Interaction of the Foreign Affiliate Surplus and Safe-Income Regimes: Selected Anomalies, Issues, and Planning Considerations

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P R É C I S
Le gouvernement canadien a présenté, dans son budget de 2015, des modifications substantielles à l’article 55 de la Loi de l’impôt sur le revenu. Ces modifications comprennent deux nouveaux critères de l’objet qui permettent d’établir si le paragraphe 55(2) s’applique pour requalifier un dividende intersociétés autrement libre d’impôt lorsqu’il est versé par une société qui réside au Canada à une autre société résidente en tant que gain en capital qui est assujetti à l’impôt. Étant donné la large portée de ces nouveaux critères de l’objet, et de l’incertitude qu’ils créent, il sera à présent probablement plus courant pour les sociétés de se prévaloir, lorsque c’est possible, de l’exception pour revenu protégé. Ces circonstances pourraient inclure, par exemple, le paiement d’un dividende intersociétés par une filiale canadienne détenue en propriété exclusive à sa société mère. En outre, si cette filiale détient, directement ou indirectement, une ou plusieurs sociétés étrangères affiliées, il est possible que la totalité ou une partie des surplus mis en commun d’une ou de plusieurs de ces sociétés affiliées puisse faire partie intégrante, dans certaines circonstances, du calcul d’un revenu protégé. Cet article présente une comparaison des aspects fondamentaux de ces deux régimes, en mettant particulièrement l’accent sur les anomalies, les questions et les considérations de planification les plus courantes dans le contexte de leur interaction. L’analyse présentée par l’auteur montre que, bien que les deux régimes aient un objectif de calcul similaire, l’interaction des deux peut parfois être difficile et produire des résultats imprévus.

A B S T R A C T
In the 2015 budget, the Canadian government introduced sweeping amendments to section 55 of the Income Tax Act. These amendments include two new purpose tests that apply in determining whether subsection 55(2) applies to recharacterize an otherwise “tax-free” intercorporate dividend paid between two Canadian-resident corporations as

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a capital gain that is subject to tax. Given the broad scope of, and the uncertainty arising from, these new purpose tests, it will now likely be more common for corporations to, where possible, rely on the safe-income exception. These circumstances could include, for example, the payment of an intercompany dividend by a wholly owned Canadian subsidiary to its parent company. Furthermore, if that subsidiary owns, directly or indirectly, one or more foreign affiliates, it is possible that all or a portion of the surplus pools of one or more of those affiliates could, in certain circumstances, form an integral part of a safe-income calculation. This article provides a comparison of the fundamental aspects of these two regimes, with a particular focus on some of the more commonly encountered anomalies, issues, and planning considerations that can arise in the context of their interaction. The analysis presented by the author shows that, although the two regimes have a similar computational objective, the interplay between them can at times be uneasy and can give rise to unexpected results.

**KEYWORDS:** FOREIGN AFFILIATES ■ SURPLUS ■ SAFE INCOME ■ DIVIDENDS ■ AMENDMENTS ■ SURPLUS STRIPPING

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In the 2015 budget, the Canadian government introduced sweeping amendments to section 55 of the Income Tax Act.\(^1\) After a lengthy consultation period, a modified version of those amendments was enacted on June 21, 2016 as part of Bill C-15.\(^2\) The amendments, which apply to dividends received after April 20, 2015, include two new purpose tests\(^3\) that apply in determining whether subsection 55(2) applies to a particular dividend received by a corporation.

Subsection 55(2) is an anti-avoidance rule that, if applicable, can recharacterize an otherwise “tax-free” intercorporate dividend paid between two Canadian-resident corporations as a capital gain that is subject to tax. As was the case under the former version of subsection 55(2), it is still possible in certain circumstances to avoid the potential application of subsection 55(2) to a particular dividend if that dividend does not exceed the “safe income” of any relevant corporation.

Given the broad scope of, and the uncertainty arising from, the two new purpose tests, it will now likely be more common for corporations to rely, where possible, on the safe-income exception—even in circumstances where no disposition of shares is expected to occur. These circumstances could include, for example, the payment of an intercompany dividend by a wholly owned Canadian subsidiary to its parent company. Furthermore, if that subsidiary owns, directly or indirectly, one or more foreign affiliates,\(^4\) it is possible that all or a portion of the surplus pools\(^5\) of one or more of those affiliates could, in certain circumstances, form an integral part of a safe-income calculation. Alternatively, if a foreign affiliate is itself a shareholder of a taxable Canadian corporation\(^6\) or of a corporation resident in Canada,\(^7\) the concept of safe income could also be relevant for the purposes of determining the treatment of a

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1. RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Canada, Department of Finance, 2015 Budget, April 21, 2015. Unless otherwise stated, statutory references in this article are to the Act.
2. Budget Implementation Act, 2016, No. 1; SC 2016, c. 7. See, for example, amended subsections 55(2) to (2.5) of the Act.
4. As defined in subsection 95(1). In general terms, a non-resident corporation is a foreign affiliate of a Canadian-resident taxpayer if the taxpayer’s equity percentage in the corporation is not less than 1 percent and the total equity percentage in the corporation owned by the taxpayer and each person related to the taxpayer is not less than 10 percent.
5. A corporation resident in Canada is generally required to maintain exempt surplus (or deficit), hybrid surplus (or deficit), taxable surplus (or deficit), hybrid underlying tax, and underlying foreign tax pools for each of its foreign affiliates (herein collectively referred to as “surplus pools”).
6. As defined in subsection 248(1).
7. For ease of reference and except as otherwise noted, in the text that follows a “taxable Canadian corporation” and a “corporation resident in Canada” may also be referred to as a “Canadian corporation.”
dividend that is received by the affiliate from such a corporation in computing the affiliate’s foreign accrual property income\(^8\) (FAPI) and surplus pools.

The amendments to section 55 have been discussed at length in other papers,\(^9\) as have the safe-income and foreign affiliate surplus regimes.\(^10\) Accordingly, this article will not undertake a detailed analysis of those amendments or regimes, or the legislative and policy considerations related to them.

The interaction between the safe-income and foreign affiliate surplus regimes has also been considered, to some extent, in other papers.\(^11\) However, given the increasing importance of the computation of safe income in light of the recent amendments to section 55, the interaction of the two regimes has become correspondingly more important. Thus, the purpose of this article is to provide a closer

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\(^8\) As defined in subsection 95(1). FAPI of a foreign affiliate includes, among other things, “income from property” as defined in subsection 95(1) (for example, dividends, interest, rents, royalties, etc., depending on the facts and circumstances); business income that is deemed under subsection 95(2) to be income from a business other than an active business (and consequently FAPI); and, very generally, taxable capital gains from the disposition of property that does not constitute “excluded property” (as defined in subsection 95(1)). In computing taxable income for a particular taxation year, a taxpayer resident in Canada is required under subsection 91(1) to include its participating percentage (as defined in subsection 95(1)) of the FAPI earned by each of its controlled foreign affiliates.


and more comprehensive comparison of the fundamental aspects of these regimes, with a particular focus on some of the more commonly encountered anomalies, issues, and planning considerations that can arise in the context of their interaction. The analysis presented in this article will show that, although the two regimes have a similar computational objective, the interplay between them can at times be uneasy and can give rise to unexpected results.

To set the stage for the discussion that follows, I first provide a brief history of each of the foreign affiliate surplus and safe-income regimes before diving into overviews of certain relevant aspects of the recent amendments to section 55 and the skeletal frameworks of the two regimes. Next, I highlight some of the key similarities and differences between these regimes and subsequently focus on certain anomalies, issues, and planning considerations that can arise from their interaction. Finally, I attempt to decipher the reasons behind the stark difference in the approach taken in the drafting of each of these regimes, before turning to the question of whether the time has finally come not only to have a detailed set of mechanical rules for the computation of safe income but also to more fully harmonize the two regimes.

HISTORICAL OVERVIEW OF THE FOREIGN AFFILIATE SURPLUS AND SAFE-INCOME REGIMES

In trying to understand the differences in, and the legislators’ approach to, the foreign affiliate surplus and safe-income regimes, it is informative to look to the past.

Foreign Affiliate Surplus Regime

In the years leading up to 1972, the taxation of dividends received by a Canadian corporation from a foreign subsidiary was remarkably simple. That is, a dividend, regardless of the nature of the subsidiary’s underlying earnings, was generally received by the corporation entirely free of Canadian tax, by virtue of an offsetting deduction,\(^\text{12}\) provided that certain basic tests of share ownership were met.

The policy rationale behind permitting such dividends to be received free of tax appears to have been primarily to achieve simplification. The ability to simply claim an offsetting deduction against a dividend that is included in computing the Canadian corporation’s income, regardless of the quantum of foreign tax that was paid in respect of the underlying earnings of the foreign subsidiary, is clearly straightforward for both taxpayer compliance and administration by the Canadian tax authorities.

In designing the Canadian taxation of such dividend income in a manner that favours simplicity over complexity, it is likely that the government of the day decided to arbitrarily presuppose that the quantum of taxes paid by a foreign subsidiary in the course of earning its income available for distribution would generally approximate the Canadian corporate tax rate. The rationale implicit in such an approach was likely that the granting of foreign tax credits to a Canadian corporation to offset

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the Canadian tax otherwise payable in respect of a dividend received from a foreign subsidiary could result in significant complexity for taxpayers and the Canadian tax authorities alike, with little, if any, additional Canadian income tax likely being payable at the end of the day.

The cost of such simplicity was that there were large gaps in the system that could be exploited, particularly where a foreign subsidiary earned income through a low-tax jurisdiction. Furthermore, Canada’s approach to the taxation of such dividends was perceived as being out of line with, or overly favourable as compared with, the approach being taken by other countries. At the time, it was not uncommon for countries to tax a dividend received by a domestic corporation from a foreign subsidiary and grant a deduction or credit for any underlying foreign tax paid in respect of such dividend.

In recommending the repeal of the exemption system that existed prior to 1972 for dividends received by a Canadian corporation from a foreign subsidiary, as part of an overall objective of promoting neutrality in the Canadian tax system, the 1967 report of the Carter commission stated:

It is apparent that within the Canadian treatment of foreign source business income may be found the two classical extremes of allowance for foreign taxation. One provides for the full, accurate and precise measurement of the foreign income and tax liability, with a precisely computed credit against Canadian tax. The other grants an exemption from tax under conditions very easily met. The United States and the United Kingdom have followed the first method both for branch income and direct investment income, and no provision comparable to section 28(1)(d) of the Income Tax Act may be found in the tax system of either country. There are some examples of exemption of foreign dividends to be found in other countries, but Canada is virtually unique in its adoption of a provision as sweeping as section 28(1)(d). Its origins and effects are therefore of considerable interest.

