# *An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules*

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**PRÉCIS**

Un avant-projet de loi modifiant les règles sur le revenu étranger accumulé, tiré de biens et sur les sociétés étrangères affiliées a été publié dans le cadre du budget de février 1994 et sous forme révisée à la fin de juin 1994. L'avant-projet de loi contient de nombreux changements aux règles sur le revenu étranger accumulé, tiré de biens et sur les sociétés étrangères affiliées. Les changements les plus importants sont :

- les règles de présomption de propriété introduites dans le but de définir une société étrangère affiliée;
- les nouvelles définitions des expressions «entreprise exploitée activement» et «revenu de biens» et les dispositions déterminatives relativement aux montants inclus dans le revenu étranger accumulé, tiré de biens;
- les modifications apportées à la définition de «perte déductible» pour éliminer les pertes d'une entreprise exploitée activement;
- la liste des pays figurant au règlement 5907(11) est remplacée par une définition de «pays désigné»; et
- les nouvelles règles pour la détermination de la résidence d'une société étrangère affiliée.

Les modifications ont une portée subtile et considérable. L'article constitue une analyse détaillée du point de vue technique et politique du projet de loi.

**ABSTRACT**

Draft legislation amending the foreign accrual property income (FAPI) and foreign affiliate rules was issued as part of the February 1994 budget and in revised form in late June 1994. The draft legislation makes several significant changes to the FAPI and foreign affiliate rules. The most important changes are

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• constructive ownership rules for purposes of the definition of a foreign affiliate;

• new definitions of “active business” and “income from property” and deeming rules with respect to amounts included in FAPI;

• amendments to the definition of “deductible loss” to eliminate active business losses;

• replacement of the list of countries in regulation 5907(11) by a definition of “designated treaty country”; and

• new rules for the determination of the residence of a foreign affiliate.

The implications of the amendments are subtle and far-reaching. The article provides a detailed policy and technical analysis of the draft legislation.

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## INTRODUCTION

As part of the February 1994 budget, the minister of finance introduced draft amendments to the foreign accrual property income (FAPI) and foreign affiliate rules.[1] After consultation with the public, the minister issued revised draft amendments in late June 1994.[2] In general, the draft amendments propose the following changes to the rules:

• several new definitions and deeming provisions are introduced with respect to amounts included in FAPI;

• the deductibility of active business losses against FAPI is eliminated;

• the list of countries in regulation 5907(11) is replaced by a definition of a “designated treaty country,” and new rules with respect to the determination of the residence of a foreign affiliate are introduced; and

• constructive ownership rules are introduced for purposes of the definition of a foreign affiliate.

Most of these changes are applicable for taxation years of foreign affiliates commencing after 1994.

This article provides a detailed analysis of the amendments to the FAPI and foreign affiliate rules from both a policy and a technical perspective. The technical implications of the amendments are both subtle and far-reaching; the need to explain these implications has resulted in a somewhat longer article than might be anticipated. The article also contains a brief

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[1] Canada, Department of Finance, Budget Papers, Tax Measures: Supplementary Information, “Foreign Affiliates: Draft Amendments to the Income Tax Act” and “Foreign Affiliates: Draft Amendments to the Income Tax Regulations,” February 22, 1994. The FAPI and foreign affiliate rules are contained in the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”) and the Income Tax Regulations, CRC, c. 945, as amended (herein referred to as “the regulations”).

[2] Canada, Department of Finance, Revised Draft Amendments to the Income Tax Act and Regulations, June 1994.

analysis of the effects on the FAPI and foreign affiliate rules of the draft legislation on debt forgiveness issued in July 1994. The article commences with a brief description of the background events that led to the introduction of the draft legislation.

## BACKGROUND

As an academic, I am accustomed to writing books and articles that no one reads or that, even if they are read, have no practical consequences. In 1986, I wrote a book comparing the controlled foreign corporation legislation of six countries, including Canada.[3] The two concluding chapters of that book presented assessments of the FAPI and foreign affiliate rules and recommendations for improving those rules.[4] As might be expected, the book, and the concluding chapters in particular, were ignored by Canadian tax practitioners and policy makers. The final two chapters of my book were intended to stimulate and contribute to a public debate concerning the merits of our FAPI and foreign affiliate rules, rather than to be a definitive prescription for reforming those rules. However, there was no public debate.

This situation changed abruptly with the release of the auditor general's annual report on November 24, 1992.[5] The primary concern raised by the auditor general was the serious erosion of the Canadian tax base caused by the ability of Canadian corporations to deduct interest on borrowed money used to earn income through foreign affiliates. The auditor general also pointed out deficiencies in the FAPI rules, namely, the lack of any definition of active business income and the ability of taxpayers to deduct active business losses in computing FAPI. In conclusion, the auditor general called on the Department of Finance to complete the reviews of interest deductibility, foreign source income, and foreign affiliates that it had announced in 1987. Although the auditor general's report might be criticized for sensationalism in stating that "hundreds of millions of dollars in tax revenue have already been lost and will continue to be at risk,"[6] the deficiencies in the FAPI and foreign affiliate rules described in the report were accurate and were widely known and exploited by tax practitioners. Moreover, the report's conclusion that the Department of Finance should complete its studies was mild and reasonable.

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[3] Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986).

[4] In chapter 14, I suggested a number of ways of simplifying the foreign affiliate system by moving from the current transactional approach to an entity approach. Under an entity approach, an affiliate's surplus would be characterized as either all exempt or all taxable, on the basis of the affiliate's residence and/or the nature of its activities. In chapter 15, I suggested that the concept of active business should be defined and that certain base company income should be included in FAPI.

[5] Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992), 46-51. The author was a consultant to the auditor general for purposes of the audit observations on foreign affiliates.

[6] Ibid., at 50.

The response of the Department of Finance, which is included in the auditor general's report, was surprisingly aggressive. The department totally rejected the auditor general's claims and asserted that the FAPI and foreign affiliate rules were operating properly as intended:

> The existing foreign affiliate regime accurately reflects the policy intention of Parliament and provides for the taxation of all income that is intended to be subject to Canadian income tax. Moreover, any theoretical revenue gains that might be realized by amending the Income Tax Act would be largely offset as a result of behavioral changes on the part of taxpayers. Specifically, any significant change in the existing rules would likely result in large numbers of businesses moving completely offshore.[7]

In general, the department's response reads like a submission from a trade association of Canadian multinational corporations. It is peppered with references to international competitiveness, a buzzword that has been used to justify many things.

The auditor general's report was referred to the Public Accounts Committee of the House of Commons. The committee held hearings late in 1992 and early in 1993 concerning the report. The auditor general, officials from the Department of Finance and Revenue Canada, and four experts from the private sector testified during the hearings.[8] The members of the committee were very antagonistic toward the officials from the Department of Finance, who attempted to defend the existing FAPI and foreign affiliate rules. The committee's report, tabled on April 23, 1993,[9] made five specific recommendations with respect to those rules:

1) the list of countries in regulation 5907(11) should be revised to list treaty countries and delist non-treaty countries;

2) the concept of active business should be defined;

3) the ability to offset active business losses against FAPI should be eliminated;

4) the Department of Finance should study the merits of allowing subsidiaries of Canadian corporations to repatriate profits without any Canadian tax; and

5) the Department of Finance should study the problem of interest deductibility and foreign affiliates.

The committee made four additional recommendations that are more general:

1) the Department of Finance and Revenue Canada should develop better communications;

[7] Ibid., at 51.

[8] The private sector witnesses were the author, Robert Brown, Allan Lanthier, and Alan Schwartz.

[9] Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parliament, 3d session, 1991-92-93, issue no. 48, April 23, 1993.

2) Revenue Canada should assess more aggressively;

3) the Department of Finance and Revenue Canada should submit an annual report on the effectiveness of the general anti-avoidance rule in combating abusive transactions involving foreign affiliates; and

4) the problem of transfer pricing should be studied.

The report requested a response from the Department of Finance within 40 days, significantly less time than the customary 150 days. The stated reason for this unusually short response period was the extraordinary nature of the problem. It seems more likely, however, that the real reason was the perceived arrogance of the Department of Finance. In any event, the department ignored the deadline and the 1993 election intervened. In the end, Finance's response came with the issuance of the draft legislation as part of the February 22, 1994 budget.

Tax practitioners generally agreed with the position taken by the Department of Finance.[10] In their view, the FAPI and foreign affiliate system was operating properly; the system was in accordance with international norms; and the ability of Canadian corporations to use foreign subsidiaries to avoid foreign taxes was an enlightened feature of the system. More specifically, practitioners were against the adoption of any statutory definition of active business, any significant changes to the list of countries in regulation 5907(11), and the complete elimination of the deductibility of active business losses against FAPI.

Revenue Canada's reaction to the auditor general's report was cautiously supportive.[11] Revenue Canada had previously advised the Department of Finance about the need for legislative amendments

• to limit the ability of Canadian corporations to import foreign losses through the deductible loss provision;

• to define active business income for purposes of the definition of FAPI; and

• to reduce the interest deduction claimed by Canadian taxpayers by the net investment income of any controlled foreign affiliates of the taxpayer.

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[10] See, for example, Allan R. Lanthier, "Policy or Abuse? The Auditor General's Report" (1993), vol. 41, no. 4 *Canadian Tax Journal* 613-38; and J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72. See also Samuel Slutsky, "Foreign Affiliate System Not Full of Holes," in *Tax Administration News*, release no. 167, March 11, 1993, supplement to Samuel Slutsky, ed., *Tax Administration Reports* (Scarborough, Ont.: Carswell Thomson Professional Publishing) (looseleaf); and Donald R. Huggett, "A Fox in the Henhouse" (January/February 1993), 10 *Canadian Tax News* 57-60.

[11] See, generally, Robert M. Beith, "Auditing Foreign Affiliates: Practice and Policy," in International Fiscal Association (Canadian Branch), *Special Seminar on International Tax Issues* (Toronto: Carswell Thomson Professional Publishing, 1994), 235-40.

In short, Revenue Canada seemed to be concerned about the erosion of the Canadian tax base caused by the deficiencies in the FAPI and foreign affiliate rules. Also, Revenue Canada generally endorsed the recommendations of the Public Accounts Committee.[12]

The general approach and the scope of the draft legislation issued on February 22, 1994[13] are the same in the revised draft legislation issued in June 1994. However, there are significant technical differences between the two versions. In many cases, the differences are stylistic; in some cases, the June 1994 draft legislation corrects mistakes in the earlier version. The definitions of active business and income from property have been simplified and clarified significantly. The most important changes made in the June 1994 draft legislation are to paragraph 95(2)(a). Its application has been restricted to related foreign corporations; at the same time, it has been expanded to facilitate the financing of the acquisition of shares of a foreign affiliate by a related holding company resident in the same country.

## THE DEFINITION OF FAPI

### Introduction

For purposes of the FAPI rules, FAPI consists of income from property and from inactive businesses and certain taxable capital gains, or, more generally, passive investment income. Income from an active business carried on by a foreign affiliate is excluded from FAPI. Until the February 1994 budget proposals, the concepts of income from property and active business were not defined for purposes of the definition of FAPI in paragraph 95(1)(b). Most commentators considered that the term "active business" for purposes of the FAPI rules had the same meaning that it had under the case law during the early 1970s for purposes of the small business deduction, before the specific definition of the term was added to section 125 for taxation years commencing after 1979. In accordance with this view, the term "active business" has a broad meaning encompassing any business with any quantum of business activity. Revenue Canada, on the other hand, took the official position that the case law meaning with respect to the definition of active business for purposes of the small business deduction was not necessarily applicable for purposes of the FAPI rules.[14] However, Revenue Canada did not pursue an aggressive assessing policy with respect to the definition of active business.

[12] Ibid., at 237.

[13] For a discussion of the February 22, 1994 draft legislation, see John G. Haag and Reginald W. Kowalchuk, "International Tax Provisions of the 1994 Federal Budget," in *Corporate Tax Planning in a Changing Business Environment*, 1994 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, forthcoming); and Patrice Simard, "Impact of the February 22, 1994 Federal Budget on the Canadian Foreign Affiliate Rules," paper presented at a seminar of the International Fiscal Association (Canadian Branch) in Montreal, May 17, 1994.

[14] See David Burton, "Revenue Canada, Taxation's Administration of the FAPI and Foreign Affiliate Rules," paper presented at a seminar sponsored by the International Fiscal Association (Canadian Branch) in Toronto, May 29, 1971, 6-9.

In 1990, the first important case involving the meaning of active business for purposes of the FAPI rules, the *Canada Trustco* case,[15] was decided by the Tax Court of Canada. Canada Trust had a Netherlands subsidiary that earned interest income from a portfolio of Canadian residential mortgages approved by Canada Housing and Mortgage Corporation. The mortgages were administered in Canada by Canada Trust on behalf of the Netherlands subsidiary. The affairs of the Netherlands subsidiary were conducted by a managing director who spent less than half his time on those affairs. Nevertheless, the Tax Court held that the interest income was income from an active business and not FAPI. The case has been appealed to the Federal Court.

