a threshold issue that often arises in assessing FA status is whether the particular entity in question is a corporation for Canadian income tax purposes. A corporation is defined to include an incorporated company;\footnote{123} however, the Act does not provide any additional guidance or rules for determining the status of an entity as a corporation.

The Canadian courts have adopted a two-step approach to characterize a foreign entity for purposes of the Act.\footnote{124} The first step involves determining the characteristics of the foreign entity under foreign commercial law by examining its constating documents and the applicable governing legislation. The second step involves comparing those characteristics with those of recognized entities under Canadian commercial law - being corporations, partnerships or trusts - in order to classify the foreign entity under one of those categories.

Historically, the CRA defined a corporation for purposes of the FA rules as an entity “created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation.”\footnote{125} Consequently, the CRA focused mainly on the concept of legal

\footnotesize{\begin{itemize}
\item \textsuperscript{120} Paragraph (a) of the definition of “controlled foreign affiliate” in subsection 95(1).
\item \textsuperscript{121} Paragraph (b) of the definition of “controlled foreign affiliate” in subsection 95(1). In applying this provision, see also the supporting rules in subsections 95(2.01) and (2.02).
\item \textsuperscript{122} \textit{Buckerfield’s Ltd. v. MNR}, [1964] CTC 504 (Ex. Ct.), at paragraph 10. See also \textit{Duha Printers (Western) Ltd. v. The Queen}, [1998] 3 CTC 303 (SCC).
\item \textsuperscript{123} Definition of “corporation” in subsection 248(1).
\item \textsuperscript{124} See, for example, \textit{Economics Laboratory (Canada) Ltd. v. MNR}, [1970] Tax ABC 303; \textit{Backman v. The Queen}, [2001] 2 CTC 11 (SCC); and \textit{Boliden Westmin Limited et. al. v. British Columbia}, 2007 BCSC 351.
\item \textsuperscript{125} \textit{Interpretation Bulletin} IT-343R “Meaning of the Term ‘Corporation’,” September 26, 1977, paragraph 2.
\end{itemize}
personality to characterize foreign entities. Over the years, however, the CRA appears to have gradually changed its approach to entity characterization. Now, rather than focusing principally on whether an entity has a separate identity and existence, the CRA uses the two-step approach developed in the case law and seems to rely more on other distinguishing characteristics when characterizing a foreign entity that some — but not all — of the attributes of a legal person.\textsuperscript{126}

\textit{(b) Corporate Residency}

A second threshold issue that often arises in determining FA status is the residency of the corporation in question, since only a non-resident corporation may be an FA of a Canadian-resident taxpayer. With the exception of certain deeming rules,\textsuperscript{127} the Act does not define the terms “resident” or “residency” and this assessment must be made by reference to common law principles. The seminal case on corporate residency is \textit{De Beers Consolidated Mines Ltd. v. Howe},\textsuperscript{128} where the UK House of Lords stated:

\begin{quote}
In applying the conception of residency to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business.\ldots The decision of Kelly C.B. and Huddleston B. in the \textit{Calcutta Jute Mills v. Nicholson} (1) and the \textit{Cesena Sulphur Co. v. Nicholson} (1), now thirty years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides.\textsuperscript{129}
\end{quote}

\textsuperscript{126} \textit{Income Tax Technical News} no. 38, September 22, 2008 (ITTN no. 38). The evolution of the CRA’s approach to entity characterization can be traced in part through the positions of the CRA relating to partnerships formed under the Delaware Revised Uniform Partnership Act (DRUPA). The initial concern was that a DRUPA partnership would be characterized as a corporation given that it is a separate legal entity distinct from its partners (unless otherwise provided in the partnership agreement). After a full analysis, however, the CRA concluded that a DRUPA partnership would be treated as a partnership for Canadian tax purposes because its attributes more closely resemble those of a partnership formed under Canadian commercial law (see \textit{Income Tax Technical News} no. 20, June 14, 2001; and \textit{Income Tax Technical News} no. 25, October 30, 2002). On a subsequent review of this position, the CRA reached the same conclusion (see \textit{Income Tax Technical News} no. 34, April 27, 2006).

\textsuperscript{127} Subsections 250(4) to (6).

\textsuperscript{128} [1906] AC 455 (HL).

\textsuperscript{129} \textit{Ibid.} at 458.
In sum, a corporation is considered to be resident in the country in which its central management and control is exercised. The central management and control of a corporation generally refers to the exercise of the power and control over the business and affairs of the corporation granted to the corporation’s board of directors under applicable corporate law. Consequently, provided that the board of directors of the corporation exercises these powers, the central management and control of the corporation will generally be found to exist where the board holds its meetings. If, however, another party, such as a controlling shareholder, takes over and exercises the functions of the board, the central management and control of the corporation may instead be found to exist where the other party is located.

The UK Court of Appeal considered corporate residency in *Wood v. Holden*. In that case, the Court adopted the *De Beers* test and noted that when assessing corporate residency, a distinction must be made between cases where the central management and control of the corporation is exercised by the board of directors and cases where the functions of the board are usurped and exercised by another person. In situations where the board of directors does in fact exercise central management and control, the Court held that a further distinction must be made between dictating actions to the board and the mere ability to influence it. The Court ultimately found that the corporation in question was resident in the Netherlands, since this was where its sole board member was located and the corporate actions approved by the board were not dictated by a third party. The Court found this to be the case even though there were only a small number of decisions made by the board and some decisions were taken without proper information or consideration. The Canadian courts have not yet had the opportunity to consider the *Wood v. Holden* decision.

(c) Equity Percentage

A described above, a non-resident corporation is an FA of a Canadian-resident taxpayer only if the taxpayer’s equity percentage in such corporation is not less than one percent and the total equity percentages of the taxpayer, together with each person related to the taxpayer, is not less than 10 percent.

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130 This test has been adopted by the Canadian courts. See, for instance, *MNR v. Crossley Carpets (Canada) Limited*, [1968] CTC 570 (Ex. Ct.); and *Birmount Holdings Ltd. v. The Queen*, [1978] CTC 358 (FCA).