The exemption contained in section 28(1)(d) appears to have had as its original purpose the achievement of an equitable and administratively simple alternative to the complexities of the gross-up and credit procedure. At the time of its introduction in 1949, the bulk of Canadian foreign source income originated in countries having corporation taxes as high as the Canadian, mainly the United States and the United Kingdom. The effect of this section was undoubtedly to provide directly for the virtual exemption of foreign source income from Canadian tax which was the end result of the complicated gross-up and tax credit procedure previously in force. Its origins in section 4(r) and subsections (2A) and (2B) of section 8 of the Income War Tax Act are clearly discernible, and the fact that both of these sections were repealed in 1949 on the enactment of section 27(1)(d) (now section 28(1)(d)) supports the conclusion that, initially, the provision was looked on mainly as a device for administrative simplification. At first the ownership requirement was 50 per cent or more but in 1951, following the recommendation of the Advisory Committee on Overseas Investment, the ownership test was reduced to its present 25 per cent as a means of encouraging foreign investment by Canadians. It has since remained at that level.

One result of these provisions is that the Canadian taxpayer has enjoyed a much greater simplicity and ease of calculation for foreign income than his United States or
United Kingdom counterparts. The tax minimization possibilities of the exemption privilege, in combination with the use of foreign tax havens, have not gone unnoticed. The provision can be used to reduce Canadian tax on income generated in Canada for the benefit of Canadians. By establishing companies in jurisdictions which impose little or no tax, Canadians can reduce their Canadian tax by engaging in a series of paper transactions which exploit the provisions of tax treaties in combination with section 28(1)(d).

There is also evidence that the provision has offered the possibility to use Canada itself as a tax haven for international business. Data compiled for us by the Taxation Division show that over a period of years a very substantial part of the dividends reported under this section has originated in jurisdictions imposing little or no tax, and that a very high proportion of these dividends has been received in Canada by holding companies not having a substantial Canadian economic interest but representing for the most part foreign ownership. Of a total of $1,500 million received by all Canadian corporations (including those that were owned by non-residents) in the five years from 1957 to 1961, only 10 per cent came from the United States and 4 per cent from the United Kingdom.

The defects of the present section 28(1)(d) are obvious, and we therefore recommend its repeal.13

Much of the analysis underlying the recommendations of the Carter report was considered by the Department of Finance in its 1969 white paper.14 The white paper also contained various proposals to reform Canada’s international tax system, and it is in those proposals that one can see the beginnings of the foreign affiliate system that is in place today.15

After the release of the Carter report and the white paper, an extensive tax reform process followed in the early and mid-1970s and ultimately culminated in a complete redesign of Canada’s approach to the taxation of income earned by, and dividends received from, a foreign subsidiary of a Canadian corporation. As part of this redesign, the regulations dealing with the computation of foreign affiliate surplus were finalized in 1976. Although there have been many amendments to these regulations over the years, the framework for the computation of foreign affiliate surplus remains largely the same as it was when the regime first came into existence.

As evidenced by chapter 26 of the Carter report (from which the extract above is taken), the white paper, and the extensive tax reform process, it is clear that a great deal of time and effort was spent in designing the foreign affiliate surplus regime that exists today. Furthermore, the manner in which the legislators designed the

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14 E.J. Benson, Proposals for Tax Reform (Ottawa: Department of Finance, 1969) (herein referred to as “the white paper”).

regime, and its detailed framework, is such that the underlying policy objectives are quite clear. What is not so clear, as a matter of interest, is why the legislators decided to place the rules for computing foreign affiliate surplus pools in the regulations, as opposed to the Act itself.

Presumably the primary reason for this structural approach was that the intricate and technical nature of the subject matter was such that it was best served by locating the surplus regime in the regulations. After all, it is commonly believed that the main difference between a provision in the Act and a provision in the regulations is that the latter, by virtue of not always requiring passage by Parliament, can be amended frequently and on a fast-track basis.

Nevertheless, in recent years many substantive additions (or amendments) to regulations, particularly those that relate to the foreign affiliate surplus regime, have been passed by Parliament as part of a bill. So common has this become, and given the confusion that can arise from following two methods to pass regulations, at least one author has questioned whether the concept of regulations is outdated.16

### Safe-Income Regime

Whereas the government legislated a detailed framework for the computation of foreign affiliate surplus, such was not the case for safe income, even though the latter regime was enacted almost five years after the foreign affiliate surplus regime. In enacting subsection 55(2) and ultimately the concept of safe income in 1981, the government decided not to legislate a detailed set of mechanical rules for the computation of safe income. In other words, the legislators deliberately chose not to use the foreign affiliate surplus regime as a precedent model in enacting the concept of safe income. To try to understand why the legislators decided to adopt a far less prescriptive approach for the determination of safe income, and perhaps why such an approach continues to this day, it is helpful to understand the evolution of the corporate tax system in Canada and in particular the historical tug-of-war involving the taxation of capital gains and dividends.

Prior to 1972, capital gains were not subject to tax. Accordingly, an individual was not taxed on a capital gain realized on a disposition of shares of a Canadian corporation. In contrast, and unlike an intercorporate dividend paid by one Canadian corporation to another, a dividend received by an individual from a Canadian corporation was generally taxable, although starting in 1949 a dividend tax credit was available to partially offset the tax otherwise payable on such a dividend.

Given the preferential tax treatment of a capital gain as compared with a dividend, there was an inherent incentive in the tax system for individuals to try to convert what would otherwise be a taxable dividend into a tax-free capital gain. It was therefore not uncommon for taxpayers to engage in so-called surplus-stripping transactions that attempted to convert undistributed surplus (that is, retained earnings) of a Canadian corporation into a capital gain. Surplus-stripping transactions

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were structured in a variety of ways, some of which involved surplus of one corporation being extracted to another via a tax-free intercorporate dividend.

To combat surplus stripping, the government introduced various specific measures that were targeted at certain types of transactions. These measures included, for example, rules that deemed a shareholder to have received a dividend where certain types of reorganizations or transactions involving the shares of a corporation occurred at a time when that corporation had undistributed surplus. Another measure was the introduction of the concept of designated surplus.

In general terms, designated surplus included undistributed surplus of a corporation at the time that control of the corporation was acquired by another corporation. If a dividend was considered to have been paid out of a corporation's designated surplus to another corporation, that dividend was not eligible for the intercorporate dividend exemption and thus was taxable to the recipient. In addition, tax was generally imposed on a dividend that was paid by a corporation out of designated surplus to a non-resident corporation or a tax-exempt person.

Given their narrow application, these specific anti-surplus-stripping measures had only limited effect in curbing surplus-stripping transactions. As a result, in 1963 the government enacted a new targeted anti-avoidance rule in the form of section 138A(1) of the former Act. Although this anti-avoidance measure seemed to be more effective in combating surplus stripping, concerns were raised by taxpayers regarding the uncertainty that arose from this vaguely worded measure.

In a review of Canada's system of corporate taxation, chapter 19 of the Carter report\(^7\) highlighted numerous significant defects and made various recommendations for reform. Those recommendations included the introduction of an integrated tax system, which would achieve full integration of personal and corporate income taxes. As part of such a tax system, and because the favourable treatment of capital gains encouraged surplus-stripping transactions, the Carter report also recommended that capital gains be taxed.

After the publication of the Carter report and the subsequent release of the government's white paper, the stage was set for significant changes to the Canadian tax system. The resulting tax reform ultimately included far-reaching changes to the taxation of shareholders and corporations, starting in 1972, particularly in respect of the taxation of dividends and capital gains.

After tax reform, the general rule was that any distribution made by a corporation would be treated as a taxable dividend to the recipient. There were, however, a number of important exceptions. For example, intercorporate dividends generally continued to be received tax-free. Also, a shareholder could now access the paid-up capital of the shares of a corporation on a tax-free basis. Similarly, if a corporation followed certain procedures to treat a distribution as having been paid out of its "1971 undistributed income on hand" or its "1971 capital surplus on hand,"\(^8\) that

\(^7\) Supra note 13, at 3-98.

\(^8\) See, for example, former sections 83, 89, and 196.
distribution was not taxable to the recipient, but tax was imposed on the corporation in respect of a distribution that was paid out of the first of these two pools. As in the case of a distribution of paid-up capital, the price for receiving a distribution from one of these pools was that the adjusted cost base of the shares of the corporation held by the shareholder(s) was reduced by the amount of the distribution.

In addition to changes to the taxation of dividends, capital gains were also now taxable. However, since the capital gains inclusion rate was only 50 percent whereas dividends received by non-corporate shareholders were fully taxable, the government also made some other significant supporting changes in a continued effort to combat surplus stripping.

In particular, a decision was made not only to retain the concept of designated surplus, but also to strengthen it. Instead of taxing a corporation on the receipt of a dividend that was paid out of designated surplus, such a dividend was now deductible in computing the income of the corporate recipient but was subject to tax at a rate of 25 percent.19 As a backstop measure, the targeted anti-avoidance rule in section 138A(1) of the former Act was retained but moved to subsection 247(1). Also, section 84 was introduced to deem an amount to be a dividend, as opposed to a capital gain, in certain situations involving a redemption of shares, a reduction of share capital, or the liquidation of a corporation.

After the Act was amended to tax post-1971 capital gains, taxpayers turned their attention to ways of structuring their affairs so as to minimize the amount of tax otherwise payable on capital gains. In other words, tax reform ultimately effected a change in the behaviour of taxpayers whereby the focus gradually shifted from surplus stripping (that is, the conversion of taxable dividends otherwise receivable by individuals into capital gains that were either not taxed or taxed at preferential rates) to capital gains stripping (that is, the conversion of capital gains into tax-free intercorporate dividends).

Prior to 1981, there were limited legislative measures in place to discourage capital-gains-stripping transactions. The primary tool to combat these types of transactions was a broadly worded anti-avoidance rule found in a former version of section 55. That rule, which was introduced as part of the tax reform in 1971, applied where a taxpayer disposed of property in circumstances whereby the taxpayer may reasonably be considered to have artificially or unduly reduced the amount of the capital gain otherwise arising from the disposition.

Given the lack of a detailed legislative framework for the application of section 55, in the late 1970s Revenue Canada, the predecessor to the Canada Revenue Agency (CRA), started developing and publishing its own views as to what constituted an artificial or undue reduction of a capital gain. Some of these views or administrative practices, commonly referred to as “the Robertson guidelines,” were outlined in two papers written by J.R. Robertson, then director of the Rulings Division of Revenue Canada, and published in 1978 and 1979 by the Canadian Tax

19 The concept of designated surplus was ultimately repealed for dividends paid or received after March 31, 1977.
Foundation (CTF). It is in the Robertson guidelines that one can see the beginnings of the safe-income regime that exists today, as is evident in the following statement:

In general terms the Department considers that the capital gain should not be less than the increase in the value of the shares reasonably attributable to unrealized or untaxed appreciation in goodwill and other assets after 1971. Therefore, the above transactions would be viewed as unduly reducing the gain if the dividends exceed the amount of Opco’s retained taxed earnings.

