Treaty Shopping: An Update

By Patrick J. McCay

Cross-border tax structures periodically optimize available tax treaty benefits having regard to the differences between various bilateral tax treaties. Structures that take advantage of such differences in bilateral treaties (e.g., holding companies situated in advantageous jurisdictions) may, however, be susceptible to attack under treaty shopping principles.

This article will discuss both Canadian and international jurisprudence that has considered such principles.

There is no widely recognized definition of treaty shopping; however, the Canada Revenue Agency (CRA) has commented that it considers treaty shopping to include transactions that involve the establishment of entities or residency in a particular jurisdiction to permit a taxpayer to avail itself of the benefits of a treaty with the particular jurisdiction for tax avoidance purposes.¹

Treaty shopping has developed a high profile, and the CRA has indicated that it will target treaty shopping structures.²

² Refer to Income Tax Technical News, no. 22 (January 2002); Income Tax Technical News, no. 30 (May 2004); CRA comments at the 2006 IFA Roundtable.
The CRA typically seeks to challenge treaty shopping on the basis of one or more of the following principles:

1. specific limitation on benefit (LOB) rules;
2. the general anti-avoidance rule (GAAR);
3. an abuse of treaties principle;
4. residency requirements; and/or
5. beneficial ownership requirements.

I. Limitation on Benefit (LOB) Rules

Unlike many US treaties, Canada's bilateral tax treaties do not generally contain detailed "limitations of benefits" or "LOB" provisions, which are expressly designed to counteract treaty shopping.

The notable exception is the current Canada-United States Income Tax Convention (Canada-US Treaty). On December 15, 2008, the Fifth Protocol to the Canada-US Treaty came into force. The provisions of this Protocol substantially amended the Canada-US Treaty in a number of important respects, including the amendments to Article XXIX-A of the Canada-US Treaty to create a reciprocal LOB rule that denies the benefits of the Canada-US Treaty to certain US residents where they have an insufficient nexus with the United States. While the LOB rules are highly complex, the general role of the LOB provision is that only a "qualifying person" will be entitled to all of the benefits of the Canada-US Treaty and, except as expressly provided, persons other than "qualifying persons" will not be entitled to treaty benefits.

Very generally, "qualifying persons" include natural persons, certain governmental bodies, companies (or trusts) the shares or units of which are primarily and regularly traded on a recognized stock exchange, certain other companies satisfying an indirect publicly traded test, and companies (or trusts) satisfying a combined ownership and "base erosion" test.

Persons other than qualifying persons may nevertheless access treaty benefits in relation to (i) income connected with or incidental to an active trade or business; (ii) dividends, interest and royalties received by a company where the ultimate owners of a defined percentage of the votes and value of the affected company are resident in a country that has a tax treaty with Canada, and where such treaty provides the same or lower withholding tax rate than the Canada-US Treaty on the relevant payment; and (iii) certain amounts where the competent authority permits treaty benefits to be applied. The LOB provision applies in respect of withholding taxes for amounts paid or credited after February 1, 2009, and in respect of other taxes for taxation years commencing after 2008.

Due to the short time during which such provisions have been in force, we are not aware of the CRA having challenged any structures on the basis of such rules. However, such LOB provisions will be extremely important going forward, and the introduction of LOB provisions in the Canada-US Treaty may foreshadow the introduction of similar LOB provisions in other bilateral Canadian tax treaties.

3 Other Canadian bilateral treaties contain a more limited form of LOB provision. Refer to Article 29(3) of the Canada-Germany Tax Convention, which provides “The Agreement shall not apply to any company (nor to income derived from such company by a shareholder thereof), trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State, if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more individuals who were residents of that State.” Refer also to Article 26(3) of the Canada-Mexico Income Tax Convention, which contains similar language.
2. **General Anti-Avoidance Rule (GAAR)**

The retroactive change to the GAAR, which was introduced following the 2004 federal Budget, eliminated any debate over whether the GAAR applied to tax treaties as the GAAR now expressly refers to tax treaties.4