131 While the location of where this power and control is exercised is regarded as the most important factor in determining where the central management and control of a corporation resides, the Canadian courts have also taken into account other factors, including the location of the corporation’s head office, books and bank accounts and the location where the majority of the directors reside. See, for instance, *MNR v. Tara Exploration and Development Company*, [1970] CTC 557 (Ex. Ct.), aff’d [1972] CTC 328 (SCC); *Victoria Insurance Company Ltd. v. MNR*, [1977] CTC 2443 (TRB); and *Birmount Holdings*, *ibid*.


The equity percentage of a person in a corporation is essentially the aggregate of its direct and indirect ownership interests in the particular corporation.\(^{134}\) Where a Canadian-resident taxpayer owns shares in a particular corporation directly, the taxpayer’s equity percentage is its direct equity percentage, which varies depending on whether the taxpayer owns shares of one or more classes.\(^{135}\) If the Canadian-resident taxpayer owns shares of a single class, the direct equity percentage in that corporation is the percentage of the issued shares of that class that is owned. If, however, the Canadian-resident taxpayer owns shares of two or more classes, the direct equity percentage is the highest of the ownership percentages calculated for each class. Where the Canadian-resident taxpayer indirectly owns shares of a lower-tier corporation, the taxpayer’s equity percentage in that corporation is equal to the product obtained when the taxpayer’s direct equity percentage in the first-tier corporation is multiplied by that corporation’s direct equity percentage in the lower-tier corporation.

\((d)\) **Paragraph 95(6)(b)**

A final consideration that is relevant in determining FA status is paragraph 95(6)(b).\(^{136}\) Paragraph 95(6)(b) is an anti-avoidance rule that, if applicable, can affect the status of a non-resident corporation as an FA for purposes of the FA rules, other than section 90. Paragraph 95(6)(b) applies where a person acquires or disposes of shares or partnership interests and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit any person to avoid, reduce or defer tax that would otherwise be payable under the Act. In these circumstances, the acquisition or disposition of the shares or partnership interests is deemed not to have taken place, and, if the shares or partnership interests were previously unissued, those shares or partnership interests are deemed not to have been issued. Where paragraph 95(6)(b) applies in the context of a share acquisition by a Canadian-resident corporation, the corporation is considered to own the shares for purposes of including dividends in the corporation’s income, but is deemed not to own the shares for purposes of the surplus rules.

In *Univar Canada Ltd. v. The Queen*,\(^{137}\) the Court considered paragraph 95(6)(b) in the context of a second-tier financing structure. In this case, the taxpayer was a Canadian-resident subsidiary of a US parent that was also the parent of a large European group. The taxpayer incorporated a new subsidiary

\(^{134}\) Definition of “equity percentage” in subsection 95(4).

\(^{135}\) Definition of “direct equity percentage” in subsection 95(4).

\(^{136}\) Paragraph 95(6)(a) contains two other anti-avoidance rules that can apply where a person has a right to acquire shares or partnership interests. The first rule provides that where the principal purpose for the right is to cause two or more corporations to be related for purposes of the income recharacterization rules in paragraph 95(2)(a), those corporations are deemed not to be related for that purpose. The second rule provides that where the principal purpose for the right is to permit any person to avoid, reduce or defer tax that would otherwise be payable under the Act, the shares or partnership interests subject to the right, as the case may be, are deemed to be owned by that person.

\(^{137}\) [2006] 1 CTC 2308 (TCC).
in Barbados, Barbadosco, that was a CFA of the taxpayer. The taxpayer made an equity investment in Barbadosco using surplus funds and borrowed money. Barbadosco used these funds to purchase from its US parent certain notes receivable owing by a Netherlands subsidiary of its parent. The taxpayer did not have a direct or indirect equity interest in the Netherlands subsidiary, but was related to it for Canadian tax purposes.

From 1995 to 1999, Barbadosco earned interest income on the notes receivable from its Netherlands sister-company and this income was recharacterized as active business income under subparagraph 95(2)(a)(ii) of the FAPI rules as they read for the years in question. Barbadosco paid nominal tax on this income in Barbados and, because Barbados is a treaty country, under the surplus rules, Barbadosco was able to repatriate this income to the taxpayer in the form of tax-free dividends. In essence, the use of this second-tier financing structure permitted the taxpayer to invest funds offshore and receive its return on the investment without the imposition of Part I tax (and presumably also permitted the taxpayer to reduce its other income by deducting the interest it paid on the money borrowed to finance the acquisition of the Barbadosco shares). The structure also benefited the corporate group because the taxpayer’s funds were ultimately used to make loans to related European operating entities that were able to deduct the interest expense in computing income subject to tax in their respective countries.

The Court found that paragraph 95(6)(b) did not apply to the acquisition of the Barbadosco shares by the taxpayer. The Court focused on the question of whether the acquisition of the Barbadosco shares by the taxpayer permitted a person to avoid, reduce or defer tax otherwise payable under the Act. The Minister argued that this should be assessed by reference to the tax results of an alternative transaction and that the appropriate alternative transaction was a direct purchase by the taxpayer of the notes receivable. The Court rejected the alternative transaction proposed by the Minister since a direct purchase of the notes receivable had never been contemplated by the taxpayer. As a result, the tax that might have been payable as a consequence of the Minister’s alternative transaction could not represent the tax that would otherwise have been payable by the taxpayer, as required by paragraph 95(6)(b). Instead, the Court compared the tax consequences of the transactions actually undertaken by the taxpayer with those that would have arisen had the taxpayer not acquired any shares of Barbadosco — and concluded that the taxpayer had not avoided, reduced or deferred any tax otherwise payable under the Act.

The narrow manner in which the Court applied the alternative transaction test makes the Univar decision less relevant in other circumstances. For example, the Court did not consider whether the taxpayer avoided or reduced tax otherwise payable as a consequence of the actual transactions it undertook. For instance, the Court did not consider whether the reduction of tax resulting from the interest expense on the borrowed money used to make the equity investment in Barbadosco, without
any offsetting income inclusion, could be an avoidance or reduction of taxes otherwise payable for purposes of paragraph 95(6)(b). \(^{138}\)

Following the *Univar* decision, the CRA released its views on the application of paragraph 95(6)(b) in two *Income Tax Technical News*. \(^{139}\) In ITTN no. 36, the CRA sets out its approach for applying paragraph 95(6)(b) in the context of five examples. In general terms, the CRA takes the position that the principal purpose of an acquisition or disposition is to be determined objectively from the facts and circumstances surrounding that transaction. In determining the principal purpose of an acquisition or disposition, the CRA appears to focus on a quantitative comparison of the expected economic return from the share investment with the overall tax benefits associated with the series of transactions that includes the particular acquisition or disposition. In ITTN no. 38, the CRA confirms its own view that other transactions in the series may be considered to determine the principal purpose of an acquisition or disposition where such acquisition or disposition is part of a series of transactions. Whether the CRA’s position on this point is supportable as a matter of law has been the subject of debate.