Owing to limited success in using existing tools to combat capital-gains-stripping transactions, in 1981 the government enacted new legislation, which included the original version of subsection 55(2), to try to more adequately counter these types of transactions. Although this legislation bore some similarity to the Robertson guidelines, there were also some significant differences. However, in enacting subsection 55(2) and the related provisions, the government deliberately chose not to legislate a comprehensive set of mechanical rules defining how safe income was to be calculated.

In the absence of a detailed legislative framework, the calculation of safe income came to be developed largely through administrative practice. One of the earliest examples of these administrative practices was the publication of the so-called Robertson rules presented at the CTF’s 1981 annual conference. So much has the determination of safe income relied upon administrative practice that one author has remarked that “over the years, these administrative practices have taken on statute-like authority, being in large measure accepted by the tax community as a practical set of rules and guidelines to address issues related to the computation of safe income.”

So why did the government decide not to legislate a detailed definition for the computation of safe income, and why does that approach continue to this day? Before attempting to answer these questions, and the question of whether it is time to reconsider the government’s decision, it is perhaps helpful to first understand the impact of the recent amendments to subsection 55(2) on the relevance of the safe-income and foreign affiliate surplus regimes, as well as some of the similarities and differences between these regimes.


22 See Brender, supra note 10, at 12:7-8.


24 Brender, supra note 10, abstract.
OVERVIEW OF THE SECTION 55 AMENDMENTS, AND THE COMPUTATION OF SAFE INCOME

The recent amendments to section 55 included, but were not limited to, the restructuring of subsection 55(2) into two provisions (subsections 55(2) and (2.1)) and the addition of two new purpose tests in subparagraph 55(2.1)(b)(ii).

In general, where either of these two new purpose tests is satisfied and none of the exceptions in subsection 55(2) is available, subsection 55(2) will apply with the result that an otherwise “tax-free”25 intercorporate dividend26 received by a corporation resident in Canada as part of a transaction or event, or a series of transactions or events, will be treated as a capital gain. The new purpose tests are satisfied where one of the purposes of the payment or receipt of the dividend is to effect either a significant reduction in the fair market value of any share or a significant increase in the total cost of properties of the recipient of the dividend. As a result, it is no longer as clear as it might have been in the past that a corporation resident in Canada can claim an offsetting deduction under subsection 112(1) or (2) (or subsection 138(6)) in respect of a taxable dividend received by it from another corporation resident in Canada, a taxable Canadian corporation, or a non-resident corporation described in subsection 112(2), as the case may be, including a taxable dividend received from a wholly owned subsidiary of the recipient corporation.

The safe-income exception is one of the potential exceptions to the application of subsection 55(2). Whether this exception is available in respect of a particular dividend will ultimately depend upon the particular facts. In this regard, the safe-income exception essentially has two requirements.27 First, the amount of the dividend cannot exceed the amount of the income earned or realized by any corporation, after 1971 and before the “safe-income determination time”28 for the transaction or event, or series of transactions or events (herein referred to as “safe income”). Second, that safe income must reasonably be considered to contribute to the capital gain that could be realized on a disposition at fair market value, immediately before the dividend, of the share on which the dividend was received.29

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25 By virtue of the ability of the corporate recipient of the dividend to claim an offsetting deduction under subsection 112(1) or (2), or subsection 138(6).
26 Other than, pursuant to the carve-out in subparagraph 55(2.1)(b)(ii), a dividend that is received on a redemption, acquisition, or cancellation of a share, by the corporation that issued the share, to which subsection 84(2) or (3) applies.
27 Paragraph 55(2.1)(c).
28 As defined in subsection 55(1).
29 The concept of safe income is generally thought of as the “income earned or realized” by the corporation during the relevant holding period, as determined under subsection 55(5). In contrast, the concept of safe income on hand is generally interpreted as the portion of the income earned or realized by the corporation during the relevant period that could reasonably be considered to contribute to the capital gain that would be realized on a disposition of the particular share. As a result, certain adjustments must be made to safe income to reflect the
Although it is not the purpose of this article to undertake a detailed analysis of the various issues and considerations associated with the computation of safe income (or the determination of the availability of the safe-income exception), the following points are particularly relevant for the purposes of providing context for the discussion that follows:

1. Subject to certain limitations (in particular those in paragraph 55(2.1)(c) and subsection 55(5)), for the purposes of the safe-income exception, safe income potentially includes that of the dividend payer as well as that of any corporation, domestic or foreign, in respect of which the payer is a direct or indirect shareholder.\[30\]

2. Subsection 55(5) is the starting point for determining safe income. However, the computation of safe income is also based on a significant amount of jurisprudence, as well as published administrative views of the CRA.

3. Depending on the facts, the safe-income determination time may not always be clear or obvious. More specifically, the definition of “safe-income determination time” is such that it can be triggered by the payment of a dividend as part of a series of transactions. For example, the safe-income determination time is the time immediately before the payment of the first dividend that is paid as part of a series of transactions, as opposed to the time immediately before the payment of a dividend that occurs later in the series. In the context of whether annual recurring dividends could be viewed as part of a series, the CRA stated the following at the Tax Executives Institute—CRA liaison meeting held on November 15, 2016:

   In a recent ruling, the CRA took the view that regular, recurring annual dividends would not, in the circumstances of the ruling request, be part of a series of transactions. Accordingly, a ruling confirmed that the safe income determination time in respect of the first and second annual dividends will be immediately before each such dividend.\[31\]

4. Even if it can be established that there is sufficient safe income at the safe-income determination time, the safe-income exception may not always be available. For example, assuming that it is determined that one of the purpose tests in paragraph 55(2.1)(b) applies to a particular dividend, the exception is not available if

\[30\] In particular, paragraph 55(2.1)(c) refers to the amount of the income earned or realized by “any” corporation.

\[31\] CRA document no. 2016-0672321C6, November 15, 2016.
a. there is no capital gain on the share on which the dividend was paid, including, for instance, where there is an accrued loss on the share or its fair market value is equal to the adjusted cost base\(^\text{32}\) of that share; or
b. the safe income cannot reasonably be considered to contribute to the capital gain that could otherwise be realized on a disposition at fair market value, immediately before the payment of the dividend, of the share on which the dividend was received.\(^\text{33}\)

5. If a dividend received by a corporation exceeds the safe income of the dividend-paying corporation at the safe-income determination time, on the surface it appears that the entire dividend may potentially be recharacterized as a capital gain under subsection 55(2). Under the former version of paragraph 55(5)(f), the recipient corporation was provided with the discretion to designate any portion of the dividend as a separate taxable dividend. By making such a designation, the recipient corporation could ensure that the portion of the dividend equal to safe income was not recharacterized as a capital gain under subsection 55(2). As a consequence of the amendments to section 55, paragraph 55(5)(f) now applies automatically so that the portion of a dividend that is considered to have been paid out of safe income will be treated as a separate dividend without the need for the recipient corporation to make a designation.

OVERVIEW OF THE COMPUTATION OF FOREIGN AFFILIATE SURPLUS POOLS

Although it is not the purpose of this article to undertake a detailed analysis of the various issues and considerations associated with the computation of the surplus pools of a foreign affiliate, the following points are particularly relevant for the purposes of providing context for the discussion that follows:

1. A corporation resident in Canada is generally required to maintain separate exempt surplus (deficit), hybrid surplus (deficit), taxable surplus (deficit), hybrid underlying tax, and underlying foreign tax pools (herein collectively referred to as “surplus pools”) for each of its foreign affiliates. These pools are computed in accordance with part LIX of the regulations. The computation involves a complex interaction of Canadian and foreign tax principles.
2. Although a detailed discussion of the components of the surplus pools of a foreign affiliate is beyond the scope of this article, the following is a non-exhaustive, layman’s summary of the primary components of a foreign affiliate’s surplus (deficit) pools:

\(^{32}\) As defined in subsection 248(1).

\(^{33}\) Paragraph 55(2.1)(c).
a. Exempt surplus (deficit)\textsuperscript{34} of a foreign affiliate includes, among other things,
   i. earnings\textsuperscript{35} from an active business where the affiliate is a resident of a designated treaty country\textsuperscript{36} and those earnings are considered to be attributable to activities occurring in such a country;
   ii. the non-taxable portion of any capital gains (losses) as well as the taxable portion of any capital gains (losses) arising on a disposition by the affiliate of excluded property,\textsuperscript{37} other than any capital gains (losses) that are included in computing the affiliate’s hybrid surplus (deficit);\textsuperscript{38} and
   iii. exempt surplus dividends received from another foreign affiliate of the corporation.

b. Hybrid surplus (deficit) of a foreign affiliate includes, among other things,
   i. gains or losses of the affiliate from certain dispositions of partnership interests and shares of another foreign affiliate of the taxpayer; and
   ii. hybrid surplus dividends received from another foreign affiliate of the corporation.

c. Taxable surplus (deficit)\textsuperscript{39} of a foreign affiliate includes, among other things,
   i. earnings from an active business where the affiliate is not a resident of a designated treaty country and/or such earnings are not considered to be attributable to activities occurring in such a country;
   ii. FAPI;
   iii. the taxable portion of any capital gains (losses) arising on a disposition by the affiliate of property that is not excluded property; and
   iv. taxable surplus dividends received from another foreign affiliate of the corporation.

d. Hybrid underlying tax\textsuperscript{40} includes the portion of any income or profits tax paid to a government of a country by the affiliate that can reasonably be regarded as having been paid in respect of an amount that is included in computing the affiliate’s hybrid surplus.

e. Underlying foreign tax\textsuperscript{41} includes the portion of any income or profits tax paid to a government of a country by the affiliate that can reasonably be

\textsuperscript{34} As defined in regulation 5907(1).
\textsuperscript{35} As defined in regulation 5907(1).
\textsuperscript{36} As defined in regulations 5907(11) through (11.2).
\textsuperscript{37} As defined in subsection 95(1).
\textsuperscript{38} As defined in regulation 5907(1).
\textsuperscript{39} As defined in regulation 5907(1).
\textsuperscript{40} As defined in regulation 5907(1).
\textsuperscript{41} As defined in regulation 5907(1).
regarded as having been paid in respect of an amount that is included in computing the affiliate's taxable surplus.

3. Surplus pools are relevant in characterizing a dividend paid by a foreign affiliate of a corporation resident in Canada, including the determination of a deduction that may be claimed by that corporation under subsection 113(1) in respect of such a dividend so received.42

4. Subject to the potential application of the so-called 90-day rule,43 the characterization of a dividend paid by a foreign affiliate is based on the surplus pools of that affiliate at the time of payment. For these purposes, the exempt surplus (deficit), taxable surplus (deficit), and underlying foreign tax pools of a foreign affiliate at a particular time only includes earnings (losses) and income taxes paid in respect of taxation years of a foreign affiliate that ended before that time. In contrast, amounts are added to, or deducted from, the hybrid surplus (deficit) and hybrid underlying tax of a foreign affiliate at a point in time and without regard to completed taxation years of the foreign affiliate.