The Supreme Court of Canada has most recently provided guidance on the application of the GAAR in *Lipson v. The Queen*.5

The *Lipson* decision did not involve alleged treaty shopping, but rather involved interest deductibility on a borrowing of funds that had permitted a home to be purchased as part of the same series of transactions as the borrowing. Justice LeBel, for the majority, largely applied the framework and principles set forth in prior GAAR jurisprudence that requires the following three elements to be satisfied:

1. a tax benefit results from a transaction or a series of transactions;
2. the transaction is an avoidance transaction (i.e., it cannot be reasonably viewed as having been undertaken primarily for a bona fide non-tax purpose); and
3. there was abusive tax avoidance in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

Justice LeBel also made certain comments relevant to tax planning and the GAAR risk:

- The Duke of Westminster principle, which states that a taxpayer is entitled to arrange his or her affairs to minimize taxes payable, remains valid but was circumscribed by the GAAR to limit avoidance transactions while maintaining certainty for taxpayers.
- The entire series of transactions should be considered in determining whether individual transactions within the series result in abuse of the *Income Tax Act* (Canada), although it is not the purpose or motivation for the transaction that determines abuse, but rather the result.
- The GAAR is a residual provision that can apply even if the transactions fall outside the scope of more specific anti-avoidance rules.
- The burden was on the Minister to prove, on the balance of probabilities, that the transactions had resulted in abuse — this may represent a softening of the prior GAAR jurisprudence, which held that the GAAR may only be invoked where the abuse is clear.

For the CRA to succeed on the GAAR in the treaty shopping context, it will have to demonstrate that a particular transaction defeats the object, spirit and purpose of a particular provision of a treaty. This may be difficult for CRA to establish in light of rules in most of Canada’s treaties, which already create a framework addressing who may benefit from such treaties:

---

4 Subsection 245(4) was amended to refer to tax treaties, and the *Income Tax Conventions Interpretation Act* was similarly amended to refer to the GAAR.
• Most of Canada’s tax treaties are drafted based upon the OECD Model Convention, and specifically address who is entitled to the benefits of the treaty. Article 1 typically provides that the treaty shall apply to persons who are residents of one or both of the contracting states, and Article 4 defines who is a resident of the contracting state for purposes of the convention.

• A number of Canada’s treaties specifically deny the benefits of the treaty to certain types of residents.6

• Other Canadian bilateral treaties more directly address the treaty shopping issue through express LOB provisions.

• The residency and beneficial ownership requirements may be considered stand-alone anti-avoidance measures.

Canadian courts have addressed the GAAR in the treaty shopping context. The decision in MIL (Investments) S.A. v. The Queen7 related to a capital gains exemption claimed under the Canada-Luxembourg Tax Convention (Luxembourg Treaty) in respect of the disposition of shares of mining companies. The crown challenged the availability of such exemption based inter alia on the GAAR. MIL held over 29 per cent of the shares of a Canadian mining company, Diamond Fields Resources. Initially, MIL was a Cayman Islands company, a jurisdiction with which Canada does not have a tax treaty. Diamond Fields discovered the Voisey Bay nickel find, following which another Canadian mining company, Inco, agreed to acquire Diamond Fields. Inco effected a share exchange on a rollover basis with MIL, so that MIL held less than 10 per cent of the shares of Diamond Fields. MIL then continued into Luxembourg and subsequently sold its Inco and Diamond Fields shares, realizing a gain of almost $500 million. MIL claimed a treaty exemption under the Luxembourg Treaty on the basis that it was a resident of Luxembourg and it (and related persons) held less than 10 per cent of the shares, such that the exemption applied even though the shares derived their value from immovable property situated in Canada.

The Tax Court concluded that the GAAR did not apply on the basis that the exempt sale transaction was not part of the same series of transactions that included the reorganization transactions that permitted the taxpayer to benefit from the Luxembourg Treaty exemption, and on the basis that the sale transaction was itself undertaken for commercial and not for tax reasons.