In 1992 and early 1993, in response to the auditor general's report and in testimony before the Public Accounts Committee, the Department of Finance argued that it was unnecessary to define active business for purposes of the FAPI rules and, further, that any such definition would be unworkable. According to the department, the meaning of the term "active business" was well understood. The department argued that any definition would constitute a road map for taxpayers to avoid it. Other commentators also have suggested that there is no need to amend the definition of active business for purposes of the FAPI rules.[16]

In a striking about-face, in the draft legislation issued on February 22, 1994, the department proposed to enact definitions of active business and income from property for purposes of the FAPI rules. As noted earlier, a revised version of the draft legislation was issued in June 1994. More specifically, the new rules

- provide definitions of active business, income from an active business, and income from property as well as supplementary definitions;
- deem certain Canadian source income earned by foreign affiliates to be FAPI; and
- make revisions to paragraph 95(2)(a) and consequential changes to the regulations.

The implications of the new definitions concerning the concept of active business are far-reaching in three contexts:

1) the FAPI rules,
2) the foreign affiliate rules, and
3) the definition of excluded property.

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[15] *Canada Trustco Mortgage Company v. MNR*, 91 DTC 1312; [1991] 2 CTC 2728 (TCC).

[16] See Lanthier, supra footnote 10, at 634: "The more precise and complex a definition is, the more opportunities will exist for structuring transactions that fall within the letter but outside the spirit of the law. . . . Ambiguities and uncertainties indeed exist in the facts-and-circumstances approach to a court-developed definition; this ambiguity and uncertainty, however, has its own deterrent effect in many situations." See also Wilkie et al., supra footnote 10, at 2:67: "It is at best unclear that the adoption of 'bright line' tests, such as a definition of 'active business income,' would be helpful in this context. In our view, this concept in particular is satisfactorily defined by its context."

The new concept of active business has the effect of expanding the income included in computing the FAPI of controlled foreign affiliates. Income from investment businesses and certain Canadian source income will be included in FAPI. However, the fundamental policy of the FAPI rules remains unchanged. Legitimate active businesses carried on outside Canada are unaffected by the amendments. The changes are consistent with the prophylactic nature of the FAPI rules. They are aimed at preventing the use of foreign affiliates to earn passive income and certain types of Canadian source business income. Relative to the controlled foreign company rules of other countries, however, the FAPI rules are still rather narrow in scope. Most important, they do not attempt to deal with the use of base companies (corporations established in tax havens to earn business income from related-party transactions outside the tax havens). In most countries, the controlled foreign corporation legislation applies to at least some types of base company income. In contrast, the Canadian attitude continues to be that Canadian multinationals use foreign base companies to avoid foreign, rather than Canadian, tax and that this practice should be encouraged.

Although FAPI is relevant only for controlled foreign affiliates, the new concept of active business also affects the surplus accounts of foreign affiliates whether controlled or not. FAPI is included in a foreign affiliate's taxable earnings and its taxable surplus. Active business income, on the other hand, is included in either taxable earnings or exempt earnings, depending on the affiliate's residence and the source of its business income.

The new rules with respect to the concept of active business also have a significant impact on the definition of excluded property. Excluded property is defined in paragraph 95(1)(a.1) to mean, in part, property that is used or held principally for the purpose of earning income from an active business. Consequently, to the extent that the definition of active business has been narrowed under the new rules, property used in businesses that are no longer active businesses will not qualify as excluded property. Most important, property used or held in an investment business or in a business deemed to be an inactive business will not be excluded property under the new rules. Accordingly, any taxable capital gains realized on the disposition of such property will be included in FAPI.

## The New Definitions of Income from Property and Income from an Active Business

Active business is defined in subsection 95(1) to be any business other than an investment business or any business deemed by subsection 95(2) not to be an active business. An adventure in the nature of trade is not a business, as defined in subsection 248(1), for purposes of the FAPI rules and therefore cannot qualify as an active business.

Income from an active business is defined in subsection 95(1) to include income pertaining to or incident to an active business. Income from property as defined in subsection 95(1) is specifically excluded; therefore, income from property and income from an active business are mutually

exclusive. Income from property is defined to include income from an "investment business" and income from an adventure in the nature of trade. Accordingly, the crucial issue with respect to the characterization of items of income under the new definitions is whether the income is from an active business or from property.

Under the definition of income from an active business, incidental income is included unless it constitutes income from property. Therefore, income from an investment business or from an adventure in the nature of trade, both of which are expressly included in the definition of income from property, cannot qualify as income from an active business. Income from property also has its ordinary meaning, and such income also cannot qualify as income from an active business, even if it is incidental to an active business. For this purpose, income from property probably does not mean any dividends, interest, rent, or royalty derived by a foreign affiliate because this interpretation would mean that incidental income would be restricted to income from an inactive business.[17] In any case, it is a question of fact whether dividends, interest, rent, or royalties constitute income from business or income from property. Moreover, there is a rebuttable presumption that corporations earn business income. Therefore, for example, where a foreign affiliate engaged in a construction business earns interest on funds that are invested temporarily, the interest should be included in active business income as being incidental to the construction business. The interest must be considered to be income from business rather than income from property in order to achieve this result. Where the affiliate earns interest on funds that are not required for its business, the interest should be considered to be income from property.

The definition of an investment business in subsection 95(1) is the key aspect of the new concept of FAPI. An investment business is defined to be a business (other than a business that is deemed by subsection 95(2) not to be an active business)[18] the principal purpose of which is to derive income from property. For this purpose, income from property has a special extended meaning, which is described in more detail subsequently. A specific exception is provided for foreign affiliates engaged in certain businesses that have more than five full-time employees in the active conduct of the business. More specifically, the exception applies to a foreign affiliate if

- its only business is that of a financial institution (bank, trust company, credit union, or insurance company) or a trader or dealer in securities, and its activities are regulated in the country in which its business is principally conducted; or

[17] In other words, the parenthetical definition of income from property in the definition of investment business does not apply for any purpose other than that definition.

[18] The effect of excluding businesses deemed by subsection 95(2) not to be active is that such businesses cannot qualify for the more than five full-time employees exception to the definition of investment business.

- its principal business is the development of real estate for sale to, the lending of money to, the leasing or licensing of property to, or the insurance of risks of, arm's-length persons, or a combination of these activities.

An affiliate cannot qualify for the exception if its principal business is trading in debt obligations for its own account or for non-arm's-length persons.

The definition of investment business is modelled on the definition of specified investment business in paragraph 125(7)(c) for purposes of the small business deduction. This approach is surprising, since the Department of Finance stated unequivocally in its testimony before the Public Accounts Committee that the definition of specified investment business was inappropriate for the FAPI and foreign affiliate rules.[19]

One fundamental difficulty with the definition of investment business is that it confuses two sources of income, income from business and income from property, by defining one in terms of the other. The definitions of specified investment business and investment business assume that a business can produce income from property. In my view, this assumption is incorrect. Corporations can earn income from business or income from property. The initial issue is whether a corporation's income-earning activities amount to a business. For this purpose, according to the Supreme Court in the *Marconi* case,[20] there is a rebuttable presumption that a corporation earns income from business. If it is established that a corporation is carrying on a business, the income from the business is business income, not income from property. This is the case even if the corporation uses property in its business. For example, a bank is engaged in a business and the interest it earns from loans is business income. On the other hand, interest received by a corporation whose business does not include lending money probably constitutes income from property, unless the interest is incidental to the corporation's business, as discussed earlier.

Despite this fundamental deficiency, the definition has apparently worked reasonably well in the context of the small business deduction. Consequently, it seems unlikely that a court would pervert the intention of the provision by holding that any business produces business income.

The definition of investment business specifies that income from property includes "interest, dividends, rents, royalties, insurance premiums, or any similar returns or substitutes therefor and profits from the disposition of investment property." A similar approach is used in the definition of specified investment business, although in that case the list of types of income consists only of interest, dividends, rents, and royalties. The expression "any similar returns or substitutes therefor" is presumably an

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[19] See the testimony of R. Alan Short, General Director, Tax Policy Branch, Department of Finance, in Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parliament, 3d session, 1991-92, issue no. 37, December 8, 1992, 37:27-28: "We believe that approach would be singularly inappropriate in the area of foreign affiliates."

[20] *Canadian Marconi v. The Queen,* 86 DTC 6526; [1986] 2 CTC 465 (SCC).

attempt to avoid any technical legal niceties in the definitions of interest, dividends, rents, royalties, and insurance premiums. Such niceties often occur with respect to interest because of its narrow legal definition. Thus, returns similar to interest or substitutes for interest might include discounts, premiums, and profits from currency and interest rate swaps and other financial products.

The inclusion of profits from the disposition of "investment property" is problematic. Investment property is defined to include the following property and any interests or options in such property:

- shares, partnership interests, and interests in trusts other than excluded property;[21]
- indebtedness and annuities;
- commodities or commodities futures;
- currency;
- real estate;
- Canadian and foreign resource properties; and
- interests in funds or entities other than corporations, partnerships, or trusts.

This definition is patterned on the definition of "offshore investment fund property" in section 94.1, with some obvious modifications.

First, the definition of offshore investment fund property is limited to "portfolio investments" in the listed properties. There is no similar limitation with respect to the definition of investment property, although a similar result is accomplished with respect to shares and interests in partnerships and trusts by the exclusion of shares and interests that are excluded property. With respect to the other listed investment properties, however, there is no such limitation. Consequently, if a foreign affiliate's principal activity is selling commodities, currency, real estate, bonds, or resource properties, the affiliate will be considered to be carrying on an investment business even though its business is not one of investing in the ordinary sense of the word. The affiliate's sales income will be income from property and FAPI unless the affiliate can qualify for the exception to the definition of investment business. For example, if a Canadian corporation that produces base metals establishes a foreign subsidiary to sell the product to end users outside Canada, the subsidiary is carrying on an investment business because the principal purpose of its business is to earn income from sales of investment property, namely, commodities. Therefore, the subsidiary's sales income is FAPI unless the subsidiary is a regulated trader or dealer in commodities and employs more than five full-time employees.

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[21] An interest in a trust may be excluded property (despite the absence of any explicit reference to trusts in the definition of excluded property) because, by virtue of paragraph 94(2)(d), non-discretionary foreign trusts are deemed to be corporations and the beneficiaries are deemed to own shares. Paragraph 94(1)(d) applies for the purpose of section 95, which includes the definition of excluded property.

Moreover, depending on the interpretation of the word "commodities," the definition of investment business may include any foreign affiliate whose principal business is selling goods, unless the affiliate has more than five full-time employees. The ordinary meaning of commodity includes any tangible personal property, which would obviously include manufactured goods. It may be, however, that for tax purposes a narrower definition that is limited to agricultural products (including forest and fish products), minerals, and currency is more appropriate. The history and context of the FAPI rules justify the narrower meaning. The rules have never applied to foreign sales companies as a matter of clear policy. Also, the introduction of paragraph 95(2)(a.1) dealing with sales of property to Canada by a foreign affiliate appears to reflect an assumption that income from sales of goods is active business income.[22] Nevertheless, there does not appear to be any sound policy reason for distinguishing between sales of commodities and sales of manufactured goods. What seems to be lacking from the definition of investment property is some notion of investment, as opposed to trading, in the listed properties.

Second, unlike the definition of offshore investment fund property, the definition of investment property is inclusive. In other words, the term has its ordinary meaning plus the listed properties. The dictionary meaning of investment is extremely broad. *The Shorter Oxford English Dictionary*, 3d ed., gives the meaning of "invest" as "[t]o employ (money) in the purchase of anything from which interest or profit is expected." The inclusive nature of the definition of investment property results in an element of uncertainty in the scope of the concept of FAPI.[23] To the extent that the term "investment property" is given a broad meaning, the concept of active business will be correspondingly narrowed.

On the basis of general principles, profits from the disposition of property are either capital gains or income from business, and not income from property. Therefore, by effectively deeming such profits to be income from property for purposes of the FAPI and foreign affiliate rules,[24] the amendments have made the treatment of gains from the disposition of property quite tricky. If the gain is a capital gain, the taxable capital gain is included in computing FAPI unless the property is excluded property within the meaning of paragraph 95(1)(a.1). If the gain results from an adventure in the nature of trade, it is included in the affiliate's income from property and FAPI. Since an adventure in the nature of trade is not a business for purposes of the FAPI rules, an adventure cannot be an investment business

[22] Note also subsection 95(3), which excludes from the definition of services those services performed in connection with the sale of goods.

[23] It seems likely that the same issues that have arisen with respect to the distinction between capital gains and ordinary income will be involved in distinguishing between investment property and business property.