5. Subject to certain potential elective mechanisms,44 the characterization of a dividend paid by a foreign affiliate45 is generally determined by an ordering rule that takes into account any deficit that the affiliate may have in any of its surplus pools.46 A dividend paid by a foreign affiliate is typically deemed to have been first paid out of the affiliate’s available exempt surplus, if any, at the time of payment.47 If the amount of the dividend exceeds the affiliate’s

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42 Surplus pools are also potentially relevant in determining the Canadian tax consequences that arise on a disposition of foreign affiliate shares. Section 93 effectively permits, in certain circumstances, all or a portion of a taxable capital gain otherwise realized by a Canadian corporation or another foreign affiliate of the Canadian corporation (and in certain cases, a partnership) on a disposition of shares of a foreign affiliate to instead be treated as a dividend (which is potentially eligible for an offsetting deduction under section 113). The application of section 93 is elective where a Canadian corporation disposes of shares of a foreign affiliate, but is automatic in the case where one foreign affiliate of a Canadian corporation disposes of shares of another affiliate and the vendor affiliate otherwise recognizes a gain in respect of that disposition.

43 Regulation 5901(2)(a).

44 See, for example, subsection 90(3), regulation 5901(1.1), and regulation 5901(2)(b).

45 In general, for the purposes of the Act, an amount is deemed under subsection 90(2) to be a dividend paid or received, as the case may be, on a share of a class of the capital stock of a foreign affiliate of a taxpayer if that amount was paid pro rata on all of the shares of that class that were issued and outstanding at the time of the distribution and that distribution did not involve a redemption, acquisition, or cancellation of any of the issued and outstanding shares of the affiliate.

46 Regulation 5901(1).

47 Regulation 5901(1)(a). For this purpose, the amount of the whole dividend (as defined in regulation 5907(1)) considered to have been paid from exempt surplus is the lesser of (1) the amount of the whole dividend and (2) the amount by which the affiliate’s exempt surplus exceeds the total of the affiliate’s hybrid and taxable deficits (if any).
available exempt surplus, the excess is considered to have been paid out of the affiliate’s available hybrid surplus, if any, at the time of payment.\textsuperscript{48} If the amount of the dividend exceeds the total of the affiliate’s available exempt and hybrid surplus, the excess is considered to have been paid out of the affiliate’s available taxable surplus, if any, at the time of payment.\textsuperscript{49} To the extent that a dividend exceeds the total of a foreign affiliate’s available exempt, hybrid, and taxable surplus pools, the excess is deemed to have been paid out of “preacquisition” surplus.\textsuperscript{50} 

6. Preacquisition surplus is not defined in the Act or the regulations. It is a notional account for which no calculations are maintained. Conceptually, preacquisition surplus represents not only the shareholder’s investment in the shares of the affiliate, but also the shareholder’s accrued gain in respect of those shares to the extent that such gain is not otherwise reflected, for one reason or another, in the underlying exempt, hybrid, and/or taxable surplus pools of the affiliate.

**CONCEPTUAL COMPARISON OF THE FOREIGN AFFILIATE SURPLUS AND SAFE-INCOME REGIMES**

From a purely theoretical perspective, the safe-income and foreign affiliate surplus regimes share a similar computational objective: to determine, or reflect, the earnings of a particular corporation that are available for distribution to the corporation’s shareholders. However, as might be expected, there are many potentially significant differences in the computation mechanics that apply under the two regimes. Table 1 attempts to highlight, on a conceptual basis, some of the similarities and differences between the frameworks of these regimes.

\textsuperscript{48} Regulation 5901(1)(a.1). For this purpose, the amount of the whole dividend considered to have been paid from hybrid surplus is limited to the lesser of (1) the amount by which the whole dividend exceeds the portion of the dividend that was considered to have been paid out of the exempt surplus of the affiliate and (2) the amount by which the affiliate’s hybrid surplus exceeds the affiliate’s exempt deficit and/or taxable deficit (except to the extent that such taxable deficit is not otherwise offset by the exempt surplus, if any, of the affiliate at that time).

\textsuperscript{49} Regulation 5901(1)(b). For this purpose, the amount of the whole dividend considered to have been paid from taxable surplus is limited to the lesser of (1) the amount by which the whole dividend exceeds the portion of the dividend that was considered to have been paid out of the exempt and/or hybrid surplus pools of the affiliate and (2) the amount by which the affiliate’s taxable surplus exceeds the affiliate’s exempt deficit and/or hybrid deficit (except to the extent that any such deficit is not otherwise offset by the exempt or hybrid surplus, if any, of the affiliate at that time).

\textsuperscript{50} Regulation 5901(1)(c).
TABLE 1 Comparison of the Safe-Income and Foreign Affiliate Surplus Regimes

<table>
<thead>
<tr>
<th>Key attribute</th>
<th>Safe-income regimea</th>
<th>Foreign affiliate surplus regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary purpose</td>
<td>Exception to the anti-avoidance rule in subsection 55(2).</td>
<td>Characterization of a dividend paid by, or potentially the conversion (under section 93) into a dividend of all or a portion of the proceeds of disposition, and ultimately a capital gain, otherwise arising on a disposition of shares of, a foreign affiliate of a corporation resident in Canada.</td>
</tr>
<tr>
<td>Elective versus automatic application to a particular dividend</td>
<td>Generally automatic to the extent of safe income.b</td>
<td>Generally automatic, subject to certain elective mechanisms.c</td>
</tr>
<tr>
<td>Restrictions on ability to access</td>
<td>Safe income is computed in respect of a particular share, and, subject to considerations that could arise where there is more than one class of issued and outstanding shares,d generally accrues on a pro rata basis.e The safe-income exception is not, however, available in respect of a particular dividend if (1) there is no capital gain on the share on which the dividend was paid, or (2) the safe income cannot reasonably be considered to contribute to the capital gain that could otherwise be realized on a disposition at fair market value, immediately before the dividend, of the share on which the dividend was received.f</td>
<td>Except where section 93 applies to convert into a dividend all or a portion of the proceeds of disposition, and ultimately a capital gain, otherwise arising on a disposition of the shares of a foreign affiliate, the ability of a Canadian corporate taxpayer to access surplus pools of the affiliate for the purposes of characterizing a dividend paid by that affiliate is not necessarily restricted to the taxpayer’s proportionate “share” of those pools (as determined on the basis of the taxpayer’s surplus entitlement percentage or some other basis). For the purposes of characterizing a dividend that is paid on a particular share of a foreign affiliate of a Canadian corporate taxpayer, there is no requirement that the surplus pools of the affiliate must reasonably be considered to be attributable to a gain in respect of the share.</td>
</tr>
</tbody>
</table>

(Table 1 is continued on the next page.)
### TABLE 1  Continued

<table>
<thead>
<tr>
<th>Key attribute</th>
<th>Safe-income regime</th>
<th>Foreign affiliate surplus regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated versus single-entity approach</td>
<td>Generally computed on a consolidated basis (that is, includes safe income of the dividend payer and potentially that of any corporation, domestic or foreign, in respect of which the payer is a direct or indirect shareholder). In contrast to the foreign affiliate surplus regime, there is no explicit ownership threshold that must be met in order for a particular corporation’s safe income to be potentially eligible for inclusion.</td>
<td>Computed on a foreign-affiliate-by-foreign-affiliate basis, except where section 93 is applicable to deem all or a portion of the proceeds of disposition, and ultimately a capital gain, otherwise arising in respect of a foreign affiliate share to be a dividend.</td>
</tr>
<tr>
<td>Computation period (subject to comments below regarding the inclusion of stub-period earnings)</td>
<td>Determined on a share-by-share basis and generally limited to the income earned or realized by the corporation and its subsidiaries during the period throughout which the particular shareholder owned the particular share (except potentially where the share is acquired in a rollover transaction), and ending with the safe-income determination time.</td>
<td>Subject to certain rollover provisions and/or certain changes in the surplus entitlement percentage of the Canadian corporate taxpayer in respect of the foreign affiliate, restricted to the period that begins with the first day of the taxation year of the affiliate in which it last became a foreign affiliate of the taxpayer and that ends at a particular time.</td>
</tr>
<tr>
<td>Inclusion of stub-period earnings</td>
<td>Includes income earned or realized by a corporation up to the safe-income determination time.</td>
<td>Exempt earnings and taxable earnings are added to the respective surplus pools of the foreign affiliate only at the end of its taxation year. As a result and unless the so-called 90-day rule in regulation 5901(2)(a) is applicable in respect of a dividend that is paid by the foreign affiliate, current-year earnings of the affiliate are generally not relevant for the purposes of characterizing a dividend.</td>
</tr>
</tbody>
</table>

(Table 1 is continued on the next page.)
Income earned or realized by a corporation is generally to be determined under Canadian tax principles using division B of part I of the Act. After determining the income earned or realized by a corporation, certain adjustments (for example, reductions for taxes and dividends previously paid) are made to arrive at safe income on hand (the portion of the income earned or realized by the corporation during the relevant period that could reasonably be considered to contribute to the capital gain that would be realized on a disposition of the particular share).

Notional, or so-called phantom, income is generally included in computing the safe income of a corporation to the extent that such amounts are included in computing the corporation’s net income for tax purposes under division B of part I of the Act.

The treatment of notional income and expenses is not entirely clear in all cases, but general prevailing practice is to exclude such amounts in computing surplus pools.

Because safe income is computed on a consolidated basis, the deficit (loss) of a particular corporation is generally relevant in computing the safe income in the shares of the dividend-paying corporation.

The deficit of one affiliate is generally not relevant in computing the surplus pools of another affiliate since surplus pools are computed on a foreign-affiliate-by-foreign-affiliate basis. However, depending on where a deficit is located in a chain of affiliates, it could be relevant in certain circumstances.