The Federal Court of Appeal also found in favour of the taxpayer in a very brief oral decision where the Court held that, interpreting the Luxembourg Treaty purposively and contextually, it found no support for an abuse of the specific provisions of the Income Tax Act (Canada) or the Luxembourg Treaty. Further, the Court held that it could find no object or purpose whose abuse would justify a departure from the plain words of the treaty that exempted the disposition of the relevant shares. Finally, the Court stated that the issue raised by the GAAR is the incidence of Canadian taxation, so that a result of ‘double non-taxation’ was not relevant.

3. Abuse of Treaties Principle

Canada’s tax treaties contain no express abuse of treaties principles. Any abuse of treaties principle would need to be implied, perhaps on the basis of one or more of the following arguments:8

6 Refer to Article 28(3) of the Canada-Luxembourg Tax Convention, which addresses holding companies formed under special Luxembourg laws and companies subject to similar fiscal laws in Luxembourg; Article XXX(3) of the Canada-Barbados Income Tax Agreement regarding Barbados IBCs, SRLs and similar entities; Article 4(5) of the Canada-Switzerland Tax Convention, which relates to individuals not subject to tax on a comprehensive base; and Article 4(1)(b) of the Canada-United Arab Emirates Convention where a resident is restricted to persons having certain close connections with the UAE.

7 [2007] 4 CTC 235 (FCA); [2006] 5 CTC 2552 (TCC).

8 Articles 31 and 32 of the Vienna Convention on the Law of Treaties (binding Canada in 1980) address the interpretation of treaties. Klaus Vogel agrees that a court should ascertain the common interpretation of a treaty, by both contracting parties (reference Klaus Vogel on Double Taxation Conventions: A Commentary (Deventer: Kluwer, 1991)). Such an approach, including referring to extrinsic materials, was endorsed in Crown Forest, supra. Refer also to N. Goyette in her article Tax Treaty Abuse: A Second Look, 2003 CTJ 764.
• the preamble of the relevant treaty, which often provides that its purpose includes the prevention of fiscal evasion;

• Article 26 of the Vienna Convention on the Law of Treaties, which provides that parties to a treaty must perform the treaty in good faith, coupled with the revised 2003 OECD Commentary;

• an abuse of treaties principle may be an accepted principle of international law; and/or

• an abuse of treaties principle may be an accepted principle of Canadian law based upon the principle against treaty shopping adopted in Crown Forest Industries Ltd. v. Canada.9

It is not at all clear that the combined effect of these arguments establishes a recognized abuse of treaties principle.

The pre-2003 OECD Commentary strongly suggests an abuse of treaties principle should not be implied. Where both Canada and the foreign treaty state are OECD members, a court would likely consider the OECD Commentary in construing the Luxembourg Treaty.10

7. ... taxpayers have the possibility, irrespective of double taxation conventions, to exploit differences in tax levels between States and the tax advantages provided by various countries’ taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.

10. ... It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.11

43. Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of "pacta sunt servanda" even if considered to be improper.12

The OECD Commentary was, however, substantially revised in January 2003. The revised 2003 OECD Commentary represents a significant departure from the essence of the older commentary and is more consistent with an implied abuse of treaties principle.

9.4 ... it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.

9.5 It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

9 [1995] 2 CTC 64 (SCC). Refer to para. 58: “In fact, under the respondent’s interpretation, a foreign corporation whose place of management is in the US would be a resident of the US for purposes of the Convention notwithstanding that such a corporation may not have any effectively connected income to the US, and hence no US tax liability at all. I find this possibility to be highly undesirable. ‘Treaty shopping’ might be encouraged in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded its jurisdiction to tax as the source country, namely that the US as the resident country would tax the income...”