[24] Note that the definitions in subsection 95(1) apply only for purposes of subdivision i relating to FAPI. Consequential amendments to subsection 248(1) appear to be necessary to extend this definition to other parts of the Act, in particular to section 113 and part LIX of the regulations.

and cannot qualify for the more than five full-time employees exception to the definition of investment business. If the affiliate is carrying on an investment business, any gain from the disposition of investment property is income from property and FAPI unless the affiliate qualifies for the exception or the income is deemed to be active business income under paragraph 95(2)(a). If the affiliate is not carrying on an investment business, profits from the disposition of investment property are included in active business income unless the disposition is an adventure in the nature of trade. Therefore, the system of rules is intricate, and any overlap in the definitions of investment property, excluded property, property held as an adventure in the nature of trade, and property used or held to earn income from an active business may produce serious interpretative difficulties.

The exception for investment businesses with more than five full-time employees provides one of only two ways in which foreign affiliates whose principal business is deriving income from property can avoid having the income from the business characterized as FAPI. (The other way is if paragraph 95(2)(a) applies to deem the income from the investment business that is included in income from property to be active business income.) As might be expected, the exception is not as broad as the definition. For example, if a foreign affiliate's principal business is earning dividends, the affiliate will not qualify for the exception even if it has more than five full-time employees. Similarly, businesses that are deemed by subsection 95(2) to be inactive businesses are excluded from the definition of investment business and cannot qualify for the exception.

The exception is applicable to a foreign affiliate that has more than five full-time employees if

- the affiliate's sole business is the business of a bank, trust company, credit union, or insurance company, or of a trader or dealer in securities or commodities;
- the activities of the business are regulated in the country in which the business is principally carried on; and
- the business is not conducted principally with non-arm's-length persons;

or if its principal business, ignoring non-arm's-length transactions, is

- the development of real estate for sale;
- lending money, which is defined to include arm's-length factoring of trade receivables and arm's-length purchases of foreign resource rentals and royalties;
- leasing or licensing of property, which is defined to include authorizing the use, production, or reproduction of property, including information or anything else;
- insurance; or
- any combination of these activities.

These requirements must be met throughout the year or the part of the year during which the business is carried on by the affiliate.

A foreign affiliate is expressly prohibited from qualifying for the exception if its principal business is trading or dealing in debt obligations for its own account or for non-arm's-length persons. This prohibition is intended to prevent a controlled foreign affiliate that earns essentially passive income from holding debt obligations and, if it has more than five employees, from arguing that it is a trader or dealer in securities because it trades debt obligations extensively. Although the exclusion applies to both subparagraphs (a)(i) and (ii) of the definition of investment business, it seems to be relevant only to traders or dealers in securities in subparagraph (a)(i).

It is not clear why foreign affiliates that are financial institutions or securities dealers must be engaged exclusively in those businesses and their businesses must be regulated, whereas other affiliates are required to meet only a principal business test. The principal business aspect of the exception would be available to financial institutions whose principal business is lending money or insuring risks. In any event, ordinarily financial institutions and securities and commodities dealers are engaged exclusively in one business. If not, it is easy for the businesses to be segregated into separate corporations. The requirement for foreign regulation appears to be an ineffective attempt to limit the exception to legitimate business operations. However, even tax havens have legislation that authorizes and regulates financial institutions, although the regulation often amounts to little more than window dressing.[25] For example, does the obligation to obtain a licence and file an annual report constitute regulation? In any event, Revenue Canada will likely have enormous difficulties in enforcing this requirement very strictly.

If a foreign affiliate qualifies for the exception to the definition of investment business, the immediate consequence is that the business is characterized as an active business. It follows that the income from the business is not included in FAPI (if the affiliate is a controlled foreign affiliate) and is included in the affiliate's exempt or taxable earnings, depending on where it is resident and where the business is carried on. Similarly, any income that pertains to or is incident to the business is treated as active business income. Finally, any income from property derived by a related foreign affiliate that is connected to the business, as required by paragraph 95(2)(a), is treated as active business income.

The "more than five full-time employees" requirement presents several issues of interpretation, some of which have been dealt with in connection with the definition of specified investment business. For example, in *Interpretation Bulletin* IT-73R4, Revenue Canada indicates that a full-time employee is a person who works a full business day or shift on each working day of the year, with the exception of days of vacation and illness.[26]

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[25] See, generally, Barry Spitz, ed., *Tax Havens Encyclopaedia* (London: Butterworths) (looseleaf). Few tax havens have any legislation regulating investment and commodities dealers.

[26] *Interpretation Bulletin* IT-73R4, February 13, 1989, paragraph 14. Temporary vacancies will not disqualify the corporation.

Further, employees who job-share are considered to constitute one full-time employee.[27] If a foreign affiliate has five full-time employees and one part-time employee, is the requirement met? In IT-73R4, Revenue Canada interprets more than five as meaning six or more full-time employees, and the Federal Court has recently confirmed this interpretation.[28] Although the case was not appealed, the interpretation bulletin remains unchanged. Unlike the definition of specified investment business, the definition of investment business requires that the employees must be employed "in the active conduct" of the business. This requirement is intended to prevent affiliates from hiring employees just to satisfy the test. However, the requirement generates difficult issues of application (for example, is a gardener employed in the active conduct of a leasing or trading business?) and may be very difficult for Revenue Canada to enforce.

Where an affiliate is a member of a partnership that has more than five full-time employees, the legislation expressly provides that the requirement is met unless the affiliate is a specified member of the partnership in its fiscal period ending in the affiliate's taxation year. A specified member of a partnership is defined in subsection 248(1) to mean both a limited partner and a partner that is not actively engaged in the activities of the partnership. Although a difficulty could arise from the fact that the affiliate and the partnership are separate entities, the draft legislation finesses this problem by using the words "where the affiliate carries on the business as a member of a partnership." In effect, although the partnership is carrying on the business, each partner is also considered to be carrying on the same business. The employees must be employed by the partnership in the active conduct of the business, which refers literally to the business of the foreign affiliate carried on through the partnership and presumably means the business of the partnership.

The partnership rule is quite generous. If two foreign affiliates carry on business through a partnership in which they have equal interests, the exception applies if the partnership has more than five full-time employees. However, if the affiliates carry on business separately with three employees each, the exception does not apply. Further, if a foreign affiliate hires independent contractors to perform functions that could be performed by employees, the independent contractors will not count as employees. A partnership might be used to ameliorate the arbitrariness of the employee test. More generally, it seems likely that use of partnerships to take advantage of the more than five full-time employees exception will be the focus of tax-planning efforts.

The new definitions relating to the concept of active business apply to taxation years of foreign affiliates beginning after 1994. Presumably, the prospective coming-into-force rule for these definitions is intended to

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[27] Claude Désy, ed., *Access to Canadian Income Tax* (Markham, Ont.: Butterworths) (looseleaf), paragraph 125-1450.

[28] *Hughes & Co. Holdings Ltd. v. MNR*, [1994] FCJ no. 935 (FCTD). Accordingly, five full-time employees and one or more part-time employees do not satisfy the requirement.

allow corporations that may be affected by the new rules to rearrange their affairs accordingly.

## The New Deeming Rules in Paragraphs 95(2)(a.1), (a.2), and (a.3)

### *Introduction*

The concept of FAPI is extended by three new rules that effectively deem certain (generally Canadian source) income to be FAPI in certain circumstances. More specifically, these rules require certain amounts (certain related-party sales income, insurance premiums, interest, and rent) to be included in a foreign affiliate's income from business other than an active business unless more than 90 percent of the affiliate's gross income from the activities is derived from transactions with arm's-length parties. Where income is deemed to be income from a business other than an active business by virtue of paragraph 95(2)(a.1), (a.2), or (a.3), the activities are deemed to be a separate business other than an active business of the affiliate, and any income that pertains to or is incident to the business is deemed to be inactive business income.

The consequences of the application of paragraph 95(2)(a.1), (a.2), or (a.3) are not immediately obvious. Subject to one possible argument, the end result is that any income included under these paragraphs must be included in FAPI. The income is treated as income from a business other than an active business, and the business is deemed to be a separate business other than an active business. It is obvious, therefore, that the income cannot be excluded from FAPI as income from an active business. Moreover, since the income is deemed to be income from an inactive business, it cannot qualify for the deeming rules in paragraph 95(2)(a), which apply only to income from property. Also, any business deemed by paragraph 95(2)(a.1), (a.2), or (a.3) to be an inactive business is expressly excluded from the definition of an investment business; consequently, it cannot qualify for the more than five full-time employees exception. The only possible argument that the income is not FAPI is that it pertains to or is incident to an active business carried on by the same foreign affiliate. It may seem unlikely that a court would accept this argument, especially since the income is deemed to be derived from a separate business. However, under the former version of subparagraph 95(2)(a)(i), taxpayers argued that income from one business could be incidental to another business even if the other business were carried on by another corporation. The argument could have been precluded if the definition of income from an active business had been limited to income from property that pertains to or is incident to an active business, or if inactive business income under paragraph 95(2)(a.1), (a.2), or (a.3) had been specifically excluded from qualifying as incidental income.

The activities in paragraphs 95(2)(a.1), (a.2), and (a.3) are deemed to be a separate business so that any incidental income can be deemed to be income from an inactive business. The separate business rule may also preclude certain arguments that, although tenuous, might otherwise be made

by taxpayers. For example, under these paragraphs, certain income is treated as inactive business income; the taxpayer is not deemed to be carrying on an inactive business. Therefore, in the absence of the separate business provision, taxpayers could argue that the activities constitute an active business either because they do as a question of fact or because the principal purpose of the business is to earn income from property but the more than five full-time employees exception applies.

The effects of treating the income under paragraphs 95(2)(a.1), (a.2), and (a.3) as income from an inactive business and FAPI are twofold. First, if the affiliate is a controlled foreign affiliate of any Canadian taxpayer, the taxpayer's share of the FAPI is included in its income under subsection 91(1). Second, the income is included in computing the affiliate's taxable earnings and taxable surplus whether or not it is a controlled foreign affiliate. Accordingly, the income cannot be repatriated to Canada as a tax-free dividend. Any dividend paid by the affiliate to a Canadian corporate shareholder out of this income is taxable subject to the deductions for withholding taxes and underlying foreign taxes paid by the affiliate on the income under paragraphs 113(1)(b) and (c).

The 90 percent gross income exception is intended to operate as a de minimis rule. If more than 90 percent of the particular type of income earned by the affiliate (that is, sales income, insurance premiums, interest, and rent) is derived from transactions with arm's-length parties, the relevant Canadian source income of the affiliate is not deemed to be FAPI. It is difficult to justify this de minimis rule except as a concession to make paragraphs 95(2)(a.1), (a.2), and (a.3) more palatable to taxpayers. There is no similar de minimis rule with respect to other components of FAPI. For example, if a foreign affiliate has income from property that constitutes less than 10 percent of its total income, the income from property nevertheless constitutes FAPI.

The major components of FAPI are income from property, income from inactive business, and certain taxable capital gains. As a result of the new rules, income from inactive business is less significant because income from an investment business and income from an adventure in the nature of trade have been included in income from property. It seems unlikely, therefore, that any income will be characterized as inactive business income on a factual basis under the new rules. The category is still important, however, because certain Canadian source income and services income derived by foreign affiliates is deemed by paragraphs 95(2)(a.1) to (b) to be income from inactive business.

The new deeming rules apply to taxation years of a foreign affiliate beginning after 1994. Therefore, taxpayers that are adversely affected by the rules have an opportunity to rearrange their affairs.

***Paragraph 95(2)(a.1)***

Under paragraph 95(2)(a.1), income derived by a foreign affiliate from the sale of property must be included in its income from inactive business if two conditions are met:

1) the cost of the property is relevant in computing the business income of the taxpayer (the Canadian resident in respect of whom the foreign corporation is a foreign affiliate) or a non-arm's-length Canadian resident, or in computing the income from a business carried on in Canada by a non-arm's-length non-resident; and

2) the property was not created in the country where the foreign affiliate is formed or organized and in which its principal business is carried on.

For this purpose, sales income is considered to include services income derived by a foreign affiliate as an agent if the services relate to the purchase or sale of property. Consequently, paragraph 95(2)(a.1) cannot be avoided by having a foreign affiliate purchase or sell property as an agent of a Canadian taxpayer and receive a fee for its services, rather than act on its own account. Because the rule is limited to services provided as an agent, it does not conflict with paragraph 95(2)(b) and subsection 95(3), which effectively exclude from the FAPI rules services income derived by a foreign affiliate in connection with the purchase or sale of goods.

Presumably, the cost of property is relevant in computing Canadian business income if the property is inventory, depreciable property, or eligible capital property. The cost of non-depreciable capital property is not relevant in computing income from a business. The question arises whether the cost of inventory is relevant in computing income if the property is not sold in the year by the Canadian resident or non-resident carrying on business in Canada.[29] Similarly, if a taxpayer chooses not to claim capital cost allowance or an allowance in respect of cumulative eligible capital in the year in which the affiliate realizes income from the sale of the property, it may be argued that paragraph 95(2)(a.1) does not apply because the cost of the property is not relevant in computing income until a subsequent year. It is reasonably clear, however, that the provision is intended to apply if the cost of the property is relevant in computing the taxpayer's business income for any year. Otherwise, it is relatively easy to defer the application of the provision.