(Table 1 is continued on the next page.)
TABLE 1  Continued

<table>
<thead>
<tr>
<th>Key attribute</th>
<th>Safe-income regimea</th>
<th>Foreign affiliate surplus regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency</td>
<td>Safe income is to be computed in Canadian currency, but presumably subject to any functional-currency election that has been made by a relevant corporation to compute its Canadian tax results in a different currency.v</td>
<td>The surplus pools of a foreign affiliate of a corporation resident in Canada are to be maintained on a consistent basis from year to year in the currency of the country in which the affiliate is resident, or any currency that the corporation demonstrates to be reasonable in the circumstances.w</td>
</tr>
<tr>
<td>Treatment of permanent non-deductible outlays (including taxes)</td>
<td>Generally deducted in computing safe income on hand.x</td>
<td>Subject to certain potential exceptions,y generally deducted in computing surplus pools.</td>
</tr>
</tbody>
</table>

a For a more detailed explanation of one or more of the key attributes in the context of the safe-income regime, see, for example, Duncan Osborne, “Practical Issues in Computing Safe Income,” in Report of Proceedings of the Fifty-Fourth Tax Conference, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003), 42:1-23.
b Paragraph 55(5)(f). For dividends paid before April 21, 2015, paragraph 55(5)(f) applied only to the extent that one or more designations were filed in respect of the dividend.
c Such elective mechanisms include, for example, subsections 93(1) and 90(3), and regulations 5901(1.1) and (2)(b).
d See, for example, CRA document no. 2015-0593941E5, December 3, 2015, in which the CRA commented on the allocation of safe income on hand to preferred shares that are entitled to discretionary dividends.
e The Queen v. Nassau Walnut Investments Inc., 97 DTC 5051 (FCA).
f Paragraph 55(2.1)(c).
g Ibid. Also see D & D Livestock Ltd. v. The Queen, 2013 TCC 318, at paragraph 14, and Lamont Management Ltd. v. Canada, 2000 CanLII 17131 (FCA).
h Paragraphs 55(5)(a) through (c).
j See, generally, regulation 5905, including the definition of “surplus entitlement percentage” in regulation 5905(13).
k See the preambles of the definitions of “exempt surplus,” “hybrid surplus,” “taxable surplus,” “hybrid underlying foreign tax,” and “underlying foreign tax” in regulation 5907(1).
l Paragraph 55(2.1)(c) and subsection 55(5).
m It should also be noted that the 90-day rule in regulation 5901(2)(a) is not applicable for the purposes of determining any dividend that is deemed to arise under section 93.
n Paragraphs 55(5)(b) and (c). Also see Canada v. Kruco Inc., 2003 FCA 284, and D & D Livestock Ltd., supra note g, at paragraph 11.
o Regulation 5907.
p See, for example, Kruco Inc., supra note n; Income Tax Technical News no. 33, September 16, 2005; and Income Tax Technical News no. 34, April 27, 2006.

(Table 1 is concluded on the next page.)
See, for example, CRA document no. 2000-0021965, January 9, 2001, regarding stock option expense, and CRA document no. 9709005, March 2, 1998, regarding Mexican inflationary adjustments. However, the technical basis for the CRA’s views is not clear. Alternatively, in certain circumstances, regulation 5907(2) might, directly or indirectly, require notional amounts to be excluded in computing a foreign affiliate’s earnings from an active business where those earnings are required to be computed under foreign tax principles.

There is an exception to this position where there is a deficit in the shares of a foreign affiliate and the deficit does not affect the gain or value of the dividend-paying corporation. See, for example, paragraph 55(5)(d) and *Canada v. Brelo Drilling Ltd.*., 1999 CanLII 8151 (FCA).

A detailed discussion of when a deficit of a foreign affiliate could be relevant is beyond the scope of this article. However, examples of situations that may be encountered include (1) a “blocking deficit” in a higher-tier foreign affiliate that prevents the distribution of all or a portion of the exempt (or other) surplus pool from a lower-tier affiliate to the Canadian corporate shareholder of that higher-tier affiliate; (2) certain reorganizations, such as a merger described in regulation 5905(3) or a transaction that triggers the application of the fill-the-hole rules (as described in regulation 5905(7.2)); or (3) by virtue of the consolidation mechanism in regulation 5902(1)(a), a deficit of a foreign affiliate (other than that of a foreign affiliate at the bottom of a chain of foreign affiliates) that is relevant for the purposes of a transaction that results in the application of subsection 93(1).

Subsection 261(2).

As defined in subsection 261(1).

Subsections 261(3) and (5). However, the computation of safe income in the context of a relevant functional-currency election appears to be unclear in numerous respects since section 261 (in particular, subsections 261(5) and (7)) does not make any reference to section 55. Also, where a shareholder of a particular corporation has not made a functional-currency election, but the particular corporation has, it is not entirely clear whether the CRAs views in document no. 2016-0642111C6, May 26, 2016, could apply to require the safe income of the corporation to be computed in Canadian currency, on the basis that the computation of safe income relates to the Canadian tax results of the shareholder in respect of a particular taxable dividend.

Regulation 5907(6).

See, for example, *Deuce Holdings Limited v. The Queen*, 97 DTC 921 (TCC), and *Income Tax Technical News* no. 37, February 15, 2008. Also see CRA document no. 2016-0672321C6, November 15, 2016.

In computing a foreign affiliate’s earnings from an active business, regulation 5907(2) applies to reduce those earnings for any permanently non-deductible outlays incurred by the affiliate only if those earnings are required to be computed under subparagraph (a)(i) or (ii) of the definition of “earnings” in regulation 5907(1).
INTERSECTION OF THE FOREIGN AFFILIATE SURPLUS AND SAFE-INCOME REGIMES

There are two basic scenarios in which the foreign affiliate surplus and safe-income regimes potentially intersect. One involves a “sandwich structure,” in which a foreign affiliate of a corporation resident in Canada owns shares of another Canadian corporation. The second, and by far the more common, scenario involves the typical “outbound structure,” in which a corporation resident in Canada owns shares of a foreign affiliate and that corporation is itself owned by another Canadian corporation.

Sandwich Structure

An interesting dichotomy arises within the foreign affiliate regime in a situation where a foreign affiliate of a corporation resident in Canada owns shares of another Canadian corporation. The shares of such a corporation do not constitute excluded property of the affiliate. As a result, any gain arising to the affiliate on a disposition of those shares should be included in computing that affiliate’s FAPI. Assuming that the shares are held on account of capital, the taxable and non-taxable portions of the capital gain should be included in computing the affiliate’s exempt and taxable surplus pools respectively. Notwithstanding that the shares of a Canadian corporation constitute a “FAPI property” of the foreign affiliate, all or a portion of a taxable dividend51 that the foreign affiliate receives from the Canadian corporation could, in certain circumstances, be treated differently. The reason for this is that such a dividend does not constitute FAPI of the foreign affiliate, and is included in computing the foreign affiliate’s exempt surplus, to the extent that the dividend would otherwise have been deductible under section 112 had it instead been received by the Canadian taxpayer in respect of the foreign affiliate.52

Since the treatment of such a dividend depends on its deductibility under section 112, the recent amendments to section 55 may also be relevant in determining the treatment of that dividend in computing the foreign affiliate’s FAPI and surplus pools. In other words, if it were determined that one or both of the purpose tests in paragraph 55(2.1)(b) was met in respect of a particular dividend, and subsection 55(2) applied to deem the dividend to be a capital gain, it appears that the dividend would be included as a capital gain in computing the foreign affiliate’s FAPI (with the taxable and non-taxable portions of that gain being included in computing the affiliate’s taxable and exempt surplus respectively) unless, or to the extent that, it could be established that the safe-income exception was applicable. As a result, the ability to wholly include such a dividend in computing the exempt surplus of a foreign affiliate is no longer as clear as it might have been in the past.

51 As defined in subsection 248(1).
52 Paragraph (c) of element A of the definition of “foreign accrual property income” in subsection 95(1) and paragraph (v) of element A of the definition of “exempt surplus” in regulation 5907(1).
Outbound Structure

In the context of a typical outbound structure in which there is a chain of Canadian corporations located above one or more foreign affiliates, the foreign affiliate surplus and safe-income regimes are linked by paragraph 55(5)(d). The safe income of a corporation for a period ending at a time when that corporation was a foreign affiliate of another corporation is deemed, under paragraph 55(5)(d), to be the lesser of

1. the fair market value at that time of all of the issued and outstanding shares of the capital stock of that affiliate and
2. the amount that would be the “tax-free surplus balance” (TFSB) of that affiliate in respect of the other corporation at that time.

There are a couple of potentially important observations to be made about the mechanics for determining the safe income of a foreign affiliate.

First, the requirement to determine and document the fair market value of the shares of a particular foreign affiliate at each and every safe-income determination time could be challenging or, at the very least, administratively burdensome.

Second, the TFSB of a foreign affiliate is intended to represent the amount of the affiliate’s surplus pools, as determined on a stand-alone or non-consolidated basis, that could be repatriated by the affiliate to the particular corporation resident in Canada as a dividend if the affiliate were directly owned by that corporation. In other words, and building on the concepts discussed earlier in this article, the TFSB of a foreign affiliate effectively includes

1. the amount, if any, by which the affiliate’s exempt surplus in respect of the corporation exceeds the total of the affiliate’s hybrid and taxable deficits;
2. the affiliate’s hybrid surplus in respect of the corporation, as determined after deducting any applicable exempt and/or taxable deficits of the affiliate, but

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53 As defined in regulation 5905(5.5) and as if the Act were read without reference to regulation 5905(5.6).

54 For this purpose, it appears that any foreign tax (for example, withholding tax) that would otherwise be payable in respect of such a repatriation is not taken into account. In contrast, if an actual dividend had been paid and withholding tax incurred, it appears that such tax would be deducted, under general principles, in computing the amount of safe income on hand.

55 The TFSB of a foreign affiliate is, by virtue of regulation 5905(5.6), typically determined on somewhat of a “consolidated” basis to the extent that the affiliate would have otherwise received (on the basis of certain assumptions) a dividend that was paid from the “net surplus” of another foreign affiliate. However, since paragraph 55(5)(d) provides that the TFSB of a foreign affiliate is to be determined without reference to regulation 5905(5.6), solely for purposes of determining the safe income of a foreign affiliate under paragraph 55(5)(d), the TFSB of a particular foreign affiliate is effectively computed on a stand-alone basis as if that affiliate were directly owned by the particular corporation resident in Canada.

56 Regulation 5905(5.5)(a).
only if the entire amount of that hybrid surplus balance is fully sheltered by hybrid underlying tax (that is, if that balance were paid out as a hybrid surplus dividend received by the corporation from the affiliate, provided that such dividend would be fully deductible by the corporation under paragraph 113(1)(a.1));

3. the affiliate’s taxable surplus in respect of the corporation, as determined after deducting any applicable exempt and/or hybrid deficits of the affiliate, but only to the extent that such taxable surplus, or portion thereof, is sheltered by the grossed-up amount of underlying foreign tax (that is, the taxable surplus, or portion thereof, could be received as a dividend free of Canadian tax by the Canadian corporate taxpayer).

After determining the safe income of a foreign affiliate in accordance with paragraph 55(5)(d), it is necessary to apply the general principles, some of which are described in table 1, that are relevant for the purposes of computing safe income on hand. This is necessary in order to determine the portion of the income earned or realized by the foreign affiliate during the relevant period that could reasonably be considered to contribute to the capital gain that would be realized on a disposition of the particular share.

SELECTED ANOMALIES, ISSUES, AND PLANNING CONSIDERATIONS

Although the safe-income and foreign affiliate surplus regimes share a similar computational objective, they do not mesh seamlessly because of differences in the detailed computation mechanics applied to each regime. As a result, it is perhaps not surprising that the interaction of these regimes could raise planning considerations or have unexpected consequences in certain circumstances.

The following is an overview of some of the considerations that can arise, from time to time, in the context of the interaction of the two regimes. Some of these considerations are more commonly known and have been at least partially addressed in other papers (and for the sake of completeness are included here), whereas others are perhaps less obvious or less well known.