2. **Financing a Foreign Affiliate**

If a Canadian-resident corporation borrows to make an investment in an FA, the principal consideration is generally whether interest on the borrowing is deductible. \(^{140}\) The investment by the Canadian-resident corporation can be in the form of either debt or equity. If the FA is funded with debt, the Canadian-resident corporation will also need to consider section 17, which is a specialized transfer pricing rule that could impute interest income on certain debts owed by non-resident persons. Finally, in certain circumstances, it may be advantageous for the Canadian-resident corporation to finance its FAs through a financing subsidiary located in a low-tax jurisdiction. Section 17 and the use of foreign finance subsidiaries are discussed in greater detail below.

(a) **Section 17**

Section 17 is an anti-avoidance rule that applies to ensure that a Canadian-resident corporation includes in income a reasonable amount of interest in respect of certain loans and other amounts owing

\(^{138}\) Notwithstanding that this conclusion was sufficient to dispose of the appeal, the Court also considered whether the principal purpose of the acquisition of the Barbadosco shares by the taxpayer was to permit a person to avoid, reduce or defer tax otherwise payable under the Act. The Court concluded that the acquisition did not have such a principal purpose. The *Univar* decision is of limited precedential value on this point, however, given that the Court did not fully disclosure what facts it relied on in reaching its conclusion.

\(^{139}\) *Income Tax Technical News* no. 36, July 27, 2007 (ITTN no. 36); and ITTN no. 38.

\(^{140}\) The deductibility of interest in this context is governed by the general interest deductibility rules in the Act, *supra* note 32.
by non-resident persons. Subsection 17(1) applies where a non-resident person\textsuperscript{141} owes an amount to a corporation resident in Canada, the amount is outstanding for one year or longer and the Canadian-resident corporation includes less than a reasonable amount of interest in income in respect of the amount owing. In these circumstances, the Canadian-resident corporation is required to include in income an amount of interest on the amount owing, computed using a prescribed rate, less the amount of the actual interest inclusion. Notably, subsection 17(1) does not apply to a debt owing by a corporation that is a CFA of the Canadian-resident corporation for purposes of section 17, provided that the debt arose in the course of an active business carried on by the CFA.\textsuperscript{142}

An indirect debt rule added to the Act in 1999 extends the application of subsection 17(1) to certain debts owing between non-residents.\textsuperscript{143} This rule applies where a non-resident person owes an amount to a second non-resident person and it is reasonable to conclude that the second non-resident person entered into the transaction under which the amount became owing, or permitted the amount owing to remain outstanding, because either a corporation resident in Canada loaned or transferred property to any person or the second non-resident person anticipated that such a loan or transfer of property would be made. The use of the word “because” in the indirect debt rule requires that there be a causal link between the debt owing between the two non-resident persons and the actual or anticipated loan or transfer of property by the Canadian-resident corporation.\textsuperscript{144} If the conditions in the indirect debt rule exist, the rule applies to deem the non-resident person to owe an amount to the Canadian-resident corporation equal to the amount owing to the second non-resident person; this deemed amount is then subject to subsection 17(1).\textsuperscript{145} The indirect debt rule does not apply where the debt is owing between corporations that are CFAs of the Canadian-resident corporation for purposes of

\textsuperscript{141} Subsection 17(6) contains a look-through rule for partnerships that provides that, where a partnership owes an amount to any person, each member of the partnership is deemed to owe a portion of the amount equal to the relative fair market value of that member’s interest in the partnership.

\textsuperscript{142} Subsection 17(8). For purposes of subsection 17(8), subsections 17(8.1) and (8.2) contain rules applicable to certain refinancings by the CFA. Other exceptions to subsection 17(1) are contained in subsections 17(7) and (9).

\textsuperscript{143} Subsection 17(2).

\textsuperscript{144} Generally, the requisite causal link between a debt owing between the two non-resident persons and the transfer of property by the Canadian-resident corporation would exist where the non-resident lender makes a loan to the non-resident borrower using share subscription proceeds received from a Canadian-resident corporation.

\textsuperscript{145} Subsections 17(4) and (5) contain look-through rules applicable to amounts owing by a non-resident person to a partnership and a trust, respectively. These two look-through rules apply only if subsection 17(2) does not apply.
section 17 or where the loan or transfer of property made or anticipated to be made by the Canadian-resident corporation is an exempt loan or transfer.

Subsection 17(1) and the indirect debt rule each contain an exception for certain debt of a corporation that is, or between corporations that are, a CFA of the Canadian-resident corporation for purposes of section 17. A CFA for this purpose is defined to mean a corporation that would be a CFA of the Canadian-resident corporation under the definition of “controlled foreign affiliate” in the FA rules if the non-arm’s-length persons referred to in items (2) and (4) of the hypothetical control test were limited to non-arm’s-length persons resident in Canada. This modification is designed to ensure that only those non-resident corporations that are actually controlled by a person resident in Canada qualify as CFAs for purposes of section 17. In assessing CFA status for purposes of section 17, one must also consider paragraph 17(14)(b), which contains an anti-avoidance rule similar to paragraph 95(6)(b).

(b) Financing Subsidiaries

A Canadian-resident corporation will generally seek to finance its CFAs in a tax-efficient manner. A popular method of financing a wholly owned non-resident subsidiary (Opco) of a Canadian-resident corporation that carries on an active business in a designated treaty country is through a basic treaty-based double-dip financing structure. In this type of structure, a Canadian-resident corporation borrows money from a third party and uses it to subscribe for common shares of a new wholly owned non-resident corporation (Finco) resident in a low-tax jurisdiction that has a tax treaty with Canada. Finco uses the subscription proceeds to make an interest-bearing loan to Opco, which Opco uses in its active business. Going forward, Opco makes periodic interest payments to Finco and Finco uses these funds to pay dividends to the Canadian-resident corporation, which the corporation uses to fund interest payments on the third-party loan.