Paragraph 95(2)(a.1) does not apply if the property sold to Canada is manufactured, produced, grown, extracted, or processed in the country where the foreign affiliate is organized and principally carries on business. It is not necessary for this purpose for the manufacturing, producing, growing, extracting, or processing activities to be performed by the foreign affiliate. It is necessary only that the property be produced by someone in the country in which the affiliate is organized and principally carries on business. It may be very difficult with respect to certain manufactured and processed goods (automobiles are a good example) to determine the country of origin.

The policy thrust underlying this requirement is not completely clear. A Canadian corporation can use a foreign affiliate as its purchasing agent,

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[29] See *Friesen v. The Queen*, 93 DTC 5313; [1993] 2 CTC 113 (FCA), under appeal to the Supreme Court of Canada.

but only for the country in which the affiliate is organized and principally carries on business. Therefore, for example, if a foreign affiliate incorporated in Barbados or another tax haven purchases American goods for sale to Canada, the sales profit will be included in FAPI. On the other hand, if a US foreign affiliate purchases American goods for resale to Canada, the sales profit will be active business income unless the affiliate is engaged in an investment business. The erosion of the Canadian tax base is the same in both situations. The only difference is likely to be the level of foreign tax paid by the foreign affiliate. In other words, it may be argued that the primary effect of the use of a tax haven purchasing company is to avoid foreign taxes, not Canadian taxes. And generally, the policy of the FAPI rules is to encourage Canadian multinational corporations to avoid foreign taxes.[30]

The residence of a foreign affiliate is irrelevant for the purpose of paragraph 95(2)(a.1).[31] It is the country where the affiliate is incorporated and where it principally carries on business that is crucial. The use of place of incorporation rather than residence is probably intended to provide certainty for taxpayers and Revenue Canada. The reason for the additional requirement that the affiliate principally carry on business in the country is unclear.[32] It means that a purchasing company incorporated in one country but carrying on business principally in another country is subject to the rule, even with respect to property produced in the country in which it is incorporated or in which it principally carries on business. In any event, the tax-planning implications of these requirements are clear. Canadian corporations must set up a separate purchasing affiliate for each country in order to avoid paragraph 95(2)(a.1). Why this is desirable from a Canadian perspective is not so clear. The use of regional purchasing affiliates rather than a purchasing affiliate for each country seems to be no more offensive from a tax policy perspective and would be much more sensible in commercial terms.

Paragraph 95(2)(a.1) does not apply if more than 90 percent of the affiliate's gross sales income is derived from sales to arm's-length persons. For this purpose, property sold by the foreign affiliate to the Canadian taxpayer, a non-arm's-length Canadian resident, or a non-resident carrying on business in Canada, is not taken into account in calculating the affiliate's arm's-length sales if the property was not produced in the country in which the affiliate is incorporated and principally carries on business. In most cases, this exclusion will not be relevant, since the sales made by

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[30] The best expressions of this policy are the subsection 93(1) election and subparagraph 95(2)(a)(ii). See also the testimony of David A. Dodge, deputy minister of finance, in Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parliament, 3d session, 1991-92, issue no. 37, December 8, 1992, 37:14-15.

[31] As a result, the residence rule in regulation 5907(11.2) does not apply.

[32] It may be that the requirement is intended to prevent taxpayers from manipulating the country of formation or organization by continuing a foreign affiliate from one country to another.

the affiliate to Canada will be non-arm's-length transactions. However, it is possible for a foreign affiliate of a Canadian taxpayer to deal at arm's length with the taxpayer because foreign affiliate status requires only the ownership of 10 percent of the shares of any class.

Paragraph 95(2)(a.1) is directed at situations like the *Irving Oil* case.[33] In that case, the Canadian parent corporation acquired crude oil from its wholly owned subsidiary in Bermuda. The Bermudan subsidiary acquired most of the oil from an American company that owned 49.9 percent of the Canadian parent company. The subsidiary made a profit on the sales to its parent of 66¢ per barrel. Although the subsidiary had a small office in Bermuda where clerical functions were performed, it did not insure the oil, nor did it ever take possession of the oil. The Federal Court of Appeal rejected the Crown's arguments that the subsidiary was a sham and that the arrangement was artificial under former subsection 245(1). The trial court had found as a fact that the purchase price of the oil paid to the subsidiary was its fair market value; consequently, the transfer-pricing rules were not applicable.

The taxation years involved in the *Irving Oil* case were 1971-1975, before the FAPI rules became effective. Nevertheless, it is unlikely that the sales profits of the subsidiary would have been characterized as FAPI in any event. Under the new rules, however, selling commodities is an investment business that generates income from property and FAPI unless the affiliate is a trader or dealer in commodities and employs more than five full-time employees. Paragraph 95(2)(a.1) makes it clear that profits derived from sales of property to Canada are FAPI even if the foreign affiliate is not carrying on an investment business.

Paragraph 95(2)(a.1) is intended to prevent the use of a controlled foreign affiliate to purchase property and resell it to its Canadian parent corporation or to a non-arm's-length person where the cost of the property is deductible in computing income from a business subject to Canadian tax. The policy assumption is that there is no good commercial reason for a Canadian corporation to use a foreign affiliate to acquire property for resale to the Canadian corporation. Although the transfer-pricing rules require the prices in the transactions to be fair market value, it will usually be appropriate for the foreign affiliate to earn some profit unless it is a sham. The profit derived by the foreign affiliate represents an erosion of the Canadian tax base. Moreover, it is well known that Revenue Canada faces enormous difficulties in enforcing the transfer-pricing rules strictly.

Paragraph 95(2)(a.1) does not apply to sales of property by a foreign affiliate to non-residents where the property is created in Canada by the taxpayer or a non-arm's-length person in the course of a business carried on in Canada. It does apply, however, to outbound sales if the property is purchased by the Canadian taxpayer and, without any value being added by the Canadian taxpayer, sold to a foreign affiliate. Once again, the policy

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[33] *The Queen v. Irving Oil Limited*, 91 DTC 5106; [1991] 1 CTC 350 (FCA).

seems to be that there is no commercial reason for this type of transaction. If the Canadian taxpayer sold the property directly to the non-resident or the foreign affiliate purchased the property directly, the sales profit would be subject to Canadian tax.

### *Paragraph 95(2)(a.2)*

Paragraph 95(2)(a.2) requires income earned by a foreign affiliate from the insurance or reinsurance of Canadian risks to be included in the affiliate's inactive business income. Canadian risks are risks in respect of Canadian residents, property situated in Canada, and businesses carried on in Canada. Paragraph 95(2)(a.2) will not apply only if more than 90 percent of the affiliate's gross premium income (less reinsurance) for a year is derived from the insurance of non-Canadian risks of arm's-length persons.

In effect, paragraph 95(2)(a.2) will reduce the use of captive insurance companies to avoid Canadian tax.[34] It represents a significant extension of the rules in paragraph 95(2)(b). Under that provision, insurance premiums paid or payable to a controlled foreign affiliate in respect of Canadian risks are deemed to be inactive business income if the premiums are deductible for Canadian tax purposes by the taxpayer or a related person or if the premiums are paid or payable by someone else but relate to deductions claimed by the taxpayer or a related person.

Paragraphs 95(2)(a.2) and (a.3) are different from paragraph 95(2)(a.1) in that they apply to Canadian source income derived from arm's-length transactions. Moreover, the exceptions are available only if the foreign affiliate derives more than 90 percent of its gross income from rents, royalties, or the insurance of risks, other than Canadian risks, of arm's-length persons. In contrast, paragraph 95(2)(a.1) is aimed only at Canadian source sales income derived by a foreign affiliate from transactions with non-arm's-length persons. The exception under that paragraph is available if more than 90 percent of the affiliate's income is derived from arm's-length transactions, including Canadian source income from arm's-length transactions.

### *Paragraph 95(2)(a.3)*

The new rule in paragraph 95(2)(a.3) is directed at the type of situation in the *Canada Trustco* case.[35] Income derived by a foreign affiliate, directly or indirectly, from debt and lease obligations, including profits from the sale of such obligations, of residents of Canada or of non-residents in respect of businesses carried on in Canada, is considered to be inactive business income. "Lease obligation" is defined to include a licence. Therefore, the provision is not limited to conventional leases of real property or tangible

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[34] See, generally, Robert J. Spindler, "Special Status Entities," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 23:1-19, at 23:9-16. It should also be noted that a foreign affiliate that is insuring non-Canadian risks may be carrying on an investment business.

[35] Supra footnote 15.

personal property. It applies to licences of intangible property and contractual arrangements involving the use of knowhow and other information. It may even apply to cross-border securities lending arrangements as defined in subsection 260(1).[36] It is also intended to apply to income derived indirectly, presumably through multiple-tier structures. Paragraph 95(2)(a.3) does not apply if more than 90 percent of the affiliate's gross income from interest and rent is derived from arm's-length non-residents.

Interest and rent paid by a Canadian resident to a foreign affiliate are generally deductible in computing the resident's Canadian income. Therefore, unless the interest and rent are included in FAPI, the Canadian tax base is eroded. In addition, the interest or rent paid to the foreign affiliate may not be subject to Canadian withholding tax because of an exemption. Moreover, if the foreign affiliate is resident in a treaty country, the income can be repatriated to Canada without tax as a dividend out of exempt surplus. The same result occurs if interest and rent are paid to a foreign affiliate by a non-resident carrying on business in Canada.

As noted earlier, in the *Canada Trustco* case, which is under appeal, interest derived by a Netherlands subsidiary of Canada Trustco from Canadian residential mortgages that were administered in Canada on behalf of the subsidiary was held to be active business income. By introducing paragraph 95(2)(a.3), the government has decided not to wait for the final resolution of the case by the courts. Perhaps the government's decision in this regard was influenced by the auditor general's report and the report of the Public Accounts Committee, both of which called for a definition of active business for purposes of the FAPI rules. From a policy perspective, the erosion of the Canadian tax base in the *Canada Trustco* case is intolerable, and paragraph 95(2)(a.3) is clearly justified. In my view, the government was justified in not waiting for the final decision in the case. It is difficult to have much confidence in the ability of the courts to provide satisfactory guidance in this area, especially in a single case. Moreover, it could take several years for the case to be finally resolved.

## The Revisions to Paragraph 95(2)(a)

Paragraph 95(2)(a) deems certain amounts to be income from an active business. Accordingly, these amounts are not included in the FAPI of controlled foreign affiliates; they are included in computing the exempt or taxable surplus of foreign affiliates. Existing subparagraph 95(2)(a)(ii) is an especially important provision. It deems amounts—most important, interest received by one foreign affiliate from another—to be active business income if the amounts are deductible in computing the payer's earnings from an active business. Existing subparagraph 95(2)(a)(i) deems income that is incident to or pertains to an active business of a foreign affiliate or another non-arm's-length non-resident corporation to be income from an

[36] Under a securities lending arrangement, a person transfers or loans a share or a debt obligation to an arm's-length party. Such an arrangement may be a lease obligation because it authorizes the use of the security, namely, its sale.

active business. Both aspects of paragraph 95(2)(a) will be revised significantly under the proposed amendments.

***Subparagraph 95(2)(a)(i)***

The changes to subparagraph 95(2)(a)(i) are intended to restrict its scope. The core aspect of the existing rule is preserved in the new definition of income from an active business, which includes any income that pertains to or is incident to an active business of a foreign affiliate. Consequently, new subparagraph 95(2)(a)(i) is restricted to income of an affiliate that is derived from activities that relate directly to an active business carried on outside Canada by a related non-resident corporation. The differences between the new and old versions of subparagraph 95(2)(a)(i) are as follows:

- The new provision applies only to income from property, whereas the old version applied to income from property and income from an inactive business. However, under the new rules, income from property includes income from an investment business.
- Under the new provision, the affiliate and the other non-resident corporation must be related, whereas under the old provision the taxpayer and the other non-resident corporation had to be dealing with each other not at arm's length. This change eliminates the uncertainty involved in determining whether corporations are not dealing at arm's length as a question of fact.[37]
- The activities of the particular foreign affiliate must be "directly related to" the active business activities of the related corporation. It is obviously intended that this "directly-related-to" test will be more restrictive than the "pertains to or incident to" test.[38] It seems to me, however, that the new wording is equally susceptible to a broad interpretation and that taxpayers are likely to make all the same arguments under the new version that they made under the old version.
- The income must be such that, if it were earned by the related corporation and the related corporation were a foreign affiliate, the income would be included in computing its earnings or loss from an active business. In effect, the deeming rule is restricted to income from activities that would generate active business income if all the activities were carried on by one foreign affiliate.