11 Reproduced from the OECD Commentary on Article I of the Model Convention. Refer also to paragraph 11 thereof.

12 Reproduced from the OECD Commentary on Double Taxation Conventions and the Use of Conduit Companies, adopted November 27, 1986.
8.1 ... It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.\(^\text{13}\)

International jurisprudence that has considered the existence of the abuse of treaties principle has been mixed. The Supreme Court of India in *Union of India v. Azadi Bacho Andolan*\(^\text{14}\) rejected the argument that an abuse of treaties doctrine was implied in India's tax treaties. The Court noted that international law has historically permitted treaty shopping and that at least one of India's treaties contained an express limitation on benefits provision. In contrast, the Swiss Federal Court in *A Holding ApS v. Federal Tax Administration*,\(^\text{15}\) held that an abuse of treaties doctrine could be implied into the Danish treaty and denied treaty benefits in respect of a dividend paid to a Danish intermediate holding company.\(^\text{16}\)

In Canada, the Tax Court in *MIL (Investments)*, supra stated that only the OECD commentary in existence at the time the relevant treaty was negotiated and entered into may be considered in assessing the intentions of the contracting states and in construing the treaty provisions.\(^\text{17}\) The Tax Court concluded that there was no ambiguity in the Luxembourg Treaty such that an "abuse of treaties rule" could be implied. Most Canadian bilateral tax treaties were entered into prior to 2003\(^\text{18}\) so that, on this reasoning, the revised 2003 OECD commentary would not typically be relevant.

More recently, the Federal Court of Appeal, in *Prévost Car Inc. v. The Queen*,\(^\text{19}\) adopted a more liberal view that has essentially permitted subsequent OECD commentary to be considered where it meets certain criteria, including that it does not conflict with the commentary in force at the time the treaty was entered into:

>counsel for both sides agree that the Judge was entitled to rely on subsequent documents issued by the OECD in order to interpret the Model Convention. I share their view. It is true that this Court, in *Cudd Pressure Control Inc. v. R.* (1998), 98 D.T.C. 6630 (Fed. C.A.), at 6635, qualified the relevance of the 1977 Commentary as being "somewhat suspect" in the search of the intention of the drafters of a Convention signed thirty-five years earlier, in 1942, but there was no Model Convention in 1942 and in any event Robertson J.A., for the Court, went on to recognize that OECD Commentaries "can provide some assistance" as the 1942 Convention follows the same general principles as the 1972 OECD Model. To the extent that it might be said that a contrary view was expressed by the Tax Court in *MIL (Investments) S.A. v. R.*, 2006 D.T.C. 3307 (Eng.) (T.C.C. [General Procedure]) at 3320, it does not appear that such a view was in the mind of this Court when it dismissed the appeal from the Bench.

\(^{13}\) Reproduced from *Model Tax Convention on Income and on Capital, condensed Version 28 January 2003* (Paris: OECD, 2002) p. 52-67. Note that in the context of certain treaties (e.g., Luxembourg) countries have entered into express reservations to the OECD Commentary, and such reservations would need to be considered.
\(^{14}\) [2003] 4 LRI 172 (Sup. Ct. India (Civil Appellate Div.)).
\(^{15}\) 8 ITLR 536 (Swiss Federal Court).
\(^{16}\) The court concluded that a treaty abuse is implied where an intermediate holding company does not carry on any real economic or business activity and appears to have been persuaded by a Holding's absence of office or staff and the fact that it retained the dividend for only 15 days prior to paying such funds to its Guernsey shareholder.
\(^{17}\) This finding was consistent with the Supreme Court's approach in *Crown Forest*, supra, but inconsistent with the OECD commentary itself (paragraph 36 of the Introduction provides that the amended commentary should apply to existing treaties).
\(^{18}\) The following Canadian bilateral treaties were entered into on or after 2003: Canada-Armenia Tax Convention; Canada-Azerbaijan Income Tax Convention; Canada-Finland Income Tax Convention; Canada-Ireland Income Tax Convention; Canada-Korea Income Tax Convention; Canada-Mexico Income Tax Convention; Canada-Oman Tax Agreement; Canada-Romania Income Tax Convention; Canada-United Kingdom Protocol; and Canada-US Treaty.
\(^{19}\) [2008] 5 CTC 2306 (TCC); 2009 FCA 57.
2007 FCA 236 (F.C.A.). The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the Commentaries on the provisions of the OECD Model a widely accepted guide to the interpretation and application of the provisions of existing bilateral conventions ... The same may be said with respect to later commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries.