From a foreign tax perspective, the objectives are to ensure that Opco obtains a deduction for the interest it pays to Finco in its home country; that Finco pays little, if any, income tax on the interest income it receives from Opco; and that both the interest paid by Opco to Finco and the dividends paid by Finco to the Canadian-resident corporation are subject to little or no withholding tax. From a Canadian tax perspective, the tax treatment is generally as follows:

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146 Paragraph 17(3)(a). Paragraph 17(3)(b) contains another exception to the direct debt rule.
147 An “exempt loan or transfer” is defined in subsection 17(15) to include a loan bearing an arm’s-length rate of interest, a dividend and a return of capital. It also includes certain arm’s-length transfers of property, other than transfers made for the purpose of acquiring shares of an FA.
148 Definition of “controlled foreign affiliate” in subsection 17(15).
149 Other supporting rules regarding CFA status for purposes of section 17 are contained in subsections 17(10), (12) and (13). In addition, subsections 17(10), (11), (11.1) and (11.3) contain rules to determine whether persons are related for purposes of section 17.
(i) Finco is an FA and a CFA of the Canadian-resident corporation and paragraph 95(6)(b) should not apply to the corporation’s acquisition of the Finco shares since the structure provides new financing to Opco for use in its active business;\(^{150}\)

(ii) under the FAPI rules, the interest income received by Finco is recharacterized as active business income under paragraph 95(2)(a) and, since each of Opco and Finco are resident in a designated treaty country, the interest income should give rise to exempt surplus;

(iii) the dividends paid by Finco to the Canadian-resident corporation should be tax-free exempt surplus dividends;

(iv) the Canadian-resident corporation should be entitled to deduct the interest paid on the third-party loan; and

(v) the indirect debt rule in section 17 should not apply to require the Canadian-resident corporation to include any amount income in respect of the loan from Finco to Opco since each of these corporations should be CFAs of the corporation for purposes of section 17.

Section 18.2 was intended to limit the deductibility of interest by a Canadian-resident corporation where the borrowed money was incurred in the context of the type of double-dip structure described above.\(^{151}\) With the repeal of section 18.2, however, these types of structures should still be a viable option to finance FAs.

### 3. Attribution of Foreign Accrual Property Income

Under the Act, a Canadian-resident taxpayer is required to include in income, on an annual basis, a percentage of the FAPI of a CFA owned by the taxpayer at the end of the CFA’s taxation year.\(^{152}\) This

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\(^{150}\) See ITTN no. 36, Example 2.

\(^{151}\) See the Department of Finance Canada, “Backgrounder - Canada’s New Government Improves Tax Fairness with Anti-Tax-Haven Initiative,” News Release 2007-041, May 14, 2007. The Backgrounder also refers to the so-called tower structures, which are double-dip structures that also rely on hybrid entities.

\(^{152}\) Subsection 91(1). The percentage of FAPI that is attributable to a Canadian-resident taxpayer is determined in respect of each share of the CFA owned by the taxpayer and is equal to each such share’s “participating percentage” as defined in subsection 95(1). The participating percentage is nil where FAPI is $5,000 or less. Where FAPI is greater than $5,000, the participating percentage is based on the Canadian-resident taxpayer’s equity percentage determined without reference to any shares held indirectly through other corporations resident in Canada. In addition, where there are two or more classes of shares outstanding, the participating percentage is based on the share’s relative distribution entitlement as determined in accordance with the rules in Regulation 5904.
inclusion is required whether or not all or any part of the income has been paid or distributed by the CFA to the Canadian-resident taxpayer. The FAPI rules are intended to prevent the deferral of Canadian tax on “passive” income earned by a CFA and the application of these rules approximates the tax treatment to the Canadian-resident taxpayer had the taxpayer carried on the activities, or held the investments, of the affiliate directly. Generally, there is no additional Part I tax when FAPI is repatriated by a CFA to the Canadian-resident taxpayer as a dividend.\(^\text{153}\)

\[(a) \text{ Foreign Accrual Property Income vs. Active Business Income}\]

The FAPI rules generally treat an FA of a Canadian-resident taxpayer as having two principal sources of income, being FAPI and active business income, and only the former is subject to annual attribution where the FA is also a CFA. There are detailed rules to categorize an FA’s income as FAPI or active business income\(^\text{154}\) and the status of property held by the FA as excluded property or investment property is relevant in making this determination. Excluded property of an FA includes, among other things, property used or held by the affiliate principally for the purpose of earning active business income and shares of another FA of the Canadian-resident taxpayer where all or substantially all\(^\text{155}\) of the property of the other affiliate is excluded property.\(^\text{156}\) Investment property includes, among other things, shares (other than shares of another FA of the Canadian-resident taxpayer that are excluded property), interests in a partnership or a trust that are not excluded property, debt, commodities, currency and real estate.\(^\text{157}\)

The five main types of income of an FA included in FAPI are:

(i) income from property, which specifically includes income from an adventure or concern in the nature of trade and income from trading or dealing in certain non-arm’s-length debt;\(^\text{158}\)

(ii) income from an investment business, which generally is a business the principal purpose of which is to earn income from property, insurance or factoring accounts receivable, or profits from the disposition of investment property, unless the business

\(^{153}\) This is achieved by means of the deduction provided for in subsection 91(5), which is discussed in Part B.III.4(c) of this brief.

\(^{154}\) Definition of “foreign accrual property income” in subsection 95(1) and various supporting rules throughout section 95. In addition, paragraphs 95(2)(f) to (f.15) contain rules for purposes of computing FAPI and amounts under the surplus rules.

\(^{155}\) The CRA generally interprets the phrase “all or substantially all” as meaning 90 percent or more. See, for instance, Interpretation Bulletin IT-151R5, “Scientific Research and Experimental Development Expenditures,” July 23, 2003, paragraph 18; and Interpretation Bulletin IT-291R3 “Transfer of Property to a Corporation under Subsection 85(1),” January 12, 2004, Definitions.