The explanatory notes give three examples to which the new rule would apply:

1) a foreign affiliate engaged in the business of selling equipment establishes a subsidiary to lease the same equipment, rather than leasing the equipment itself;

[37] Under subsection 251(1), related persons are deemed not to deal with one another at arm's length. In any other case, it is a question of fact whether persons are dealing at arm's length.

[38] See *Atlas Industries Ltd. v. MNR*, 86 DTC 1756; [1986] 2 CTC 2392 (TCC).

2) a real estate development corporation establishes a wholly owned subsidiary to develop a single rental property; and

3) a foreign affiliate carrying on a manufacturing business incorporates a subsidiary to purchase and collect the receivables of its parent.

As the examples from the explanatory notes indicate, subparagraph 95(2)(a)(i) may apply to income from property that is income from an investment business.

The new provision is still very important in providing taxpayers with flexibility in structuring their foreign affiliates. If it is beneficial for commercial or foreign tax reasons to divide the activities involved in an active business into multiple foreign affiliates, any income from property earned by an affiliate may still qualify as active business income if it satisfies the requirements of subparagraph 95(2)(a)(i). If, however, the activities are so divided among related foreign affiliates that no foreign affiliate is carrying on an active business, subparagraph 95(2)(a)(i) will not apply to treat the income as active business income, even if the income would be active business income if all the activities were performed by one foreign affiliate.

### *Subparagraph 95(2)(a)(ii)*

Subparagraph 95(2)(a)(ii) is a key aspect of the FAPI rules because it permits Canadian-based multinational corporations to use a foreign subsidiary established in a tax haven to finance the foreign activities of the group. Under the existing provision, amounts received by one foreign affiliate from another or from a non-arm's-length non-resident corporation are included in the affiliate's active business income to the extent that the amounts are deductible in computing the payer's earnings from an active business carried on outside Canada. Therefore, a typical structure involves the establishment of an international finance subsidiary in Barbados, Ireland, or the Netherlands (all of which are listed countries). The subsidiary is capitalized with equity, which is often derived from borrowings by the Canadian parent corporation. The subsidiary loans the funds at an arm's-length interest rate to other group companies engaged in carrying on active businesses. Accordingly, the interest is deductible in computing the payer's earnings under the tax law of its country of residence; the interest is not FAPI to the finance subsidiary but is included in its active business income and its exempt surplus; and the interest can be distributed by the finance subsidiary to its Canadian parent without any Canadian tax as a dividend out of exempt surplus.

In the absence of subparagraph 95(2)(a)(ii), interest and other amounts received by a controlled foreign affiliate from a related party would generally constitute passive income. The only contrary argument available to a taxpayer is that, on the facts, the controlled foreign affiliate is engaged in an active business. Subparagraph 95(2)(a)(ii) removes any uncertainty in the characterization of interaffiliate payments by effectively deeming any payments to be active business income to the extent that they can ultimately be traced to an active business.

Other countries are not as generous as Canada concerning foreign finance subsidiaries. Under the German rules, interest on loans to related parties is considered to be passive income in all circumstances. Under the US subpart F rules, such interest is treated as passive "tainted" income unless the payer corporation is established and carries on business in the same country as the finance subsidiary.[39]

The revisions to subparagraph 95(2)(a)(ii) alter the fundamental operation of the rule described above. The new provision applies only if the recipient and payer corporations are related, whereas the existing provision applies if the two corporations are both foreign affiliates of the same taxpayer or if the payer corporation does not deal at arm's length with the taxpayer. This change is consistent with a similar change to subparagraph 95(2)(a)(i). To the extent that it eliminates the uncertainty involved in determining whether corporations are not dealing at arm's length as a question of fact, the amendment is sensible. To the extent, however, that the amendment requires two foreign affiliates of the same Canadian resident to be related, it is more questionable.

Currently, it is sufficient for the application of subparagraph 95(2)(a)(ii) if payments are made between foreign affiliates. Because the threshold for foreign affiliate status is so low (10 percent of the number of shares of any class), subparagraph 95(2)(a)(ii) is broadly applicable. The revised rule, which is restricted to foreign affiliates and non-resident corporations that are related, is perhaps too restrictive. For example, it will not apply to payments between foreign corporations that are jointly owned by a Canadian corporation and one or more foreign corporations as part of a joint venture. Moreover, if interaffiliate payments qualify as active business income under subparagraph 95(2)(a)(ii) only if the affiliates are related, it is unclear why other provisions dealing with interaffiliate payments should not be subject to the same condition. For example, paragraphs 95(2)(g) and (h), which deem taxable capital gains and allowable capital gains from certain transactions involving interaffiliate debt and shares to be nil, could be restricted to transactions between related foreign affiliates. Further, taxable capital gains from the disposition of shares of a foreign affiliate that are excluded property are excluded from FAPI. This definition of excluded property could be restricted to shares of a foreign affiliate that is related to the shareholder affiliate.

Subparagraph 95(2)(a)(ii) has also been expanded to permit interest on an interaffiliate loan to be treated as active business income if the borrower affiliate uses the funds to acquire shares of another foreign affiliate and the shares constitute excluded property. Several requirements must be met in order for this provision to apply:

- The recipient and payer foreign affiliates must be related at the time of the payment.

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[39] Internal Revenue Code of 1986, as amended. For a discussion of theses rules, see generally Arnold, supra footnote 3, at 451-52.

- The foreign affiliate whose shares are acquired by the payer affiliate must be related to the recipient affiliate. Although it is not completely clear, it appears that this condition must be met only at the time that the shares are acquired.[40] Similarly, it is not completely clear whether the corporation whose shares are acquired must be a foreign affiliate before the acquisition or whether the provision applies where the corporation becomes a foreign affiliate as a result of the acquisition. The latter interpretation is applied by Revenue Canada in the context of the anti-avoidance rules in subsection 95(6).

- The interest must be paid on borrowed money pursuant to a legal obligation or on the unpaid purchase price of the shares.

- The shares of the acquired affiliate must be excluded property. It is not completely clear whether this condition must be met only when the shares are acquired or when each interest payment is made on an ongoing basis.

- The acquired affiliate and the payer affiliate must be resident and subject to income tax in the same country. The use of the subject to tax requirement is surprising because of the well-known interpretative issues raised by the phrase.

- The acquired affiliate and the payer affiliate must be members of a corporate group, and the interest must be relevant in computing the tax liability of the group under the income tax law of the country in which they are resident.

In effect, this new aspect of subparagraph 95(2)(a)(ii) facilitates the use of a holding company to own the shares of an operating affiliate if they are both resident in the same country (the same-country holding company rule). In the absence of this provision, the interest on funds loaned to a holding company to acquire shares of another foreign affiliate would probably be FAPI; subparagraph 95(2)(a)(ii) would not apply because the interest is not deductible by the holding company in computing its earnings from an active business. This result is usually avoided by having the financing affiliate loan funds directly to the operating affiliate or to another foreign affiliate that loans the funds to the operating affiliate. In some situations, however, it is advantageous for commercial and foreign tax reasons to use a holding company to own the shares of the operating company. The underlying policy appears to be that any interest received by a finance affiliate should be treated as active business income if the borrowed funds are used to finance, whether by way of debt or equity, an active business of a related affiliate. The rule does not apply, however, to contributions to capital; shares of the operating affiliate must be acquired.

It is unclear why this new rule is limited to situations in which the foreign country taxes the holding and operating affiliates on a group basis.

[40] Note, however, that the payer affiliate and the acquired affiliate must be members of a corporate group at the time of each payment under the foreign tax law.

Possibly, because the rule is new and its operation uncertain, the government decided to limit its application to our most important trading partners, such as the United States and the United Kingdom, which provide consolidation and group relief for tax purposes.

Subparagraph 95(2)(a)(ii) is intended to apply to multiple-tier foreign affiliate structures.[41] For example, where one foreign affiliate loans funds to a second foreign affiliate that loans the funds to a third affiliate that uses the funds in its active business, clause 95(2)(a)(ii)(A) applies. Further, where one foreign affiliate loans funds to a second affiliate that loans the funds to a third affiliate that uses the funds to acquire shares of a fourth affiliate that constitute excluded property, clause 95(2)(a)(ii)(B) applies.

The addition of regulations 5907(2.7) and (2.8) and the amendment to the definition of exempt earnings in regulation 5907(1)(b)(iv)(B), which are discussed in more detail below, ensure that the changes to subparagraph 95(2)(a)(ii) do not produce any inappropriate results in terms of the computation of the surplus accounts.

### *The Treatment of Paragraph 95(2)(a) Amounts for Purposes of the Surplus Accounts*

Where a foreign affiliate has income from an active business as a result of the application of paragraph 95(2)(a), the amount (less any applicable expenses) is included in its earnings for purposes of computing its surplus accounts.[42] If the foreign affiliate is resident in a listed country and the amounts are related to an active business carried on in a listed country, the amounts are included in the affiliate's exempt earnings.[43] Otherwise, the paragraph 95(2)(a) amounts are included in the affiliate's taxable earnings.

The definition of exempt earnings is changed to reflect the amendments to paragraph 95(2)(a). The changes to regulation 5907(1)(b)(iv)(B)(I) and (II) are merely consequential to the changes to paragraph 95(2)(a); there are no changes of substance. Therefore, amounts that are directly related to the active business of a related non-resident corporation under subparagraph 95(2)(a)(i) are included in the affiliate's exempt earnings if they would be included in the non-resident corporation's exempt earnings, assuming that the corporation was a foreign affiliate and, presumably, that it earned the amounts.[44] Similarly, amounts paid or payable to a foreign affiliate by a related non-resident corporation under clause 95(2)(a)(ii)(A) are included in the affiliate's exempt earnings if the amounts would be

[41] The current version of the subparagraph also accommodates these structures. The words "directly or indirectly" in the opening part of subparagraph 95(2)(a)(ii) do not appear to add anything.

[42] Regulation 5907(1)(a)(ii).

[43] Regulation 5907(1)(b)(iv)(B).

[44] Regulation 5907(1)(b)(iv)(B)(I) is deficient in that it does not make the second assumption explicit. Note also that the regulation refers to the "business activities" of the non-resident corporation, whereas subparagraph 95(2)(a)(i) refers to "active business activities."

deductible in computing the non-resident corporation's exempt earnings or loss if the corporation were a foreign affiliate.

Regulation 5907(1)(b)(iv)(B)(III) is a new provision that deals with interest received or receivable by a foreign affiliate in respect of funds loaned to a related affiliate and used by it to acquire shares of another foreign affiliate (the same-country holding company rule). Clause 95(2)(a)(ii)(B) deems this interest to be active business income if certain conditions are met. By virtue of the new regulation, the interest is included in the recipient's exempt earnings if the payer affiliate (the holding company) and the affiliate whose shares are acquired, and any other foreign affiliate in which the acquired affiliate owns shares, are resident in a designated treaty country.

Clause 95(2)(a)(ii)(B) does not apply unless the payer affiliate and the acquired affiliate are resident in the same country and the shares of the acquired affiliate are excluded property. In order for the amounts to be included in exempt earnings, it is obviously necessary for the payer and acquired affiliates to be resident in a treaty country. This condition is not sufficient, however, because the acquired affiliate may own shares of the other foreign affiliates. These affiliates also must be resident in treaty countries.[45] The wording of the regulation with respect to this requirement is deficient. The regulation refers to "each other corporation relevant for the purposes of determining whether the shares of the third affiliate are excluded property." The reference to corporations rather than foreign affiliates seems inappropriate. If a foreign affiliate has investments in marketable securities that make up less than 10 percent of its total assets, it should not matter whether the investments are in companies resident in treaty countries.[46] Even if the provision were revised to refer only to foreign affiliates, it would still be inappropriate. Where a foreign affiliate owns shares of another foreign affiliate that is not resident in a treaty country but where the shares (and other property that is not excluded property) represent less than 10 percent of its total assets, the interest should be included in the recipient affiliate's exempt earnings. However, any revision to the regulation to deal with this problem would likely result in significant complexity.

The definition of excluded property includes amounts receivable if the interest is deemed to be active business income under subparagraph 95(2)(a)(ii). Therefore, the shares of a financing affiliate that makes loans to operating affiliates are usually excluded property. For purposes of regulation 5907(1)(b)(iv)(B)(III), the definition of excluded property is to be read as including only those receivables in respect of which interest is deductible in computing the payer's exempt earnings or exempt loss.[47] In

[45] The residence of a foreign affiliate will be determined in accordance with new regulation 5907(11.2).

[46] It cannot be argued that only shares of a foreign affiliate are relevant in determining whether shares are excluded property. All of the property of a foreign affiliate is expressly relevant.

[47] The reference in the regulation to exempt surplus rather than exempt earnings is incorrect and will undoubtedly be changed.

other words, in determining whether the shares of the acquired affiliate are excluded property, any receivable is considered to be excluded property only if the interest is deductible by the payer affiliate in computing its exempt earnings or loss.