I therefore reach the conclusion that, for the purposes of interpreting the Tax Treaty, the OECD Conduit Companies Report (in 1986) as well as the OECD 2003 Amendments to the 1977 Commentary are a helpful complement to the earlier Commentaries, insofar as they are eliciting, rather than contradicting, views previously expressed.

The comments of the Federal Court of Appeal, however, were made in the context of assessing beneficial ownership and not in the context of implying an abuse of treaties principle in Canada's tax treaties. While a more flexible approach to interpreting tax treaties has been endorsed in the Canadian jurisprudence, an abuse of treaties principle has still not been recognized by the Canadian courts. Furthermore, given the rather contradictory statements in the revised 2003 OECD Commentary (as compared to the pre-2003 OECD Commentary) relating to the availability of treaty benefits in apparent treaty shopping circumstances, it is not at all clear that the principles set forth in Prévost Car, supra would permit the later OECD Commentary to be considered in the context of assessing whether an abuse of treaties principle should be recognized.

4. Treaty Residence

A treaty shopping challenge may also be advanced on the basis that the treaty resident intermediary is not resident in the particular state for treaty purposes and, therefore, not entitled to treaty benefits.

Residence for this purpose must be determined in accordance with the relevant tax convention. Most Canadian bilateral tax treaties define a resident as any person that is liable to tax under the laws of the relevant state by reason of that person's domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The Supreme Court in Crown Forest, supra clarified that:

... the criteria for determining residence in Article IV.1 involve more than simply being liable to taxation on some portion of income (source liability); they entail being subject to as comprehensive a tax liability as is imposed by a state.

In certain instances, persons seeking to claim treaty benefits may only be subject to a comprehensive base of taxation in the foreign country (as required per Crown Forest) where they are considered to be a resident of such a country. In such circumstances, transaction planning must ensure that the holding company will be recognized as a resident company such that it becomes subject to a comprehensive base of taxation. Certain non-Canadian jurisprudence has considered the concept of residence in relation to treaty resident intermediary companies with limited connections to the treaty country.

The CRA has commented on so-called "residence of convenience" in Income Tax Technical News no. 35 (February 26, 2007). The CRA primarily confirmed the principles outlined in Crown Forest, supra and noted that residence may be established even where no tax is imposed:

... unless the arrangement is abusive (e.g., treaty shopping where the person is in fact only a "resident of convenience"). Such could be the case, for example, where a person is placed within the taxing jurisdiction of a Contracting State in order to gain treaty benefits in a manner that does not create any
material economic nexus to that State … The determination of residency for the purposes of a tax treaty remains a question of fact, and each case will be decided on its own facts with an eye to the intention of the parties of the particular convention and the purpose of international tax treaties.

The issue of residence has yet to receive any recent Canadian judicial consideration in the treaty shopping context.20

5. Beneficial Ownership

A treaty shopping attack may also be brought on the basis that the person claiming treaty benefits in respect of a particular payment (e.g., dividends) is not the beneficial owner of such payment so that it does not qualify for treaty benefits based upon the beneficial ownership requirement in various provisions of Canadian tax treaties.

The beneficial ownership requirement was not considered to be satisfied in the Indofood, supra decision where the UK Court of Appeal found that treaty benefits would be denied on the basis that an interposed Netherlands company would not be the beneficial owner of any interest income received by it, despite being the formal owner of such funds, as it would not have "full privilege to directly benefit from the income" since it would be bound to pay out this income under the proposed structure.

The recent Canadian decision in Prévost Car, supra was a landmark decision on beneficial ownership and tax treaty benefits in circumstances involving a foreign holding company resident in an intermediate treaty jurisdiction. The taxpayer was successful at both the Tax Court and the Federal Court of Appeal. Volvo Bussar AB (Sweden) acquired the shares of a Canadian company, Prevost Canada. Volvo transferred the Prevost Canada shares to a Dutch holding company (Dutchco) and subsequently Volvo transferred 49 per cent of the Dutch holding company shares to a UK company, Henlys Group PLC. The treaty withholding tax rate on dividends was lower under the Dutch treaty than under the Swedish or UK treaties. Dutchco had no office or employees in the Netherlands. Volvo and Henlys agreed in their shareholders’ agreement that not less than 80 per cent of the profits of Prevost Canada and Dutchco would be distributed to the shareholders.