\(^{156}\) Definition of “excluded property” in subsection 95(1).

\(^{157}\) Definition of “investment property” in subsection 95(1).

\(^{158}\) Definition of “income from property” in subsection 95(1) and paragraph 95(2)(i).
is conducted principally with arm’s-length persons, the business is regulated or involves certain enumerated activities and more than five full-time employees, or the equivalent, are employed in the business;\(^{159}\)

(iii) income from a business other than an active business, which generally is a business comprising certain sales, insurance, interest, lease or service activities to the extent that the income is derived from or related to Canadian sources;\(^{160}\)

(iv) income from a non-qualifying business, which generally is a business carried on by the affiliate through a permanent establishment located in a country with which Canada does not have a tax treaty or a TIEA and which commenced negotiations, or was invited by Canada to commence negotiations, for a TIEA more than 60 months before that time;\(^{161}\) and

(v) taxable capital gains from the disposition of capital property, other than excluded property.\(^{162}\)

FAPI is reduced by losses from these sources and does not include active business income, taxable capital gains from the disposition of excluded property or dividends from another FA of the Canadian-resident taxpayer.\(^{163}\)

Active business income includes income from any business carried on by the FA, other than an investment business, a business other than an active business, or a non-qualifying business, and any income that pertains to, or is incident to, such business.\(^{164}\) In addition, the FA rules provide that certain income that would otherwise be income from property (and thus FAPI) of an FA is deemed to be active business income.\(^{165}\) Notably, these income recharacterization rules apply only where the Canadian-resident taxpayer has either a qualifying interest in the FA, or the affiliate is a CFA of the taxpayer, throughout the particular affiliate’s taxation year.

\(^{159}\) Definitions of “income from property” and “investment business” in subsection 95(1).

\(^{160}\) Paragraphs 95(2)(a.1) to (a.4) and (b).

\(^{161}\) Definitions of “non-qualifying business” and “non-qualifying country” in subsection 95(1).

\(^{162}\) FAPI includes taxable capital gains from the disposition of excluded property where the disposition is effected by the FA under one of the reorganization rules in paragraphs 95(2)(c), (d) or (e) and the Canadian-resident taxpayer elects to recognize a gain on the disposition.

\(^{163}\) Paragraph (b) of amount “A” in the definition of “foreign accrual property income” in subsection 95(1).

\(^{164}\) Definitions of “active business” and “income from an active business” in subsection 95(1).

\(^{165}\) Paragraph 95(2)(a). Income from an investment business is included in income from property, but income from a business other than an active business and income from a non-qualifying business is not. Consequently, income from these latter two types of businesses is not eligible to be recharacterized as active business income under paragraph 95(2)(a).
A Canadian-resident taxpayer has a qualifying interest in an FA where the taxpayer owns: (1) not less than 10 percent of the issued and outstanding shares (having full voting rights under all circumstances) of the affiliate; and (2) shares of the affiliate having a fair market value of not less than 10 percent of the fair market value of all of the issued and outstanding shares of the affiliate.\(^{166}\) In addition, for purposes of applying the recharacterization rules, a non-resident corporation is deemed to be an FA of a particular Canadian-resident corporation, and an FA in which such corporation has a qualifying interest, if the non-resident corporation is an FA of another Canadian-resident corporation, the other Canadian-resident corporation has a qualifying interest in the non-resident corporation and the particular Canadian-resident corporation is related to the other Canadian-resident corporation.\(^{167}\) In situations where shares are acquired or disposed of in a taxation year of an FA, a Canadian-resident taxpayer is deemed to have a qualifying interest in an FA throughout the year of acquisition or disposition provided that, at the beginning or end of the year, the particular non-resident corporation was an FA of the taxpayer in respect of which the taxpayer had a qualifying interest.\(^{168}\)

Under the income recharacterization rules, property income or loss of an FA is recharacterized as active business income or loss where the income or loss is derived:

(i) from activities directly related to the non-Canadian business activities of another FA of the Canadian-resident taxpayer in which the taxpayer has a qualifying interest, to the extent that the amounts would be included in computing the non-Canadian active business earnings of the other affiliate if the income had been earned by it;\(^{169}\)

(ii) from amounts received from another FA of the Canadian-resident taxpayer in which the taxpayer has a qualifying interest, to the extent that the amounts are deductible by the other affiliate in computing its non-Canadian active business earnings;\(^{170}\)

(iii) from amounts received from a second FA of the Canadian-resident taxpayer in which the taxpayer has a qualifying interest, to the extent that the amounts are interest on a

\(^{166}\) Paragraph 95(2)(m), which also provides that where shares of an FA are held through one or more corporations or partnerships, the shares are deemed to be owned by the shareholders or the partners based on the relative fair market value of their investment in the corporation or partnership, as the case may be.

\(^{167}\) Paragraph 95(2)(n).

\(^{168}\) Subsection 95(2.2). See also subsection 95(2.21) and paragraph 95(2)(y). Subsection 95(2.201) contains a rule parallel to subsection 95(2.2) in respect of CFA status.

\(^{169}\) Subparagraph 95(2)(a)(i).

\(^{170}\) Subclause 95(2)(a)(ii)(B)(I). Subclause 95(2)(a)(ii)(B)(II) and clause 95(2)(a)(ii)(C) are similar and apply where the amounts are received from a partnership of which another FA of the Canadian-resident taxpayer (and in which the taxpayer has a qualifying interest), or the particular affiliate, is a qualifying member, as determined in accordance with the rules in paragraphs 95(2)(o), (q), (r) and (u).
debt obligation that was used by the second affiliate to acquire shares of a third FA of
the taxpayer where: (a) the taxpayer has a qualifying interest in the third affiliate, (b)
the shares of the third affiliate are excluded property of the second affiliate, (c) the
second and third affiliates are resident in the same country, and (d) the second and
third affiliates are either subject to income tax in their country of residence or their
members or shareholders are subject to income tax on substantially all of the income
of the respective affiliate;\textsuperscript{171}

(iv) from factoring trade accounts receivable, or from loans and lending assets, acquired
from another FA of the Canadian-resident taxpayer in which the taxpayer has a
qualifying interest, to the extent that the receivables or loans and lending assets arose
in the course of a non-Canadian active business of the other affiliate;\textsuperscript{172}

(v) from the disposition of excluded property that is not capital property;\textsuperscript{173} and

(vi) under certain agreements for the purchase, sale or exchange of currency used to hedge
against currency exchange risks in respect of amounts recharacterized under paragraph
95(2)(a).\textsuperscript{174}

Categorizing an FA’s income as FAPI or active business income is also relevant for purposes of
determining the tax treatment of dividends received by a Canadian-resident corporate shareholder
under the surplus rules, as discussed in Part B.III.4 of this brief.