In summary, therefore, the aspects of regulation 5907(1)(b)(iv)(B)(III) dealing with excluded property represent an intention to limit the definition to excluded property that is connected to a designated treaty country. It is unclear why there is no specific provision limiting excluded property that is used or held in an active business to such property used or held in an active business carried on in a treaty country. For example, if an acquired affiliate carries on an active business in a non-treaty country but is resident in a treaty country, regulation 5907(1)(b)(iv)(B)(III) applies to any interest paid or payable by a same-country holding company on funds used to acquire the shares of the acquired affiliate. However, if an acquired affiliate owns shares of other foreign affiliates that are not resident in treaty countries, or has receivables that are not connected to treaty countries, the regulation does not apply.

The amendments to regulation 5907(1)(b)(iv) apply to taxation years of foreign affiliates beginning after 1994. For taxation years beginning before 1996, the provision is to be read as referring to listed countries rather than to designated treaty countries unless the taxpayer elects to have regulations 5907(11), (11.1), and (11.2) apply to these taxation years.[48]

## DESIGNATED TREATY (LISTED) COUNTRIES

### Introduction

The basic purpose of the Canadian foreign affiliate rules is to provide relief from the international double taxation of active business income earned by Canadian corporations through foreign corporations. For this purpose, the foreign affiliate rules involve a combined exemption-credit system. For active business income earned by foreign affiliates in certain listed countries, double taxation is eliminated by the exemption of dividends paid by these affiliates out of such income from Canadian tax. Double taxation in respect of other income—income from active businesses in unlisted countries and investment income—is eliminated by providing, in effect, a credit against Canadian tax payable on dividends from foreign affiliates for the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividend was paid and for any foreign withholding taxes on the dividend.

More specifically, under paragraph 113(1)(a), dividends received by a Canadian corporation from a foreign affiliate are deductible in computing the corporation's taxable income to the extent that the dividend is paid out of the foreign affiliate's "exempt surplus."[49] One of the principal components

[48] There is a clear error in the draft coming-into-force provision, since the references to listed countries apply if an election is made.

[49] As defined in regulation 5907(1)(d).

of exempt surplus is income from an active business carried on by a foreign affiliate in a listed country if the foreign affiliate is resident in a listed country. The list of countries in regulation 5907(11) consists basically of countries with which Canada has concluded tax treaties. However, the list also contains some countries with which Canada has commenced treaty negotiations but never concluded a tax treaty (for example, Liberia), and does not contain some countries with which Canada does have a tax treaty (for example, Mexico and Poland).[50] In addition, the list includes several countries that are generally known as tax havens, such as the Netherlands, Cyprus, Ireland, Barbados, and several other Caribbean countries.

The Public Accounts Committee recommended that the Department of Finance eliminate countries from the list if Canada did not have a tax treaty with the country and was unlikely to be able to conclude negotiations for a treaty with that country. In addition, the committee recommended that the Department of Finance assess the merits of allowing Canadian corporations to repatriate earnings from foreign affiliates in listed tax haven countries on a tax-free basis.[51]

## The Amendments

Under the amendments, the current list of countries in regulation 5907(11) is repealed and a new rule is introduced under which a country is a "designated treaty country"[52] for purposes of the foreign affiliate rules only when Canada enters into a comprehensive income tax treaty with the country. The new regulation 5907(11) does not just provide that a country is listed, as the former regulation did; it provides that a country is a designated treaty country for a taxation year of a foreign affiliate if there is a tax treaty between Canada and the country that enters into force and has effect for that taxation year. Territories or possessions of the country are not covered unless the treaty applies to such territories or possessions.

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[50] As a result, the following countries that are currently listed will not be designated treaty countries unless a treaty is subsequently entered into:

Antigua
Belize
Dominica
Liberia
Montserrat
Portugal
St. Kitts and Nevis-Anguilla
St. Lucia
St. Vincent
Senegal

The following countries that are not currently listed will be designated treaty countries under the new rules:

Czechoslovakia
Hungary
Luxembourg
Mexico
Nigeria
Papua New Guinea
Poland
South Africa
Zimbabwe

[51] Supra footnote 9, at 48:6.

[52] Several consequential amendments are necessary because of the change from "listed" to "designated treaty" country.

New regulation 5907(11.1) deems a treaty to have entered into force and to have effect for any taxation year of a foreign affiliate beginning with the taxation year in which the treaty was signed and ending with the last day of the last taxation year to which the treaty applies. In effect, although a country is designated only when the tax treaty enters into force, once that condition is satisfied the country is considered to be designated for the taxation year in which the treaty was signed and subsequent years.[53] Despite this provision, Canadian corporations may hesitate to receive dividends from foreign affiliates in countries that have signed a tax treaty with Canada if the treaty has not yet entered into force. If the treaty ultimately enters into force, any active business income earned by the foreign affiliate in the taxation year in which the treaty was signed and in subsequent taxation years will be included in its exempt surplus. If for some reason the treaty does not ultimately enter into force, the income will be included in the foreign affiliate's taxable surplus. Where a treaty is terminated, the country remains a designated country until the end of the foreign affiliate's last taxation year to which the treaty applies.

The new rules with respect to designated treaty countries apply to taxation years beginning after 1995, so that countries that are currently listed but will not be designated under the new rules have an opportunity to enter into a tax treaty with Canada. However, a Canadian corporation can elect to have the new rules apply to earlier taxation years by including a notice in its tax return for any taxation year in which a dividend is received from a foreign affiliate. The election should be made for foreign affiliates resident in countries that are not currently listed in regulation 5907(11) but with which Canada has a tax treaty.[54]

As explained earlier, new regulation 5907(11) designates countries for taxation years of a foreign affiliate, whereas the former regulation simply listed countries. This change has implications for the other provisions of the regulations that refer to regulation 5907(11). For example, under regulation 5907(1)(b)(iv), exempt earnings of a foreign affiliate resident in a designated country include income from an active business carried on in a designated country. Since a country is designated only for taxation years dating from the year in which a tax treaty has entered into force, a foreign affiliate's earnings for a year are included in exempt earnings only for those years in which a treaty with Canada is in effect.

The new rules respond to one of the recommendations of the Public Accounts Committee concerning the list of countries in regulation 5907(11). Under the new rules, countries are designated and delisted automatically by reference to objective events, such as the entry into force of a treaty; it

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[53] The period between the signature and the entry into force of Canadian tax treaties is usually a minimum of one year.

[54] If the election is made, any active business income earned by these affiliates for years beginning before 1996 and after the treaty became effective will be included in the affiliate's exempt earnings rather than its taxable earnings.

will not be necessary to revise the list periodically. This change is a significant improvement.

The new rules do not, however, address the other recommendation of the Public Accounts Committee concerning the treatment of tax havens as listed countries. Tax havens with which Canada has tax treaties, such as Barbados, Ireland, and the Netherlands, will continue to be designated countries. From a tax policy perspective, designated countries should be restricted to countries that impose tax at a rate roughly equal to the Canadian rate. The exemption for dividends received by a Canadian corporation out of the exempt surplus of a foreign affiliate is a proxy for a foreign tax credit system. Under a foreign tax credit system, dividends received from foreign affiliates are taxable, and a credit is available for the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividends were paid and for any withholding taxes on the dividends. If the foreign taxes are equal to or greater than Canadian taxes, any Canadian tax on the dividends is offset by the foreign tax credit. The exemption of such dividends is a simpler method of achieving the same result.

This rationale breaks down if an exemption is provided for dividends received from foreign affiliates in tax havens. There is little justification for treating tax havens as listed or designated countries. This does not mean, however, that countries such as Barbados, Ireland, and the Netherlands should be excluded from designation. Not all foreign affiliates in these countries are subject to low taxes. It is only those corporations that are subject to low rates, such as international business corporations in Barbados and financial centres in Ireland that should be prohibited from benefiting from the country's general status as a designated treaty country.[55]

The elimination of tax havens from regulation 5907(11) is a controversial issue. The Public Accounts Committee suggested only that the Department of Finance should study it. Clearly, Finance should be studying the issue, and perhaps it is. It seems unlikely, however, that any significant action will be taken against designated tax havens in the short term.

## The Residence of a Foreign Affiliate

For purposes of calculating the surplus accounts of a foreign affiliate, it is important to determine the country in which the foreign affiliate is resident. For example, under regulation 5907(1)(a)(i)(A), the earnings of a foreign affiliate from an active business carried on in a country must be computed, in the first instance, in accordance with the tax law of the country in which the foreign affiliate is resident if that country requires the affiliate to compute its income. Further, a foreign affiliate's exempt earnings include active business income earned in listed countries only if the

[55] Several other countries have used this approach in their controlled foreign company legislation. See Arnold, supra footnote 3, at 432-44; and Brian J. Arnold, "The Taxation of Controlled Foreign Corporations: Defining and Designating Tax Havens" (1985), vol. 33, no. 3 *Canadian Tax Journal* 445-89.

affiliate is resident in a listed country.[56] Until the February 1994 budget, the residence of a foreign affiliate was determined in accordance with Canadian tax law on the basis of the central management and control of the affiliate.[57] This test allows taxpayers considerable flexibility in selecting the country of residence of a foreign affiliate. For example, a foreign affiliate may be incorporated in Bermuda, a non-treaty country, but if the directors' meetings are held in the United States, the affiliate is resident in the United States for purposes of the foreign affiliate rules. Thus, the affiliate's active business income derived from listed countries will be included in its exempt surplus, even though the United States does not tax the affiliate on its worldwide income because it is not incorporated in the United States.

New regulation 5907(11.2) attempts to rectify this situation by deeming a foreign affiliate to be resident in a country only if the affiliate is a resident of the country for purposes of the treaty between Canada and the country. This provision applies only to treaty countries. Where a foreign affiliate is resident in a country with which Canada does not have a tax treaty, the residence of the foreign affiliate is determined by application of the central management and control test, as it is currently. Such an affiliate's earnings from active businesses are included in its taxable earnings. (Taxable earnings include all income from active business, whether derived from designated or non-designated countries, other than amounts included in the affiliate's exempt earnings.)

Regulation 5907(11.2) is intended to prevent foreign affiliates from being treated as resident in a treaty country if they are not resident for purposes of the treaty with that country. The rule is framed in the negative. It deems an affiliate not to be resident in a country; it does not deem the affiliate to be resident in a country. Therefore, for a foreign affiliate to be resident in a country with which Canada has a tax treaty, it must be resident in the country both in accordance with the Canadian central management and control test and for purposes of the tax treaty. The explanatory notes indicate that this aspect of regulation 5907(11.2) was unintentional. The regulation was intended to operate as a definition of residence, rather than a negative deeming rule.[58]

The use of a treaty residence test is perhaps not surprising, given subsection 250(5). Such an approach raises few problems. Under a typical treaty, a corporation is a resident of a country for purposes of a treaty if it

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[56] Regulation 5907(1)(b)(iv).

[57] Subsection 250(4), which deems corporations incorporated in Canada after April 26, 1965 to be resident in Canada, does not deem corporations incorporated in other countries to be resident there. Note, however, that subsection 250(6) does deem international shipping corporations to be resident in their country of incorporation in certain circumstances.

[58] Supra footnote 2, at 40: "Under this proposed new subsection, an affiliate will be considered to be a resident of such a country [designated treaty country] only where it is a resident of that country for the purposes of the ratified agreement or convention with that country."

is liable to tax in the country by reason of its "domicile, residence, place of management, or any other criterion of a similar nature."[59] However, the recent *Crown Forest* case[60] may extend the treaty residence test inappropriately if it is confirmed on appeal to the Supreme Court. In that case, the Federal Court of Appeal held that a corporation incorporated in the Bahamas and carrying on business in the United States was a resident of the United States for purposes of the Canada-US tax treaty, even though the corporation was not taxable in the United States on its worldwide income.

There is a special rule in regulation 5907(11.2)(c) to deal with certain foreign corporations, such as international business corporations in Barbados, that are explicitly excluded from the treaty with the country. For example, article 30(3) of the Canada-Barbados tax treaty provides that the treaty does not apply to international business corporations. Therefore, in the absence of a special rule, such corporations would be deemed not to be resident in Barbados for purposes of the foreign affiliate regulations. Regulation 5907(11.2)(c) provides that an affiliate is deemed to be resident in a country if it would be resident for purposes of the treaty but for a provision in the treaty indicating that the treaty does not apply to the affiliate. Accordingly, an international business corporation in Barbados is considered to be resident in Barbados if its central management and control are located in Barbados.[61] This provision applies similarly to offshore companies in Cyprus and holding companies in Luxembourg.

The rule in regulation 5907(11.2)(c) provides convincing evidence of the complete bankruptcy of the designated treaty concept as applied in the regulations. International business corporations in Barbados, for example, are specifically included within the concept, although they are expressly excluded from the treaty and are subject to Barbadian taxes of only 2.5 percent. Foreign affiliates in non-treaty countries, some of which levy tax at rates considerably greater than 2.5 percent, are no different. It cannot be argued that Canada gets the benefit of exchange of information with respect to international business corporations because the treaty does not apply to them. Moreover, for the same reason, it cannot be argued that barring international business corporations from the benefits of the designated treaty status of Barbados would be a violation of the treaty.