The Tax Court rejected the Crown’s argument that Dutchco was a “conduit” for Volvo and Henlys and found that it was the beneficial owner of the dividends paid by Prevost Canada. Further, the Tax Court stated that the term “beneficial owner” of dividends means the person who receives the dividends for its own use and enjoyment and assumes the risk and control of such dividends. The Tax Court also noted that the corporate veil should not be pierced in this way, except where the corporation has no discretion to use or apply the dividends it receives or where it is an agent for another.

The Federal Court of Appeal endorsed the Tax Court’s definition of “beneficial ownership,” stating:

It is common ground that there is no settled definition of “beneficial ownership” (or in French, “bénéficiaire effectif”) in the Model Convention, in the Tax Treaty or in the Canadian Income Tax Act... In the end the Judge determined, at par. 100 of his reasons, that “the “beneficial owner” of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received ...” The Judge’s formulation captures the essence of the concept of “beneficial owner” (or “bénéficiaire effectif”) as it emerges from the review of the general, technical and legal meanings of the terms. Most importantly, perhaps, the formulation accords with what is stated in the OECD Commentaries and in the Conduit Companies Report.

20 Although some discussion of this issue is addressed by the Tax Court in McFadyen v. R., 2000 D.T.C. 2473 (T.C.C.); 2003 D.T.C. 5015 (F.C.A.).
This reasoning highlights the need for proper directors’ meetings, minutes and other corporate formalities so that it is clear the holding company assumes the risk and control of the relevant property and exercises its discretion to distribute or otherwise deal with dividend (or similar) proceeds.

**Conclusion**

In light of the current state of Canada’s LOB provisions, the GAAR jurisprudence, and the Canadian and international jurisprudence that has considered alleged treaty shopping transactions, the current state of the law in Canada remains quite favourable for transactions structured to efficiently utilize Canada’s array of bilateral tax treaties. In the context of Canada-US transactions, proper consideration of the LOB provisions will be essential, and in cross-border transactions involving the US and other countries, proper administration of such structures will be vital to ensure residency and beneficial ownership conditions are satisfied and to defend against possible attacks on the basis of the GAAR.

---

**Foreign Affiliate Rules Relating to the Computation of Income, Gains and Losses**

*By Marc-André Godard*

**Background**

On March 12, 2009, *An Act to implement certain provisions of the budget tabled in Parliament on January 27, 2009 and related fiscal measures* (Bill C-10) received royal assent. Bill C-10 includes legislation tabled by the Minister of Finance on November 28, 2008 containing a number of tax initiatives outstanding from the 2008 budget as well as other tax changes, most of which were released on July 14, 2008 in a draft form for consultation. On December 4, 2008, the Minister of Finance released explanatory notes for the provisions included in Bill C-10.

An important set of rules contained in Bill C-10 relates to the computation of income, gains and losses of a foreign affiliate under paragraphs 95(2)(f) to (f.15). Proposed modifications to paragraph 95(2)(f) that were first introduced in 2002 have undergone several revisions throughout the years. The revised provisions in Bill C-10 essentially reproduce the corresponding draft amendments released on July 14, 2008. In turn, the 2008 draft amendments represented the answer of the Department of Finance to the concerns expressed by the tax community with regard to the draft amendments to paragraphs 95(2)(f), (f.1) and (f.2) included in the draft legislation. These had been designed to implement tax measures proposed in Budget 2007 released by the Minister of Finance on October 2, 2007 but were not included in the *Budget Implementation Act, 2007* (the 2007 Proposals).