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57 Regulation 5905(5.5)(a.1). As a result, for the purposes of computing the TFSB (and thus, the safe income) of a particular affiliate, it is not possible to include either the “taxable” or the “non-taxable” portion of any capital gain that is included in computing the foreign affiliate’s hybrid surplus unless the gain is fully sheltered by sufficient hybrid underlying tax.

58 Regulation 5905(5.5)(b).

59 For example, if it were determined that a particular foreign affiliate incurred a permanently non-deductible outlay that was not, for one reason or another, required to be deducted in computing the affiliate’s surplus pools, it appears that, to the extent that such surplus is relevant for the purposes of computing safe income, such an outlay would be deducted for the purposes of computing safe income on hand (given that a similar outlay by a corporation resident in Canada is generally required to be deducted in computing safe income on hand).

60 See, for example, Dehsi and Ferhmann, supra note 11.
Use of the Book Depreciation Election To Compute Active Business Earnings

Many foreign jurisdictions provide for accelerated rates of depreciation. In some jurisdictions, such as the United States, the claiming of depreciation expense is effectively mandatory because there is no provision for carryforward (or carryback) of the expense deduction, or a portion thereof, if it is not fully claimed in the particular taxation year.

Although depreciation claims reduce the taxable income, and thus taxes payable, of the affiliate in the foreign jurisdiction, they also effectively reduce the affiliate’s earnings from an active business, potentially reducing the affiliate’s ability to pay dividends from its exempt surplus (and ultimately its TFSB). Since depreciation is a non-cash expenditure, significant depreciation deductions arising under foreign tax principles could cause a foreign affiliate to have distributable cash that exceeds its earnings.

In certain situations, the making of an election under regulation 5907(2.1) may increase a foreign affiliate’s ability to pay a dividend from its exempt surplus, thus potentially increasing its TFSB for the purposes of a safe-income determination. Generally, if a regulation 5907(2.1) election is made, a foreign affiliate’s earnings from an active business carried on in a designated treaty country are computed using financial statement depreciation as opposed to foreign tax depreciation. If this election is made at a time when the accumulated depreciation for financial statement purposes is less than it is for tax purposes, the affiliate’s earnings (and thus its exempt surplus pool, and ultimately its TFSB) will be increased by the difference between these amounts. Of course, whether or not an immediate benefit results from making such an election in terms of an increase in the affiliate’s earnings (and thus its exempt surplus and TFSB) depends on various factors, including the age and nature of the foreign affiliate’s property. Generally, once the regulation 5907(2.1) election is made, it may not be revoked.

Owing to the complexities associated with computing the ongoing adjustments required under regulation 5907(2.1), and given that the election is made with retroactive effect, it is normally recommended that a Canadian corporation delay making such an election until the following year.

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61 For greater certainty, this election is available only where the active business earnings of a foreign affiliate for a particular taxation year are required to be determined under foreign (as opposed to Canadian) tax principles. In other words, the requirements must be met for those earnings to be computed under subparagraph (a)(i) of the definition of “earnings” in regulation 5907(1).

62 If the election is not made in the first year in which the affiliate carries on the active business and in which the affiliate was a foreign affiliate of the electing corporation resident in Canada (or a non-arm’s-length Canadian corporation), pursuant to regulation 5907(2.2) the earnings of the affiliate for the year in which the election is made are adjusted to include the total of all amounts that would have been included under regulation 5907(2.1) in computing the affiliate’s earnings for each prior year if the election had been made in the first year. In other words, a regulation 5907(2.1) election has retroactive effect if it is not made in the first year in which the affiliate carried on the particular active business and was a foreign affiliate of the electing corporation.
making the election in respect of a particular foreign affiliate for as long as possible. However, to the extent that the affiliate’s TFSB is relevant for the purposes of a particular safe-income determination time, in certain circumstances it might make sense to make this election sooner than would normally be the case if the potential increase to the affiliate’s TFSB is significant.

**Treatment of Deficits of a Foreign Affiliate**

As noted above, the safe income of a particular foreign affiliate is defined in paragraph 55(5)(d) as the lesser of the TFSB and the fair market value of all the issued and outstanding shares of the foreign affiliate. However, it is not clear whether in determining safe income on hand of a particular foreign affiliate, the deficit of a lower-tier foreign affiliate could reduce the safe income of the particular foreign affiliate even if the fair market value of its shares exceeds its TFSB. If a deficit of a lower-tier foreign affiliate does indeed reduce safe income on hand, the location of the deficit affiliate in a chain of foreign affiliates does not seem to be relevant—contrary to the general framework of the foreign affiliate surplus regime, in which so-called blocking deficits in a chain of foreign affiliates are generally more relevant (and potentially more problematic) than deficits in foreign affiliates that are at the bottom of the ownership chain.

Paragraph 55(5)(d) was amended in 2011. Arguably, one of the purposes of the fair market value test in paragraph 55(5)(d) was to capture deficits of lower-tier foreign affiliates, and therefore no adjustment should be required for lower-tier deficits in computing safe income on hand.

**Foreign Exchange Rate To Be Used for Inclusion of Foreign Affiliate Surplus Pools in Safe Income**

It appears that the general practice is for the surplus pools of a foreign affiliate to be included in computing safe income using the applicable foreign exchange rate at the safe-income determination time.

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63 Generally, for the election to be effective beginning with a particular taxation year of a foreign affiliate, pursuant to regulation 5907(2.6) the election must be filed on or before the day that is the earliest day on or before which the Canadian corporation, or any other corporation of which the affiliate is a foreign affiliate, is required to file a tax return for its taxation year following the taxation year in which the taxation year of the affiliate ends. Depending on the facts, the CRA may possibly accept a late-filed regulation 5907(2.1) election. Regulation 600 specifically provides that the CRA has the discretion to accept a late-filed regulation 5907(2.1) election under subsection 220(3.2).

64 See, for example, Canada v. Breko Drilling Ltd., 1999 CanLII 8151 (FCA). Also see CRA document no. 2001-0093385, October 5, 2001, and paragraph 55(5)(d).

Maximization of a Particular Foreign Affiliate’s Tax-Free Surplus Balance

As mentioned earlier, for the purposes of determining safe income, the TFSB is computed on a foreign-affiliate-by-foreign-affiliate basis. Since this approach is different than the consolidated approach used when computing the TFSB for other purposes (or determining the amounts in surplus pools that are available for the purposes of a subsection 93(1) election), the location of a particular foreign affiliate in a Canadian multinational’s foreign affiliate group is perhaps of less importance from the perspective of computing safe income. Nevertheless, because of the foreign-affiliate-by-foreign-affiliate approach in determining the TFSB, in certain circumstances planning may be necessary in order to maximize the TFSB amount that is available for the purposes of determining safe income of a foreign affiliate.

For example, as noted earlier, the TFSB includes hybrid surplus of a particular foreign affiliate only if such surplus is “fully sheltered” (that is, that hybrid surplus, if paid by the affiliate as a dividend to the Canadian corporation, would be fully offset by a deduction under paragraph 113(1)(a.1)). As a result, if one foreign affiliate in a chain has a hybrid surplus pool with an insufficient amount of hybrid underlying tax applicable, whereas another affiliate has an excess of hybrid underlying tax applicable if the surplus pools of those two affiliates were combined. Accordingly, and if circumstances permit, it might be prudent to try to “match up” or blend, prior to the safe-income determination time and through the payment of an interaffiliate dividend or other mechanism, the applicable excess hybrid underlying tax of one affiliate with a “low-taxed” hybrid surplus pool of another so as to permit the inclusion of the hybrid surplus in the TFSB computation for the purposes of determining safe income.

Payment of Dividends by a Foreign Affiliate

The payment of an exempt, hybrid, and/or taxable dividend by a foreign affiliate generally reduces the surplus pool(s) of the affiliate from which that dividend is paid. To the extent that such a dividend is received by another foreign affiliate of

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66 As defined in regulation 5907(1).
67 However, if this dividend were determined to be part of the series of transactions or events that includes the receipt of a dividend by a corporation resident in Canada, the safe-income determination time would be the time immediately before the payment of the dividend between the foreign affiliates as opposed to the time immediately before the receipt of the dividend by the corporation resident in Canada. If this were indeed the case, such planning would not be effective from the perspective of determining the amount of safe income that is potentially available in respect of the dividend that was received by the corporation resident in Canada.
68 Since the characterization of a dividend paid by a foreign affiliate to its shareholder depends on the balances of the affiliate’s exempt, hybrid, and/or taxable surplus pools at the time that the dividend is paid, the affiliate’s earnings for the year in which the dividend is paid are generally...
that Canadian corporation, it retains its characterization for the purposes of determining the surplus pools of that other affiliate.

Notwithstanding that the payment of a dividend from the exempt, hybrid, and/or taxable surplus of the affiliate reduces the surplus pool(s) from which the dividend is considered to be paid, depending on the facts this may not necessarily result in a corresponding reduction in the affiliate’s TFSB.\(^{69}\) Similarly, whether or not the receipt of such a dividend increases the safe income of the recipient also depends on the facts.

For example, the receipt of such a dividend by another foreign affiliate of the taxpayer could increase that affiliate’s TFSB by an amount up to the dividend amount, depending on

- the surplus pool of the distributing affiliate from which the dividend was paid\(^ {70}\) and
- the surplus balance (deficit) of the recipient.\(^ {71}\)

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69 Whether or not, or to what extent, the TFSB of the dividend-paying foreign affiliate is reduced by a dividend generally depends on the surplus pool from which the dividend is paid. For example, as noted elsewhere in this article, only fully sheltered hybrid surplus is included in computing a foreign affiliate’s TFSB. Thus, if a foreign affiliate pays a dividend from hybrid surplus, the TFSB of that affiliate is not reduced unless its hybrid surplus was fully sheltered (that is, there was sufficient hybrid underlying tax applicable). Furthermore, the TFSB of the foreign affiliate recipient of such a dividend will not be increased unless that affiliate has sufficient excess hybrid underlying tax applicable from another source.

70 See supra note 69.

71 For example, if the recipient has an exempt deficit at the time of receipt of an exempt surplus dividend from another affiliate (and such a deficit is, for one reason or another, not relevant for the purposes of determining safe income, in accordance with the court’s rationale in *Breco*
Given the potential for an unexpected (or possibly adverse) result that a dividend can have on the determination of the TFSB of the foreign affiliate recipient and/or payer of the dividend, consideration could be given to timely filing a regulation 5901(2)(b) election (or, alternatively, a subsection 90(3) election) to sidestep the normal surplus ordering rule and treat the distribution as a preacquisition surplus dividend (or a qualifying return of capital, in the case of a subsection 90(3) election).