Regulation 5907(11.2) also clarifies the treatment of limited liability companies. A limited liability company is an entity authorized by statute that affords its members the protection of limited liability but is treated as

[59] This wording is taken from article 4(1) of Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf). Most Canadian treaties conform roughly to the OECD model treaty.

[60] *The Queen v. Crown Forest Industries Limited*, 94 DTC 6107; [1994] 1 CTC 174 (FCA).

[61] As discussed earlier, because regulation 5907(11.2) is a negative deeming rule, it is necessary for these corporations to be resident in Barbados, Cyprus, or Luxembourg both under the management and control test and under the treaty, assuming that the treaty applies to such corporations.

a conduit for income tax purposes.[62] Many US states and some tax haven jurisdictions have adopted this legislation. Even if a limited liability company is treated as a conduit under foreign tax law, it seems reasonably clear that the entity is a corporation under Canadian tax law, and therefore a foreign affiliate. Revenue Canada has adopted this position. The new regulation provides that a foreign affiliate is deemed not to be resident in a treaty country unless the affiliate would be considered resident for purposes of the treaty if it were treated as a corporation under the foreign tax law. It may seem that this new rule is excessively broad, since it may appear to treat non-corporate entities as foreign affiliates if they were treated as corporations under the foreign tax law. However, the rule applies only to foreign affiliates. Since a foreign affiliate must be a corporation, the provision cannot apply to any foreign entities that are not considered to be corporations under Canadian tax law. Consequently, the only issue is the residence of the foreign affiliate. In other words, if an affiliate is not a resident of a country for purposes of the treaty with Canada only because the affiliate is not treated as a corporation under the tax law of the country, the affiliate will be considered resident for purposes of the treaty.[63]

As a final technical point, new regulation 5907(11.2) applies for the purposes of regulation 5907(1), which contains all the definitions relevant to the computation of the surplus accounts. As mentioned earlier, the determination of the residence of a foreign affiliate is important for the purposes of deciding which country's tax law applies to the computation of the affiliate's surplus accounts and including the affiliate's active business income in exempt or taxable earnings. However, the residence of a foreign affiliate is also relevant for other matters in part LIX of the regulations. For example, under regulation 5907(2.1), the election to use book depreciation rather than depreciation under the foreign tax law is available only where the affiliate is resident in a designated treaty country.[64] The new rules in regulation 5907(11.2) should probably apply to the determination of the affiliate's residence for purposes of part LIX of the regulations generally.

## DEDUCTIBLE LOSSES

### Introduction

Under F of the definition of FAPI in subsection 95(1) (formerly subparagraph 95(1)(b)(v)), the FAPI of a foreign affiliate for a year is reduced by

[62] In *Interpretation Bulletin* IT-343R, September 26, 1977, Revenue Canada has taken the position that foreign entities such as the French SARL and the German GmbH, which are similar to limited liability companies, are corporations for purposes of the foreign affiliate rules.

[63] As discussed earlier, because regulation 5907(11.2) is a negative deeming rule, it is also necessary for a limited liability company to have its central management and control in the country.

[64] The residence of a foreign affiliate is also relevant for purposes of regulations 5907(6) and (7.1).

the amount of its "deductible loss" for the year and each of the five immediately preceding years. In essence, a foreign affiliate's deductible loss is prescribed by regulation 5903 to be its net FAPI losses and its net losses from active business for the year or any of the five immediately preceding years. Thus, the relief for losses under the FAPI rules is quite generous. First, losses from one type of FAPI reduce income from other types of FAPI. For example, allowable capital losses reduce income from property, and losses from property reduce taxable capital gains included in FAPI. Second, a net FAPI loss for a year may be carried forward to offset FAPI in the five immediately following taxation years. Third, a loss from an active business for a year reduces the FAPI of the foreign affiliate for the year. Finally, a loss from an active business for a year may be carried forward to reduce FAPI in the five immediately following years to the extent that it does not reduce FAPI of the current year.

There is no provision under the Canadian FAPI rules to allow the losses of one controlled foreign affiliate to offset the FAPI of another controlled foreign affiliate. However, if one foreign affiliate in a group pays an amount to another foreign affiliate in the group for the use of its loss, the payment is treated as foreign accrual tax, which is effectively creditable against Canadian tax on any FAPI.[65] Accordingly, the payment reduces the deductible loss of the recipient foreign affiliate.[66]

From a theoretical perspective, active business losses of a controlled foreign affiliate should clearly reduce FAPI.[67] Under the Canadian FAPI rules, Canadian resident shareholders of controlled foreign affiliates are subject to tax on certain passive income earned by the affiliate, whether or not such income is distributed. In effect, either the controlled foreign affiliate is assumed to have distributed all of its income currently or the Canadian resident shareholders are considered to have earned the income of the controlled foreign affiliate directly. In either case, the Canadian resident shareholder should be taxable only on the net income of the controlled foreign affiliate.

Although the deduction of active business losses against FAPI is theoretically justified, it is subject to abuse. Where a controlled foreign affiliate engaged exclusively in active business has accumulated losses, the Canadian parent corporation may be tempted to divert to the affiliate passive income that would otherwise be subject to Canadian tax in order to have the income sheltered by the losses. If this type of loss transaction is permissible, the deductible loss provision has precisely the effect that the FAPI rules are intended to prevent, namely, the diversion of passive income from Canada to controlled foreign corporations. In other words, the deductible loss rule seems to assume that the FAPI of the controlled

[65] Subparagraph 95(1)(c)(ii) and regulation 5907(1.3).

[66] Regulation 5903(1)(b).

[67] Arnold, supra footnote 3, at 498.

foreign affiliate arises naturally in the ordinary course of its affairs, rather than being artificially diverted to the affiliate from Canadian sources.

### The Mark Resources Case

A loss transaction involving the use of the deductible loss provision was dealt with in the recent *Mark Resources* case.[68] In that case, the taxpayer was a Canadian corporation engaged in the oil and gas business. Its wholly owned US subsidiary had accumulated losses as of 1984 in the amount of approximately US$700,000. In 1984, the US subsidiary sold all its assets and ceased to carry on business. Early in 1985, the taxpayer borrowed US$7.8 million from a Canadian bank for 67 days at 9.625 percent interest. The taxpayer made a contribution to the capital of its US subsidiary in the amount of the loan. The subsidiary then purchased a term deposit with the Canadian bank in the same amount with interest at 8.75 percent for 67 days. The interest earned by the subsidiary on the term deposit was paid to the taxpayer as a dividend; the funds were used by the taxpayer to fund its interest obligations to the bank. The taxpayer deducted the interest in computing its income for Canadian tax purposes.

The effect of the scheme was to divert passive income (the interest earned on the term deposit) to the US subsidiary, which income was sheltered from Canadian and US tax by the subsidiary's losses. The taxpayer was left with an interest deduction approximately equal to the amount of the subsidiary's losses, with no corresponding income inclusion, since the dividends were received free of any Canadian tax. To put it another way, the transaction had the effect of allowing the taxpayer to deduct the subsidiary's foreign source losses. Under the scheme of the Act, foreign source losses are deductible by a Canadian taxpayer only if the losses arise from foreign branch operations. Where the foreign business is conducted through a foreign subsidiary, the subsidiary is a separate taxable entity and its losses are not deductible by its Canadian parent corporation, just as ordinarily its income is not taxable to its Canadian parent corporation until distributed in the form of dividends.

The government attacked the scheme by arguing that the interest paid by the taxpayer to the bank was not deductible, either because the borrowed money was not used for the purpose of earning income under paragraph 20(1)(c) or because the transaction was artificial under former subsection 245(1). The Tax Court (Bowman J) rejected the argument that the transaction was artificial because the transactions were real and "within accepted norms of commercial reality." In effect, the Tax Court held that if the transactions in the *Irving Oil* case[69] were not artificial within the meaning of subsection 245(1), the transactions in *Mark Resources* also could not be considered artificial. However, the court accepted the government's argument that the interest was not deductible under paragraph 20(1)(c) because

[68] *Mark Resources Inc. v. The Queen*, 93 DTC 1004; [1993] 2 CTC 2259 (TCC).

[69] Supra footnote 33.

the borrowed money was not used for the purpose of earning income. According to the court, the relevant purpose of the use of the borrowed funds was not to make a capital contribution to the US subsidiary, but to import losses into Canada as part of a series of transactions. The court emphasized "the overriding ultimate economic purpose," rather than the direct use of the borrowed funds, which the Supreme Court of Canada emphasized in the *Bronfman Trust* case.[70] Although the Tax Court espoused a gross income test for purposes of paragraph 20(1)(c), it concluded that none of the interest paid by the taxpayer was deductible because the purpose of the borrowing was not to earn dividend income, but to utilize the losses of its foreign subsidiary.[71]

Some might argue that the result in the *Mark Resources* case provides a sufficient response to the possible abuse of the deductible loss provisions. However, this is simply not true. The *Mark Resources* case involves the interest deduction. The utilization of the subsidiary's losses could also have been achieved if the parent corporation had contributed excess cash or portfolio investments to the subsidiary or, perhaps, if a cash-damming strategy had been employed.[72] In these situations, the government's only arguments appear to be based on anti-tax-avoidance doctrines. However, the Tax Court rejected the application of former subsection 245(1) to the transaction. Moreover, in the *Mark Resources* case, the US subsidiary had ceased to carry on business. The taxpayer's case would be strengthened in a situation where the foreign subsidiary continued to carry on its active business. Finally, the Tax Court's decision in the *Mark Resources* case has been appealed to the Federal Court of Appeal, and it remains to be seen how the appeal will be resolved.

## The Revision of the Deductible Loss Regulation

Because of the possibility of abuse of the deductible loss provision and the limited protection afforded by the *Mark Resources* case, it is not surprising that the minister of finance proposed in his February 22, 1994 budget to amend regulation 5903 to eliminate the reduction of FAPI by active business losses. The amendments, which apply to taxation years beginning after 1994, delete current paragraph (b) of regulation 5903(1). Accordingly, for taxation years beginning after 1994, a deductible loss

[70] *The Queen v. Bronfman Trust*, 87 DTC 5059; [1987] 1 CTC 117 (SCC).

[71] The implications of the Tax Court's reasoning in the *Mark Resources* case are potentially far-reaching with respect to the interest deduction. Arguably, the court's reference to overriding ultimate economic purpose may be inconsistent with the *Bronfman Trust* case. On the other hand, the *Bronfman Trust* case did allude to possible exceptions to the direct use tracing rule "in exceptional circumstances." Moreover, the Tax Court's use of a gross income test for purposes of paragraph 20(1)(c) seems to be inconsistent with authority. Discussion of these aspects of the case is beyond the scope of this article.

[72] Cash damming involves accumulating funds in a special account that would be used to make the contribution to the US subsidiary; meanwhile, the parent corporation would borrow for purposes of its ongoing business operations.

will consist only of a controlled foreign affiliate's net FAPI losses for any of the five immediately preceding taxation years.

Arguments will undoubtedly be made that the amendment is retroactive, since active business losses incurred in taxation years beginning before 1995 will not be included in computing the affiliate's deductible loss for taxation years beginning after 1994. For example, if a controlled foreign affiliate has a net cumulative loss from active business for the 1989 to 1994 taxation years, that loss is not deductible in the 1995 or any subsequent taxation year of the affiliate. Therefore, the loss must be used in the affiliate's 1994 taxation year or it will expire. This type of termination for active business losses might tempt taxpayers to engage in aggressive tax-planning techniques in order to utilize the losses.

Revised regulation 5903(1)(b) reduces the amount of an affiliate's deductible loss to the extent that a Canadian taxpayer has deducted an amount in respect of the deductible loss. However, this reduction is made only to the extent that such amount relates to a loss from property or inactive business, or an allowable capital loss in respect of property other than excluded property, for the relevant period. This condition is also present in the existing version of the regulation, which includes an additional reference to a loss from an active business. The deletion of the reference to active business losses in the revised legislation is necessary because such losses will not form part of a deductible loss for taxation years beginning after 1994. This point can be illustrated in the following simple example.

Assume that a controlled foreign affiliate (CFA) of Canco had a FAPI loss of $6,000 in its 1993 taxation year. Its taxation year is the calendar year. In its 1994 taxation year, CFA has FAPI of $5,000 and an active business loss of $12,000. Assume further that CFA has a FAPI loss of $2,000 and an active business loss of $10,000 in its 1995 taxation year.

CFA's deductible loss for its 1993 taxation year is $6,000. For 1994, $5,000 of CFA's deductible loss is deductible in computing its FAPI. Under regulation 5903(1)(c), there is no rule establishing the order of the deduction of a FAPI loss and an active business loss of the same year. However, CFA's deductible loss is reduced by $5,000, and it is assumed that the 1993 deductible loss is deducted first. At the end of its 1994 taxation year, CFA's deductible loss is $13,000.