(b) Deduction for Foreign Accrual Tax

Where a Canadian-resident taxpayer is required to include FAPI in its income, the taxpayer is entitled
to claim a deduction in respect of the foreign accrual tax\textsuperscript{175} paid by the CFA that is reasonably
attributable to the FAPI, multiplied by the relevant tax factor, which is currently 1/.38 for
corporations.\textsuperscript{176} The deduction and the relevant tax factor are designed to avoid double taxation by
eliminating Part I tax on the FAPI of the CFA if such earnings have been subject to foreign or Canadian
tax at a rate at least equivalent to the Canadian corporate tax rate of 38 percent (subject to
amendment). The amount of the deduction, however, cannot exceed the amount of the FAPI inclusion.

\textsuperscript{171} Clause 95(2)(a)(ii)(D).
\textsuperscript{172} Subparagraphs 95(2)(a)(iii) and (iv), respectively.
\textsuperscript{173} Subparagraph 95(2)(a)(v).
\textsuperscript{174} Subparagraph 95(2)(a)(vi).
\textsuperscript{175} Subsection 91(4) and the definition of “foreign accrual tax” in subsection 95(1).
\textsuperscript{176} Definition of “relevant tax factor” in subsection 95(1). Note that former Bill C-10 proposed to amend the definition of relevant
tax factor to take into account the general rate reduction percentage in section 123.4. As a result, the relevant tax factor for a
corporation was proposed to be 1/.29 for 2009, 1/.28 for 2010, 1/.265 for 2011 and 1/.25 for 2012 and later years.
The foreign accrual tax deduction may be claimed by the Canadian-resident taxpayer in the year of the FAPI inclusion or in any of the following five years.

(c) Adjustments to Cost Base

Where a Canadian-resident taxpayer is required to include FAPI of a CFA in computing income, the amount of the FAPI inclusion is added to the adjusted cost base of the shares of the CFA, net of the amount of the foreign accrual tax deduction claimed by the taxpayer in respect of the FAPI inclusion.\(^\text{177}\)

4. Repatriation of Profits

Like a Canadian corporation, an FA may generally distribute profits to its shareholders by way of a dividend or a return of capital.\(^\text{178}\) Active business income (as opposed to FAPI) earned by an FA is generally not taxable in Canada until such time as the income is repatriated as a dividend. More specifically, dividends received by a Canadian-resident taxpayer from an FA are required to be included in computing the taxpayer’s income.\(^\text{179}\) However, where the Canadian-resident taxpayer is a corporation, it is generally entitled to claim a full or partial deduction in computing its taxable income in respect of dividends received from an FA.\(^\text{180}\) The amount of the deduction is dependent on whether the FA is resident in, and carries on business in, a designated treaty country. Generally, active business income of an FA that is resident in and that carries on business in a designated treaty country gives rise to exempt surplus, and dividends paid from this income are exempt from Part I tax. In contrast, active business income of an FA that is not resident in, or which does not carry on business in, a designated treaty country, and FAPI, generally gives rise to taxable surplus, and dividends paid from these types of income are taxable, but relief is provided for any underlying foreign tax, and any withholding tax paid by the Canadian-resident corporate shareholder, on such dividends. The specific types of income included in the exempt and taxable surplus of an FA are further described in Part B.III.4(b) of this brief.

Where an FA effects a payment to a Canadian-resident taxpayer on a return of capital, the taxpayer is not required to include the amount received in income; rather, the amount received reduces the

\(^{177}\) Paragraphs 53(1)(d) and (2)(b) and subsection 92(1).

\(^{178}\) The CRA generally relies on the characterization of the distribution under foreign law for purposes of determining its character for purposes of the Act. See, for example, CRA document no. 2002-0177083, 2003; and CRA document no. 2004-006013117, October 21, 2004.

\(^{179}\) Paragraph 12(1)(k) and section 90.

\(^{180}\) Section 113. Notably, under the rules in subsections 258(3) to (5), dividends received by a Canadian-resident corporation from an FA on a term preferred share, a guaranteed preferred share or a collateralized preferred share may, in certain circumstances, be deemed to be interest for purposes of paragraphs 12(1)(c) and (i) and sections 113 and 126. As a result, if these rules apply, the Canadian-resident corporation is not entitled to claim a deduction in respect of such a dividend under the surplus rules.
adjusted cost base of the shares of the FA.\textsuperscript{181} In the event that the amount received exceeds the adjusted cost base of the shares, the Canadian-resident taxpayer is deemed to realize a capital gain equal to the excess.\textsuperscript{182} A Canadian-resident corporation may elect to treat all or a portion of the deemed gain on such a disposition as a dividend.\textsuperscript{183} Although the Canadian-resident corporation is required to include this dividend in income, the corporation is then entitled to claim a deduction in computing income, as determined under the surplus rules. This election is beneficial where the Canadian-resident corporation is entitled to claim a dividend deduction that reduces the effective rate of Part I tax on the dividend below the rate that would have applied to the deemed capital gain had no election been made.

The remainder of this part of the brief provides an overview of the surplus rules relating to the tax treatment of dividends received by a Canadian-resident corporation from an FA.

\textbf{\textit{(a) Designated Treaty Country Rules}}

As discussed above, a corporation is an FA of a Canadian-resident taxpayer only if the corporation is a non-resident of Canada as determined under the central management and control test. In order to generate exempt surplus, however, the FA must also be resident in, and carry on business in, a designated treaty country, as determined under the surplus rules.