Generally speaking, if the recipient of the dividend is the Canadian corporation, it appears that such a dividend should increase the safe income of that corporation regardless of the surplus pool from which the dividend is considered to be paid. The reason for this is that safe income is generally determined using division B of part I of the Act, and any section 113 deduction claimed by the corporation in respect of a dividend that is received from a foreign affiliate occurs under division C of part I.72

**Stub-Period Earnings of a Foreign Affiliate**

As noted above, one potentially significant difference between the safe-income and foreign affiliate surplus regimes involves the time of inclusion for certain amounts in the calculation of surplus and safe income.

It is generally accepted that safe income includes income earned or realized up to the safe-income determination time. In contrast, the exempt and taxable earnings of a foreign affiliate (which include, among other things, a foreign affiliate’s earnings [loss] from an active business) are added to the affiliate’s exempt and taxable surplus pools, respectively, only at the end of its taxation year. Since the TFSB of a particular foreign affiliate, as well as the characterization of a dividend paid by that affiliate to its shareholder, depends on the balances of the affiliate’s exempt, hybrid, and taxable surplus pools at that time—that is, the time for determining the TFSB or the time that the dividend is paid, as the case may be—the affiliate’s earnings (loss) for the taxation year that includes that time are generally not included in this determination.

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72 To the extent that a particular dividend is considered to have been paid to the Canadian corporation out of the preacquisition surplus of the foreign affiliate, it is not clear whether such a dividend would be excluded from the corporation’s safe income, taking into account any adjustments that are made to determine the corporation’s safe income on hand.
Nevertheless, the CRA has previously indicated, albeit prior to the changes to paragraph 55(5)(d), that it will administratively accept the inclusion of stub-period earnings in computing the safe income of a corporation when the affiliate was a foreign affiliate of another corporation. 73

**Amounts That Accrue Prior to Becoming a Foreign Affiliate of the Taxpayer**

In computing the surplus pools of a foreign affiliate of a Canadian corporation, any capital gain (loss) realized by the affiliate in respect of a disposition of a capital property is not to include the portion of that gain (loss) that can reasonably be considered to have accrued prior to the affiliate’s becoming a foreign affiliate of that corporation. 74 A similar rule applies to the extent that a foreign affiliate earns FAPI in a particular taxation year that can reasonably be considered to have accrued prior to the affiliate’s becoming a foreign affiliate of the corporation. 75 As a result, such amounts should not be included in computing the TFSB, and thus the safe income, of a foreign affiliate.

In contrast, there is no similar rule that carves out from a foreign affiliate’s earnings from an active business (and ultimately that affiliate’s surplus pools) the portion of any recognized gains (losses) that are on account of income and can reasonably be considered to have accrued prior to the affiliate’s becoming a foreign affiliate of the taxpayer (“preacquisition earnings”). 76 This could include, for example, recapture of depreciation expense that relates to the period prior to the affiliate’s becoming a foreign affiliate of the taxpayer. The CRA has previously taken the position, in respect of the former version of paragraph 55(5)(d), that the preacquisition earnings of a foreign affiliate that were included in determining the surplus pools of a foreign affiliate should be excluded in determining safe income on hand, on the basis that the inclusion of such amount would, in effect, result in double-counting of the adjusted cost base of the shares of the foreign affiliate as safe income. 77

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74 Paragraphs 95(2)(f) and (f.1) and regulation 5907(5). More specifically, paragraph 95(2)(f.1) provides that “in computing an amount described in paragraph [95(2)](f) in respect of a property or a business, there is not to be included any portion of that amount that can reasonably be considered to have accrued, in respect of the property (including . . . any property for which the property was substituted) or business, while no person or partnership that held the property or carried on the business was a specified person or partnership in respect of the taxpayer referred to in paragraph (f).”

75 See supra note 74.

76 See, for example, the definitions of “earnings,” “exempt earnings,” and “net earnings” in regulation 5907(1).

Ownership of Shares of a Foreign Affiliate Through a Partnership

The potential for anomalies and interpretational challenges to arise from the ownership of the shares of a foreign affiliate through a partnership is well documented.\(^\text{78}\) Not surprisingly, it appears that there is the potential for similar anomalies and interpretational challenges to arise in the context of the determination of safe income.

By way of background, subsection 93.1(1) permits a Canadian corporation that is a partner of a partnership to look through the partnership to determine whether a direct or indirect subsidiary of that partnership is considered to be a foreign affiliate of that corporation. However, this lookthrough provision applies only for limited purposes—namely, the purposes of the provisions listed in subsection 93.1(1.1). Generally speaking, the effect of the combined application of subsections 93.1(1) and (1.1) is that a direct or indirect subsidiary of a partnership could be considered to be a foreign affiliate of a Canadian corporation that is a partner of a partnership for the purposes of computing the surplus pools of the affiliate vis-à-vis that corporation, and ultimately the characterization of a dividend that is made by, or deemed to have been made by, the affiliate. Except for certain limited exceptions, such a subsidiary of a partnership is generally not considered to be a foreign affiliate of the Canadian corporation for other purposes of the Act, including, for example, the computation of FAPI.

As mentioned, the surplus pools of a foreign affiliate are potentially included in computing safe income under paragraph 55(5)(d). However, this provision applies only if a non-resident corporation is considered to be a foreign affiliate of another corporation. Although subsection 93.1(1) permits looking through a partnership for the purposes of determining whether a direct or indirect subsidiary of the partnership is considered to be a foreign affiliate of a Canadian corporation that is a partner of a partnership, this lookthrough mechanism applies only for the purposes of the provisions that are specifically identified in subsection 93.1(1.1), and paragraph 55(5)(d) is not one of those provisions. The reason for this omission is unclear. Caution should therefore be exercised in determining the safe income of one or more foreign affiliates if there is a partnership located in the ownership chain.

Nevertheless, in the absence of being able to rely on subsection 93.1(1.1) to look through a partnership for the purposes of applying paragraph 55(5)(d), in certain circumstances it still might be possible to include the income earned or realized by a subsidiary of a partnership in computing the safe income of the dividend payer that is a partner of the partnership, or possibly even a direct or indirect shareholder of that partner. The reason for this is that, as noted above, paragraph 55(2.1)(c) merely refers to the amount of the income earned or realized by any corporation. As a result, it is conceivable that safe income could include the income earned or realized by a corporation that is neither a corporation that is a resident of Canada.

nor a foreign affiliate of a corporation (that is, a foreign non-affiliate). Notwithstanding that paragraphs 55(5)(b), (c), and (d) only contemplate the computation of the safe income of a corporation resident in Canada and a foreign affiliate of a corporation, in *Lamont Management Ltd. v. Canada*, the Federal Court of Appeal concluded that the reference to “any corporation” in subsection 55(2) (the predecessor of paragraph 55(2.1)(c)) can include a foreign non-affiliate.

**Retroactive Adjustments to Surplus Pools**

As noted, safe income is determined at the safe-income determination time. As a result, if the Canadian tax return originally filed by a particular corporation is subsequently amended, it might be necessary to make one or more corresponding retroactive adjustments to the safe income that is determined as at a particular safe-income determination time.

Likewise, since an affiliate’s TFSB is potentially relevant in computing safe income, any retroactive adjustment that is required to be made to the surplus pools of a foreign affiliate could correspondingly affect its TFSB otherwise determined at the safe-income determination time. In some cases, such adjustments may only represent timing differences that are of no significant consequence. This might be the case, for example, if no dividends have been paid between the effective time of the retroactive adjustment and the time that the need for that adjustment becomes known. However, if one or more dividends have been paid in that intervening period, either by a foreign affiliate or by a Canadian corporation in the chain, it is possible that such adjustments could affect the quantum of safe income that was otherwise believed to have been available in respect of the dividend at the safe-income determination time.

There are a few instances where it might be necessary to make a retroactive adjustment to the surplus pools of a foreign affiliate. For instance, this might be the case if a foreign affiliate is solely engaged in carrying on an active business and the income (loss) reported by the affiliate in its income tax return filed with the tax authorities in its country of residence is amended or otherwise adjusted. More specifically, the earnings (loss) of a foreign affiliate for a taxation year from an active business are, subject to certain adjustments, generally required to be computed under the income tax law of the country in which the affiliate is resident if that affiliate is required by that law to compute its income or profit.

Another situation in which a retroactive adjustment to the surplus pools of a foreign affiliate could arise is where the affiliate is a member of a group of two or more foreign affiliates of a Canadian corporation and the tax liabilities of those members are determined on a combined or a consolidated basis. In such a situation, regulation 5907(1.1) applies in a very mechanical fashion to determine the tax liabilities of each member of the group for the purposes of computing the surplus pools.

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79 2000 CanLII 17131 (FCA).
80 See the definitions of “earnings” and “loss” in regulation 5907(1).
of those members. The overall effect of the adjustments to be made under regulation 5907(1.1) is to reduce (increase) the surplus pools of each member of the combined or consolidated group to reflect the amount of tax that has been borne or paid by (or refunded to) that member. In doing so, regulation 5907(1.1) requires that certain adjustments be made to the surplus pools of a foreign affiliate for a prior taxation year.

In the absence of any tax compensatory payments being made, and assuming that the entire tax liability of the combined or consolidated group has been paid by one affiliate (“the primary affiliate”), in principle regulation 5907(1.1)(a) only adjusts the surplus pools of the primary affiliate. As the initial step in this process, regulation 5907(1.1)(a) disregards the actual income or profits tax liability (refund) of the combined or consolidated group for the particular taxation year, and then requires the stand-alone tax liabilities of each of the primary affiliate and the other members of the group (each of which is referred to as a “secondary affiliate”) to be computed on the basis that each of those affiliates had instead filed its own tax return and had no other taxation year. This deemed income or profits tax liability, which is wholly included in computing the surplus pools of the primary affiliate, is subsequently adjusted to reflect any current and/or prior-year losses of the primary affiliate and/or a secondary affiliate that are used in computing the tax liability of the combined or consolidated group. To the extent that prior-year losses of the primary affiliate and/or a secondary affiliate are used, this adjustment (increase) is reflected in the surplus pools of the primary affiliate at the end of the taxation year in which the loss arose. Thus, if a loss arose in one year and is used by the combined or consolidated group in the immediately following year, the surplus pools of the primary affiliate are increased at the end of the prior taxation year as opposed to the year in which the loss is used.

Prior-year adjustments to surplus pools of the primary and/or secondary affiliates can also arise under regulation 5907(1.1)(b) in certain circumstances where tax compensatory payments are made between the affiliates. In this regard, if the primary affiliate compensates a secondary affiliate for the use of a loss of the secondary affiliate that arose in a prior taxation year, the surplus pools of both the primary and secondary affiliates are adjusted only as at the end of the year of the loss regardless of when the payment is made. Similarly, if a secondary affiliate makes a

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81 Likewise, regulation 5907(1.092) is applicable where a foreign affiliate of a taxpayer is liable for income or profits tax in respect of that affiliate’s share of the income (loss) of another foreign affiliate that is fiscally transparent under the laws of a foreign country. Regulation 5907(1.092) operates in a manner that is in many ways similar to regulation 5907(1.1).