Under new regulation 5903(1), CFA's deductible loss at the end of 1995 is computed as follows:

| | |
|---|---|
| 1993 FAPI loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | $6,000 |
| 1995 FAPI loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | 2,000 |
| | $8,000 |
| Less: | |
| 1994 paragraph 95(1)(b) deduction . . . . . . . . . . . . . . | 5,000 |
| Deductible loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | $3,000 |

In effect, under the new rules, the active business losses for years both before and after the effective date for the new rules are not taken into

account. FAPI losses for years beginning before 1995 continue to be included in the deductible loss calculation.

The only unresolved question concerning the operation of the proposed rules is the ordering of the deduction where a controlled foreign affiliate has both a FAPI loss and an active business loss for the same year. Assume, for example, that CFA also had an active business loss in 1993. In computing its deductible loss at the end of 1995, the issue is whether the amount deducted for 1994 relates to the FAPI loss or to the active business loss. It is obviously to the taxpayer's advantage for the deduction to relate to the active business loss, since under the new rules the FAPI loss continues to form part of the deductible loss after 1994. There is no clear factual basis on which to resolve the issue. Accordingly, it is perhaps appropriate for the ambiguity to be resolved in favour of the taxpayer on the basis of the *Johns-Manville* case.[73]

The amendments to regulation 5903 restrict deductible losses not only to net FAPI losses, but also to such losses incurred for taxation years in which the foreign corporation was a controlled foreign affiliate of the taxpayer or a related person. Currently, it is sufficient if the foreign corporation is a foreign affiliate of the taxpayer or a related person.

The amount prescribed to be a foreign affiliate's deductible loss has been amended to include a reference to any amount under C of the definition of FAPI (formerly subparagraph 95(1)(b)(ii.1)). The amount in subparagraph 95(1)(b)(ii.1) is the amount of the controlled foreign affiliate's income under section 94.1 in respect of its interest in offshore investment funds. Subparagraph 95(1)(b)(ii.1) was added to the Act in 1984, and the concept of deductible loss should have been correspondingly amended at that time.

## MISCELLANEOUS CHANGES

### The Definition of a Foreign Affiliate

Under paragraph 95(1)(d), a foreign affiliate of a taxpayer resident in Canada is a non-resident corporation in which a Canadian taxpayer has an equity percentage of at least 10 percent. Equity percentage is defined in paragraph 95(4)(b) to mean effectively the ownership, directly or indirectly, of 10 percent of the shares of any class of the non-resident corporation. The test is based simply on the number of shares of the class owned by the taxpayer. The voting rights attached to the shares and the value of the shares are irrelevant. Accordingly, the test of foreign affiliate status is simple and straightforward, but arbitrary.

The definition of foreign affiliate is relevant for two major purposes. For purposes of the FAPI rules, only a foreign affiliate can be a controlled foreign affiliate. Thus, only the FAPI of a controlled foreign affiliate is

[73] *Johns-Manville Canada Inc. v. The Queen*, 85 DTC 5373; [1985] 2 CTC 111 (SCC). The principle was recently reaffirmed by the Supreme Court in *Symes v. The Queen et al.*, 94 DTC 6001; [1994] 1 CTC 40.

attributed to the Canadian taxpayers in respect of whom the non-resident corporation is both a foreign affiliate and a controlled foreign affiliate. For purposes of the deductions under section 113, only dividends received by Canadian corporations from foreign affiliates qualify for the deductions. Therefore, foreign affiliate status has good and bad consequences. If a Canadian taxpayer owns less than 10 percent of the shares of any class of a non-resident corporation, the FAPI rules do not apply; however, any dividends received by the taxpayer are included in income, with limited relief for any foreign withholding taxes. If a taxpayer controls a non-resident corporation, the FAPI rules apply, but any dividends received from the corporation by a Canadian corporation qualify for the section 113 deduction.[74] If a taxpayer owns 10 percent or more of the shares of any class of a non-resident corporation but does not control the corporation, the FAPI rules do not apply; but if the taxpayer is a Canadian corporation, the benefits of section 113 are available for any dividends received from the non-resident corporation.

Because foreign affiliate status has good and bad consequences, it was not considered necessary when the legislation was first introduced to have constructive ownership rules that would prevent taxpayers from fragmenting the ownership of shares of non-resident corporations in order to avoid foreign affiliate status.[75] In the February 1994 amendments, the definition of foreign affiliate in paragraph 95(1)(d) was amended to add constructive ownership rules. Accordingly, in determining foreign affiliate status, the equity percentage in a non-resident corporation of any persons related to the taxpayer must be aggregated with the taxpayer's equity percentage. Therefore, if a taxpayer owns 8 percent of the shares of a class of a non-resident corporation and a related person owns 2 percent or more of the shares of the same class, the non-resident corporation is a foreign affiliate in respect of the taxpayer. The taxpayer must have an equity percentage in the foreign corporation of at least 1 percent. Accordingly, if a taxpayer does not have any direct or indirect interest in a foreign corporation but related persons have an equity percentage of 10 percent or more in the corporation, the corporation is not a foreign affiliate of the taxpayer.

The implications of the amendment are both good and bad from a taxpayer's perspective. If a taxpayer has less than 10 percent of the shares of any class of a non-resident corporation but the taxpayer and related persons have more than 10 percent of any class, both the FAPI rules (assuming that the corporation is a controlled foreign affiliate of the taxpayer) and the section 113 rules apply. It seems unlikely, however, that Canadian

[74] Under section 113, the dividends out of exempt surplus are tax-free; dividends out of taxable surplus qualify for an indirect foreign tax credit (that is, a credit for the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividends were paid) and a credit for any withholding taxes on the dividends; and dividends out of pre-acquisition surplus are tax-free but reduce the adjusted cost base of the shares.

[75] Perhaps the government considered that the anti-avoidance rules in subsection 95(6) afforded sufficient protection.

corporations would have structured their affairs without taking into account the benefits of section 113. Consequently, the practical effect of the amendment will likely be to prevent taxpayers from fragmenting the ownership of shares of non-resident corporations in order to avoid the FAPI rules.

The amendment applies to all shares of non-resident corporations owned by related persons, whether residents or non-residents of Canada. Where a Canadian taxpayer owns at least 1 percent but less than 10 percent of the shares of any class of a non-resident corporation but, together with related non-residents, owns 10 percent or more of the shares of any class, it seems fair enough that the FAPI rules should apply. However, it is questionable in this situation whether the benefits of section 113 should be available to a Canadian taxpayer.

The new definition of foreign affiliate applies to taxation years commencing after 1994.

**Regulations 5907(2.7) and (2.8)**

New regulation 5907(2.7) is related to the deeming rules in paragraph 95(2)(a). Under clause 95(2)(a)(ii)(A), amounts paid or payable to a foreign affiliate by a related non-resident corporation are included in income from an active business if the amounts are deductible (or would be deductible if the corporation were a foreign affiliate) in computing the payer's earnings from an active business. This deeming rule has two important consequences. The amounts are not taxable as FAPI to the Canadian shareholders of the foreign affiliate, and they are included in the recipient affiliate's earnings for purposes of the surplus accounts. It is clear that clause 95(2)(a)(ii)(A) is satisfied if the amounts are deductible in computing the payer affiliate's earnings for any year, whether past, current, or future. Consequently, the recipient affiliate's earnings may be increased before the payer affiliate's earnings are reduced. For example, under a zero coupon bond, an affiliate may be entitled to deduct interest only when the bond matures; however, the interest on the amount attributable to each year might be considered to be payable to the recipient affiliate either in full when the bond is issued or proportionately over the term of the bond. New regulation 5907(2.7) ensures symmetry in the timing of the calculation of the earnings of the payer and recipient affiliates. The payer is deemed to deduct the amount in the taxation year in which it is paid or becomes payable, whichever is earlier. Consequently, the payer's earnings are reduced (or its loss increased) at the same time as the recipient's earnings are increased.

Regulation 5907(2.7) also applies to amounts paid to a foreign affiliate by a related non-resident corporation that are included in the recipient's active business income because they are directly related to the non-resident corporation's active business.

Literally, regulation 5907(2.7) applies to amounts paid or payable by a non-resident corporation that is not a foreign affiliate of the Canadian taxpayer. If the non-resident corporation is not a foreign affiliate of any other

Canadian taxpayer, the reduction in its earnings has no effect. If, however, the non-resident corporation is a foreign affiliate of another Canadian taxpayer, its earnings are reduced pursuant to regulation 5907(2.7) vis-à-vis the Canadian taxpayer.

Regulation 5907(2.8) is similar to regulation 5907(2.7) and applies to interest that is deemed to be active business income by virtue of clause 95(2)(a)(ii)(B) (the same-country holding rule). Under this clause, interest paid or payable by the payer affiliate to a recipient affiliate on borrowed money used by the payer to acquire shares of a third foreign affiliate is included in the recipient's active business income. Thus, the interest is not included in FAPI and is included in the recipient's earnings for purposes of the surplus accounts. By virtue of regulation 5907(2.8), the payer affiliate is required to deduct the interest in computing its active business income (not earnings) for the taxation year in which the interest was paid or became payable, whichever is earlier, and is prohibited from deducting the interest in any other year. Also, the payer is deemed to have carried on an active business in its country of residence for such taxation year, so that the interest paid or payable reduces its earnings or increases its loss for such year under regulation 5907(1)(a) or (e), respectively. In the absence of these rules, the interest paid by the holding corporation would be deductible in computing its FAPI rather than its active business income.

New regulations 5907(2.7) and (2.8) apply to taxation years of foreign affiliates commencing after 1994.

## Debt Forgiveness

In July 1994, the Department of Finance issued draft legislation with respect to the tax consequences of debt forgiveness and foreclosures for income tax purposes.[76] Currently, it is unclear to what extent section 80 applies for purposes of the FAPI and foreign affiliate rules. The draft legislation clarifies the application of the debt forgiveness rules for purposes of the FAPI rules.

Under the new rules, the definition of FAPI is revised to include amounts required to be included in the foreign affiliate's income as a result of the settlement of a "commercial debt obligation" under subsection 80(13). A commercial debt obligation is defined to be any debt in respect of which the interest is deductible in computing FAPI or would be deductible if interest were payable on the obligation. Only forgiveness of debt that relates to income from property or income from inactive businesses is included in FAPI. Therefore, if a debt that is issued in connection with a foreign affiliate's active business is forgiven, the amount of the forgiveness is not required to be included in computing the affiliate's FAPI. In addition, to the extent that the new rules affect the calculation of capital gains and losses, the calculation of capital gains and losses for purposes of the FAPI

[76] Canada, Department of Finance, Draft Amendments to the Income Tax Act: Debt Forgiveness and Foreclosures, July 1994.

and foreign affiliate rules also is affected, since such gains and losses must be computed in accordance with Canadian tax rules as if the affiliate were resident in Canada.[77]

The new rules in section 80 concerning situations in which a debt will be considered to have been settled or forgiven are applicable for purposes of the FAPI rules. However, the new rules with respect to debt parking are not applicable to foreign affiliates.[78]

In effect, the amount of any debt forgiveness realized by a foreign affiliate reduces the affiliate's losses for the year (losses from property and inactive businesses, certain allowable capital losses, and deductible losses). Therefore, if a foreign affiliate has a debt forgiven in a year that relates to income from property or income from an inactive business but the affiliate has no losses for the year, the amount of the debt forgiveness is not included in computing its FAPI for that year. Instead, the amount of the debt forgiveness is carried forward to subsequent years to reduce the amount, if any, of the foreign affiliate's losses in those years.

Again, the operation of the new rules can be illustrated by a simple example. Assume that a controlled foreign affiliate (CFA) realizes debt forgiveness in the amount of $1,000 in its 1995 taxation year. Assume further that in the same year CFA has income from property of $600 and an allowable capital loss included in computing its FAPI in the amount of $300. CFA's FAPI for the year is $600. In other words, the $1,000 debt forgiveness offsets the amount of the $300 allowable capital loss, but the excess is not included in computing FAPI. If CFA has a loss from property of $500 in its 1996 taxation year, the balance of the debt forgiveness ($700) will offset the amount of the loss, and the remaining balance of $200 will be carried forward to a subsequent year to offset losses of CFA in those years.

The new rules with respect to debt forgiveness apply to taxation years ending after February 21, 1994.

## CONCLUSION

The general thrust of the amendments to the FAPI and foreign affiliate rules is to tighten up the rules and prevent obvious abuses. The changes are significant but not sweeping. They represent a small step in the right direction. In my opinion, however, the rules are still considerably more generous than those in other countries and require a complete overhaul.

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[77] Paragraph 95(2)(f) and regulation 5907(5).

[78] Paragraph 95(2)(g.1).