Paragraph 95(2)(f), as it read under the *Income Tax Act* (Canada) prior to the enactment of Bill C-10, provided rules applicable for computing the taxable capital gain and allowable capital loss of a foreign affiliate of a taxpayer resident in Canada from the disposition of property. These rules were generally referred to as the “main rule,” the “currency rule,” the “carve-out rule,” and the “reading rule.” They were relevant for the computation of the surplus and deficit accounts of a foreign affiliate of a taxpayer resident in Canada, and for the computation of the foreign affiliate’s foreign accrual property income (FAPI) or foreign affiliate accrual property loss (FAPL) in respect of the taxpayer. Under these rules, a taxable capital
gain and allowable capital loss of a foreign affiliate was computed as though the foreign affiliate is resident in Canada (the "main rule") and in accordance with Part I of the Act, read without reference to Section 26 of the Income Tax Application Rules (the "reading rule"). Paragraph 95(2)(f) also provided that the Canadian dollar was to be used for the computation unless the property disposed of is excluded property, in which case the foreign affiliate's calculating currency is to be used for the computation (the "currency rule"). In effect, where a taxable capital gain constituted FAPI that was included in the income of a Canadian shareholder, the currency rule specified that it must be computed in Canadian dollars. Paragraph 95(2)(f) also excluded such portion of taxable capital gains from dispositions of property (i) owned by the affiliate at the time it last became a foreign affiliate of the taxpayer; (ii) of any person with whom the taxpayer was not dealing at arm's length; (iii) of any person with whom the taxpayer would not have been dealing at arm's length if the person had been in existence after the taxpayer came into existence; or (iv) of any predecessor corporation (by virtue of a Section 87 amalgamation) of the taxpayer or of a person with whom the taxpayer was not dealing at arm's length (the "carve-out rule"). In effect, the carve-out rule generally excluded from FAPI any gain accrued prior to the time the foreign affiliate became a foreign affiliate of the taxpayer or of any person described above.

Summary of the New Rules

Subject to transitional rules, the new rules contained in Bill C-10 will apply to those taxation years of a foreign affiliate that begin after October 2, 2007. Transition rules will allow a taxpayer to elect to have the new provisions apply either on December 31, 1994; December 20, 2002; or February 27, 2004.

Paragraph 95(2)(f) sets out the revised "main rule." Under this rule, a foreign affiliate of a taxpayer is deemed to be at all times resident in Canada for the purposes of determining each amount that is its capital gain, capital loss, taxable capital gain or allowable capital loss from a disposition of property, or its income or loss from a property, from a business other than active business or from a non-qualifying business. This represents an extended application of the main rule that was previously limited to the computation of taxable capital gain or allowable capital loss from a disposition of property. The revised main rule contains two exceptions: (i) where a provision of subdivision i of Division B of Part I of the Act specifically provides otherwise (e.g., where the "reading rules" described below apply); and (ii) to the extent the context otherwise requires. The second exception should be applicable where the application of the deeming rule would lead to anomalies.

The revised "carve-out rule" is set out by paragraph 95(2)(f.1). Under this rule, any amount computed pursuant to the main rule should exclude the portion of the amount that can reasonably be considered to have accrued in respect of the property (including any property for which the property was substituted) or the business while the relevant property or business was held or carried on by a "specified person or partnership" in respect of the taxpayer. The amendments to the carve-out rule include the deletion of the unnecessary reference to the time where the relevant property was owned by the affiliate ("property owned by the affiliate at the time it last became a foreign affiliate of the taxpayer"). This reference in the 2007 Proposals could have resulted in the inclusion of gains into FAPI in certain circumstances where it was unintended (e.g., a gain realized by a corporation in the same year but prior to the time it becomes a foreign affiliate of the taxpayer would have been included in the foreign affiliate's FAPI in respect of the taxpayer). The concept of substituted property is an addition to the former rule. Furthermore and most notably, the revised carve-out rule expands the list of persons whose period of ownership is considered in the determination of the carve-out period. Under the previous legislation, the rule excluded the portion of the gain or loss that could reasonably be considered to have accrued during the period when the affiliate
was not a foreign affiliate of: (i) the taxpayer, (ii) any person with whom the taxpayer would not have been dealing at arm’s length if the person had been in existence after the taxpayer came into existence, or (iii) any predecessor corporation (by virtue of a Section 87 amalgamation) of the taxpayer or a person described in either (i) or (ii). As presented in Bill C-10, the rule excludes the portion of an amount that can reasonably be considered to have accrued while no person or partnership that held the property or carried the business was a “specified person or partnership” in respect of the taxpayer. The definitions of “specified predecessor corporation,” “designated acquired corporation,” and “antecedent acquired corporation” at subsection 95(1), and the deeming rule in subsection 95(2.6) applicable where a person or partnership is not dealing at arm’s length with a particular person at a particular time, are all relevant for the determination of whether a person is a “specified person or partnership.” This expansion of persons whose period of ownership is considered in the determination of the carve-out period will generally result in a broader application of the carve-out rule to multinational groups that are reorganizing the ownership of recently acquired foreign subsidiaries.