A country is a designated treaty country for a taxation year of an FA where Canada and that country have entered into either a comprehensive tax treaty or a TIEA that has entered into force and has effect for that taxation year of the FA.\textsuperscript{184} In order to be resident in the particular designated treaty country, in addition to being resident in that country under the central management and control test, the FA must also be resident in that country for purposes of the applicable tax treaty.\textsuperscript{185} The Canadian courts have held that this definition is generally satisfied where the person is subject to as

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  \item Subparagraph 53(2)(b)(ii). The February 2004 draft legislation proposed to revise subsection 88(3) to add rules relating to the tax treatment of distributions of property from an FA to a Canadian-resident taxpayer.
  \item Supra note 80.
  \item Subsection 93(1). Regulation 5902 contains rules for determining the surplus balances of an FA where an election is made under subsection 93(1). The February 2004 draft legislation contains numerous amendments to subsection 93(1) and Regulation 5902.
  \item Regulation 5907(11). See also Regulations 5907(11.1) and (11.11).
  \item Regulation 5907(11.2)(a) and CRA documents no. 2003-0007347, April 28, 2003. Regulation 5907(11.2) provides that an FA is deemed not be resident in a particular designated treaty country for purposes of the surplus rules unless it satisfies one the four requirements in that provision. Consequently, in the event that the FA is not resident in a particular country for purposes of the applicable tax treaty, the FA may nonetheless be regarded as being resident in a designated treaty country for purposes of the surplus rules if it instead meets one of the requirements in Regulation 5907(11.2)(b), (c) or (d).
\end{enumerate}
\end{flushleft}
comprehensive a tax liability as is imposed by the particular country. In the context of certain FA financing structures, the CRA’s interpretation of the “liable to tax” requirement in the treaty residence articles of Canada’s tax treaties is particularly helpful as it confirms that where a non-resident corporation is subject to the full taxing jurisdiction of the particular foreign country, but it either pays a very low rate of tax or is exempted from tax under special rules, it nonetheless is regarded as being “liable to tax” in that country unless the arrangement is abusive.

(b) Computation of Surplus Accounts

The tax treatment of dividends received by a Canadian-resident corporation from an FA is dependent on which of the three surplus accounts - being exempt surplus, taxable surplus and pre-acquisition surplus - of the affiliate the dividend is considered to be paid from. The exempt and taxable surplus accounts of an FA must be computed in respect of each corporation resident in Canada in respect of whom the affiliate is an FA, generally commencing on the first day of the taxation year of the affiliate in which it became an FA of the particular Canadian-resident taxpayer. In addition, the exempt and taxable surplus accounts of the FA are computed at a particular time (for example, when a dividend is paid by the FA) and must be maintained on a consistent basis from year to year in the currency of the country in which the FA is resident or such other currency (other than Canadian currency) as is reasonable in the circumstances. Generally, only earnings of the FA for completed taxation years are taken into account in computing the balance of exempt or taxable surplus at a particular time.

The main components of exempt surplus of an FA are:

(i) where the affiliate is resident in a designated treaty country: (a) income from an active business carried on by the affiliate in Canada or a designated treaty country, and (b) income that is deemed to be active business income under the recharacterization rules in paragraph 95(2)(a) provided that such amounts are related to an active business carried on in a designated treaty country;

(ii) the non-taxable portion (50 percent) of capital gains: (a) included in FAPI, (b) from dispositions of property used or held principally for the purpose of earning income from an active business carried on by the affiliate in a non-designated treaty country (other

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186 See the discussion of treaty residency in Part A.III.2 of this brief.
187 ITTN no. 35.
188 Regulation 5907(6).
189 An exception to this general rule arises where a dividend is paid more than 90 days after the commencement of the FA’s taxation year and the amount of the dividend exceeds the exempt and taxable surplus balances. In these circumstances, Regulation 5901(2) deems the excess dividend to have been paid immediately after the FA’s taxation year and the exempt and taxable surplus balances of the affiliate at that time are then taken into account in determining the tax treatment of the excess dividend.
than Canada), and (c) from dispositions of excluded property that is an interest in a partnership or shares of another FA of the Canadian-resident taxpayer;

(iii) 100 percent of capital gains from dispositions of property other than property described in paragraph (ii) above; and

(iv) exempt surplus dividends received from another FA of the Canadian-resident taxpayer.\textsuperscript{190}

Exempt surplus is generally reduced by income tax paid, net losses and dividends paid by the FA out of exempt surplus.\textsuperscript{191}

The main components of taxable surplus of an FA are:

(i) where the affiliate is resident in a designated treaty country, income from an active business carried on by the affiliate in a non-designated treaty country;

(ii) where the affiliate is not resident in a designated treaty country: (a) income from an active business carried on by the affiliate in any country, and (b) income that is deemed to be active business income under the recharacterization rules in paragraph 95(2)(a);

(iii) FAPI;

(iv) the taxable portion (50 percent) of capital gains from dispositions of: (a) property used or held principally for the purpose of earning income from an active business carried on by the affiliate in a non-designated treaty country (other than Canada), and (b) excluded property that is an interest in a partnership or shares of another FA of the Canadian-resident taxpayer; and

(v) taxable surplus dividends received from another FA of the Canadian-resident taxpayer.\textsuperscript{192}

\textsuperscript{190} Definitions of “exempt earnings” and “exempt surplus” in Regulation 5907(1).

\textsuperscript{191} There are detailed rules in the Regulations to adjust the surplus accounts of an FA to take into account certain reorganizations, which are not discussed in this brief. In addition, the February 2004 draft legislation contains numerous amendments to the rules in the Regulations regarding the computation of surplus accounts, including rules consequential to the amendments to paragraph 95(2)(a) enacted by Bill C-28.

\textsuperscript{192} Definitions of “taxable earnings” and “taxable surplus” in Regulation 5907(1).
The taxable surplus is reduced by income tax paid, net losses and dividends paid by the FA out of taxable surplus.

The underlying foreign tax of an FA must also be computed as this is relevant to the taxation of taxable surplus dividends. The underlying foreign tax of an FA generally includes foreign and Canadian income and withholding taxes paid by the affiliate on income that is included in its taxable surplus and the underlying foreign tax applicable to taxable surplus dividends received from another FA of the Canadian-resident taxpayer. The underlying foreign tax is reduced by taxes relating to dividends previously paid by the affiliate out of taxable surplus.193

(c) Deductions in Respect of Dividends from Foreign Affiliates

A dividend from an FA is prescribed as being paid out of one or more of the three surplus accounts in the following order:

(i) exempt surplus (as reduced by any taxable deficit);
(ii) taxable surplus (as reduced by any exempt deficit); and
(iii) pre-acquisition surplus.194

The portion of the dividend that is not paid out of either exempt surplus or taxable surplus of the affiliate is considered to be paid out of pre-acquisition surplus.