The revised “reading rules” are set out in paragraph 95(2)(f.11). Under these rules, the Act will, for the computation of the capital gain, capital loss, taxable capital gain or allowable capital loss from a disposition of property, be read without reference to Section 26 of the Income Tax Application Rules. When relevant to the computation of the income or loss from a property, from a business other than active business, or from a non-qualifying business: (i) the Act will be read without reference to subsections 14(1.01) to (1.03), 17(1) and 18(4) and Section 91, except that where the foreign affiliate is a member of a partnership Section 91 is to be applied to determine the income or loss of the partnership, and for that purpose subsection 96(1) is to be applied to determine the foreign affiliate’s share of that income or loss of the partnership; and (ii) if the foreign affiliate has, in the taxation year, disposed of a foreign resource property in respect of a country, it is deemed to have designated, in respect of the disposition and in accordance with subparagraph 59(1)(b)(ii) for the taxation year, the amount, if any, by which the amount determined under paragraph 59(1)(a) in respect of the disposition exceeds the amount determined under subparagraph 59(1)(b)(i) in respect of the disposition.

The revised “calculating currency rules” set out at paragraphs 95(2)(f.12) to (f.15) form an elaborate set of rules applicable to the determination of the currency to be used in the computation of various amounts in respect of a foreign affiliate. This revised set of rules covers a variety of situations not specifically covered in the previous calculating currency rules of paragraph 95(2)(f). The revised rules also include a definition of the expression “calculating currency” added to subsection 95(1), and meaning the currency of the country in which the foreign affiliate is resident at the end of the taxation year, or any currency that the taxpayer demonstrates to be reasonable in the circumstances.

Paragraph 95(2)(f.12) provides that the calculating currency will be used to determine the following amounts with respect to the foreign affiliate: (i) each capital gain, capital loss, taxable capital gain and allowable capital loss from the disposition of a capital property that was an excluded property; (ii) income or loss from each active business carried on by the foreign affiliate in a country; and (iii) the income or loss that is included in computing the foreign affiliate income or loss from an active business because of paragraph 95(2)(a).

Paragraph 95(2)(f.13), applicable where the calculating currency of a foreign affiliate is a currency other than the Canadian currency, provides that the amount included in the computation of a foreign affiliate’s FAPI that is attributable to its capital gain or taxable capital gain from the disposition of an excluded property is the amount of such gain otherwise determined under paragraph 95(2)(f.12), converted in
Canadian currency at the rate of exchange quoted by the Bank of Canada at noon on the day of the disposition.

Paragraph 95(2)(f.14) provides that, other than amounts to which paragraph 95(2)(f.12) or (f.13) applies, each amount of the foreign affiliate's income, loss, capital gain, capital loss, taxable capital gain or allowable capital loss is to be determined using the Canadian currency.

Paragraph 95(2)(f.15) provides that for the purpose of applying subparagraph 95(2)(f.12)(i), the computation of a foreign exchange gain or loss pursuant to subsection 39(2) will reflect the concept of a calculating currency.

Although it does not represent a step towards a simplification of the Act, the new provisions contained in Bill C-10 certainly improve the clarity of the rules applicable to the computation of income, gains and losses of foreign affiliates. These new provisions also resolve several technical issues and anomalies associated with the rules included in the 2007 Proposals.