A dividend paid from exempt surplus of an FA is included in the income of a Canadian-resident taxpayer, and a Canadian-resident corporation is entitled to claim a full deduction in computing taxable income for the amount of the dividend.195 No additional credit or deduction is available in respect of the underlying foreign tax of the FA relating to the exempt surplus dividend, or the foreign withholding tax paid by the Canadian-resident corporation on such dividend, since an exempt surplus dividend is effectively exempt from Part I tax.

A dividend paid from taxable surplus of an FA is included in the income of a Canadian-resident taxpayer, and a Canadian-resident corporation is entitled to claim a deduction in computing taxable income for both the underlying foreign tax of the FA on the distributed profits and the foreign withholding taxes paid by the corporation on the dividend. More specifically, the following deductions are available to a Canadian-resident corporation that receives a taxable surplus dividend from an FA:

193 Definition of “underlying foreign tax” in Regulation 5907(1).
194 Regulation 5901(1). A corporation resident in Canada may designate dividends that would otherwise be exempt surplus dividends to instead be taxable surplus dividends in certain circumstances, as per Regulation 5900(2).
195 Paragraph 113(1)(a).
(i) (the relevant tax factor\textsuperscript{196} minus one) multiplied by the underlying foreign tax of the affiliate applicable to the dividend paid out of taxable surplus;\textsuperscript{197} and

(ii) the relevant tax factor multiplied by the foreign withholding tax paid by the corporation on the dividend.\textsuperscript{198}

These deductions are similar to the foreign accrual tax deduction relating to a FAPI inclusion, in that they are designed to avoid double taxation by eliminating Part I tax on the repatriated earnings of the FA to the extent that such earnings have been subject to tax at a rate at least equivalent to the Canadian corporate tax rate of 38 percent (subject to amendment).

A dividend paid from pre-acquisition surplus of an FA is included in the income of a Canadian-resident taxpayer, and a Canadian-resident corporation is entitled to claim a full deduction in computing taxable income for the amount of the dividend.\textsuperscript{199} However, where a deduction is claimed, the Canadian-resident corporation is required to reduce the adjusted cost base of the shares of the FA by an amount equal to the deducted amount, less any foreign withholding tax on the pre-acquisition surplus dividend.\textsuperscript{200} Where the adjusted cost base of the shares of the FA becomes negative, the Canadian-resident corporation is deemed to realize a gain equal to the excess, as described above.

In addition to the foregoing dividend deductions, in order to avoid double taxation, a Canadian-resident taxpayer may claim an additional deduction where the dividend is received from a CFA of the taxpayer and is paid from previously taxed FAPI (which, as described above, is included in taxable surplus). The amount of this deduction is equal to the lesser of: (1) the taxable surplus dividend paid by the CFA, less the amount of the deduction claimed under paragraph 113(1)(b) in respect of such dividend; and (2) the additions to the adjusted cost base of the shares of the CFA in respect of previous FAPI inclusions, net of previous deductions for both foreign accrual tax and previously taxed FAPI.\textsuperscript{201} The amount of this deduction also reduces the adjusted cost base of the shares of the FA.\textsuperscript{202}

5. Disposition of an Investment in a Foreign Affiliate

Where a corporation resident in Canada disposes of its interest in an FA, the disposition is generally a taxable event for Canadian income tax purposes, subject to certain relieving rules. This part of the brief reviews the rules applicable to two types of exit transactions: (1) a sale of the shares of an FA by

\textsuperscript{196} Supra note 176.
\textsuperscript{197} Paragraph 113(1)(b) and the definition of “underlying foreign tax applicable” in Regulation 5907(1).
\textsuperscript{198} Paragraph 113(1)(c).
\textsuperscript{199} Paragraph 113(1)(d).
\textsuperscript{200} Paragraph 53(2)(b) and subsection 92(2).
\textsuperscript{201} Subsection 91(5).
\textsuperscript{202} Supra note 200.
a Canadian-resident corporation; and (2) the winding-up and liquidation of an FA into a Canadian-resident corporation.

(a) Share Sale

Where a Canadian-resident corporation disposes of shares of an FA that are held as capital property, the Canadian-resident corporation will realize a capital gain equal to the amount by which the proceeds of disposition it receives on the disposition exceeds its adjusted cost base in the shares. A Canadian-resident corporation may elect to treat all or a portion of the capital gain as a dividend to access any surplus balances of the FA, as previously described.

(b) Winding-Up

A corporation resident in Canada may also dispose of its interest in an FA by winding-up and dissolving the affiliate. An FA is generally considered to have disposed of each of its properties on the winding-up for proceeds equal their respective fair market values, which gives rise to active business income or FAPI, depending on whether the property is excluded property or investment property. The only exception to this rule is where the FA is a CFA of the Canadian-resident corporation and the property disposed of is shares of a second affiliate of the corporation. In this case, the FA is deemed to dispose of the shares of the second affiliate for proceeds equal to their adjusted cost base, unless the Canadian-resident corporation elects a higher amount.

The Canadian-resident corporation is considered to acquire each property on the winding-up of the FA at a cost equal to that affiliate’s proceeds, and the corporation is generally considered to have disposed of the shares of the affiliate for proceeds equal to the aggregate of the foregoing amounts, less the amount of any debts of the affiliate that are assumed or cancelled on the winding-up. A Canadian-resident corporation may elect to treat a capital gain realized on the disposition of the dissolving FA as a dividend to access any surplus balances of the affiliate, as previously described.

203 Subsection 69(5).

204 Paragraph 88(3)(a). If the shares of the second affiliate are excluded property, the elected gain is not FAPI, as per amount “B” of the definition of “foreign accrual property income” in subsection 95(1). The February 2004 draft legislation contains extensive amendments to subsection 88(3), and amount “B” of the definition of “foreign accrual property income,” as supplemented by various comfort letters issued by the Department of Finance (Canada).

205 Subsections 69(5) and 88(3).