82 See supra note 81.

83 Regulations 5907(1.1)(a)(i) through (iv).

84 Regulation 5907(1.1)(a)(v).

85 Regulations 5907(1.1)(a)(v)(C) through (D).

86 Regulation 5907(1.1)(b)(ii).
tax compensatory payment to the primary affiliate in respect of a particular taxation year, the surplus pools of both the primary and secondary affiliates are adjusted only at the end of that taxation year.\textsuperscript{87} This is the case regardless of whether that payment occurs in the particular taxation year or in a subsequent year. On a consolidated basis, the retroactive increase of the surplus pools of one affiliate under the mechanics of regulation 5907(1.1)(b) should generally be offset against the corresponding decrease to the surplus pools of another. However, since the TFSB is, for the purposes of computing safe income, determined on a foreign-affiliate-by-foreign-affiliate basis, there could be situations where these retroactive adjustments have an impact on the overall determination of safe income at a particular safe-income determination time, especially where the adjustments involve the hybrid surplus pools of the affected affiliates.

Reorganizations Involving the Shares or Property of Foreign Affiliates

There are a number of provisions that could apply to adjust a foreign affiliate’s surplus pools, as computed vis-à-vis a particular Canadian corporation, in a situation where there is an acquisition or disposition of the shares of the affiliate.

For example, an adjustment to the surplus pools of a foreign affiliate may be required where there is a change in the Canadian corporation’s surplus entitlement percentage\textsuperscript{88} in respect of a foreign affiliate that arises from an acquisition or disposition of the share of a relevant foreign affiliate.\textsuperscript{89} In concept, the purpose of this adjustment is to try to ensure that the Canadian corporation’s percentage share of the surplus pools of a foreign affiliate remains the same before and after a particular acquisition or disposition. This is necessary because the surplus pools of a foreign affiliate, as computed vis-à-vis a particular Canadian corporation, are to be computed on a 100 percent basis without regard to the ownership percentage, or the surplus entitlement percentage, of the corporation in that affiliate.

There are also continuity provisions that attempt to preserve the surplus pools of a foreign affiliate in respect of certain qualifying restructuring transactions, such as when a foreign affiliate is merged with another foreign affiliate\textsuperscript{90} or when a foreign affiliate with net surplus\textsuperscript{91} is dissolved into another foreign affiliate.\textsuperscript{92}

Similarly, there are numerous provisions that could apply to deny or suppress the recognition of amounts that would otherwise be included in computing the surplus

\textsuperscript{87} Regulation 5907(1.1)(b)(i).
\textsuperscript{88} As defined in subsection 95(1) and regulation 5905(13).
\textsuperscript{89} Regulation 5905(1).
\textsuperscript{90} Regulation 5905(3).
\textsuperscript{91} As defined in regulation 5907(1).
\textsuperscript{92} Regulation 5905(7).
pools of a foreign affiliate in respect of certain intragroup transfers of shares\textsuperscript{93} or property\textsuperscript{94} of a foreign affiliate.

Since all of these provisions are relevant in determining the surplus pools, and ultimately the TFSB, of a particular foreign affiliate, any proposed reorganization or transfer of the shares or property of a foreign affiliate should be carefully considered prior to undertaking the reorganization or transaction. Also, to the extent that a foreign affiliate realizes an amount, such as a capital loss, in respect of such a reorganization or transaction (or otherwise) that is suspended or not recognized for the purposes of computing the affiliate's surplus pools, it is necessary to determine whether that amount represents an adjustment to the affiliate's TFSB for the purposes of determining safe income on hand. Accordingly, advance planning is necessary to help minimize the risk of any adverse or unanticipated foreign affiliate surplus and/or safe-income consequences arising therefrom.

For example, in contrast to the Canadian domestic context, many types of stop-loss rules are “turned off” for the purposes of computing any loss to be included in computing the surplus pools of a foreign affiliate from a disposition of excluded property.\textsuperscript{95} Likewise, it is possible in certain circumstances that a shareholder affiliate could realize, in computing its hybrid surplus (deficit), a loss on a tax-deferred dissolution of another foreign affiliate of the Canadian corporation where the requirements of subparagraph (iii) of element B of the definition of “hybrid surplus” in regulation 5907(1) are met. Depending on the facts, the inclusion of a loss in computing the surplus pools of a foreign affiliate may ultimately reduce the TFSB, and ultimately the safe income, of a relevant affiliate.

There is also an anti-avoidance rule in regulation 5907(2.02) that is applicable to certain “tax-motivated” intragroup dispositions of property (other than money) that are intended to increase the exempt earnings of the transferor foreign affiliate. Where the conditions for this rule are met, amounts that would otherwise be included in computing the affiliate's exempt earnings (and thus exempt surplus) are reclassified as taxable earnings (and thus taxable surplus).

\textbf{TWO PEAS IN A POD?}

Given the history of the foreign affiliate surplus and safe-income regimes, it not unexpected that there are some potentially significant differences and similarities between these regimes. However, there are two fundamental questions that remain unanswered: Why did the government decide not to legislate a detailed definition for the computation of safe income in the first place, and why does such an approach continue to this day?

\textsuperscript{93} See, for example, paragraphs 95(2)(c) and (f), and regulation 5907(5).
\textsuperscript{94} See, for example, paragraph 95(2)(f) and regulations 5907(2)(f) and (j), (5), and (5.1).
\textsuperscript{95} Subsections 13(21.2), 40(3.6), and 93(4), and paragraphs 14(12)(a), 18(13)(a), 40(2)(e.1), (e.2), and (g), and 40(3.3)(a). Also, a rollover is not available under paragraph 95(2)(c) in respect of the transfer of one foreign affiliate to another if there is an inherent loss in the shares of the transferred affiliate.
Unfortunately, the answers to these questions are not entirely clear. That said, it seems likely that the legislators’ approach to subsection 55(2) and the provisions related thereto represents an attempt to strike a balance between the simplicity of a vaguely worded set of anti-avoidance rules and the certainty (and accompanying complexity) provided by a comprehensive set of mechanical rules.96

Although the rules regarding the computation of safe income may be fuzzy or vague, the underlying policy intent is clear. The fuzziness, and ultimately the lack of certainty, associated with the rules designed to prevent inappropriate capital gains stripping, and the relief that is potentially available under the safe-income exception, also implicitly act as a self-policing deterrent to taxpayers.

As evidenced by the historical review presented earlier in this article, the government’s battle against stripping transactions perceived to be abusive not only has been long but also has evolved as laws have changed and taxpayers have adapted to those changes. Thus, it is entirely conceivable that the legislators may have been concerned that the adoption of a detailed legislative approach to the computation of safe income would create too much certainty for taxpayers. A risk in providing taxpayers with a detailed road map of the rules is that this gives them the opportunity to poke and prod at those rules in an endless quest to exploit gaps and loopholes, ultimately leading to the introduction of even more complex legislation designed to plug those gaps and loopholes. Also, the active role that Revenue Canada took, early on, in publishing its own administrative practices regarding the calculation of safe income arguably made the drafting of detailed legislation less of a priority for the Department of Finance.

Although the foreign affiliate surplus and safe-income regimes share a similar computational objective, in respect of the determination of certain amounts that are distributable by a corporation to its shareholders, the safe-income regime has, at least historically, served a very different purpose as compared with that of the foreign affiliate surplus regime. At its heart, the safe-income regime is part of a set of anti-avoidance rules designed to prevent capital-gains-stripping transactions that the government considers to be inappropriate. In contrast, the foreign affiliate surplus regime could be viewed, at least in some respects, as being favourable to taxpayers. More specifically, under the right facts and circumstances, the regime permits a Canadian corporation to treat all or a portion of an actual or deemed dividend received from a foreign affiliate as a tax-free exempt surplus dividend as opposed to either a capital gain or a dividend that is wholly or partially taxable. Accordingly, it only stands to reason that it would be in the government’s interest to legislate detailed mechanical rules for the computation of the surplus pools of a foreign affiliate. In the absence of such detailed rules, the policing of the foreign affiliate surplus regime would likely have been much more challenging for the tax authorities.

Despite the fact that the foreign affiliate surplus and safe-income regimes have historically served very different purposes, it is arguable that the recent changes to

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subsection 55(2) have resulted in those purposes becoming much more closely aligned. Of course, the safe-income regime still remains a fundamental part of a targeted set of anti-avoidance rules. However, the effect of the recent changes to subsection 55(2) is that the ability of a corporation resident in Canada to claim an offsetting deduction under section 112 in respect of an intercorporate dividend is no longer as clear as it might have been in the past.

In effect, the default rule has become that a dividend paid by one Canadian corporation to another is now fully taxable to the recipient without the ability to claim an offsetting deduction under section 112, unless the recipient can establish that an exception applies to permit such a deduction. Depending on the facts, one of these exceptions could be that the dividend was paid out of the safe income. Likewise, a dividend paid by a foreign affiliate to a corporation resident in Canada is generally taxable to the recipient unless the recipient is a Canadian corporation and can demonstrate that the dividend was paid out of a type of surplus pool that permits all or a portion of that dividend to be deductible under section 113.

In other words, regardless of whether a Canadian corporation receives a dividend from another corporation resident in Canada or a foreign affiliate, the Canadian corporation is, subject to certain exceptions, generally required to prepare calculations to support the claiming of an offsetting deduction under section 112 or 113. As a result, it is arguable that one of the purposes of the safe-income regime has now evolved into one that is more akin to that of the foreign affiliate surplus regime—that is, a calculation function that is necessary to support the quantum of an offsetting deduction against dividend income.

Given that the purposes of the safe-income and foreign affiliate surplus regimes appear to have become more closely aligned, it is submitted that it is once again time to consider legislating a more comprehensive set of rules for the computation of safe income. Not only would a detailed legislative definition provide taxpayers with more certainty when attempting to claim a deduction under section 112 that relies on the safe-income exception, but it would also reduce the potential for the backlog of resource- and time-consuming disputes between taxpayers and the government that uncertainty inevitably breeds.

In drafting a detailed legislative framework for the computation of safe income, the legislators could consider, at least as a starting point, looking to the foreign affiliate surplus regime as a precedent. For instance, the foreign affiliate surplus regime has, among other things, clear rules dealing with the computation of amounts to be included in surplus pools and whether, or to what extent, there is a continuity of surplus pools in the event of a reorganization and/or an ownership change. Although the foreign affiliate surplus regime is certainly complex, such complexity might be preferable to many taxpayers as compared with the uncertainty that arises from relying on the CRA’s non-binding and fact-specific published administrative practices or views concerning the computation of safe income.

Regardless of whether the foreign affiliate surplus regime is used as a precedent in legislating a detailed calculation of safe income, it is important that the computation of foreign affiliate surplus and safe income be harmonized. Such harmonization...
would reduce complexity and provide more certainty, not only to taxpayers but also to the CRA in administering the Act.

**CONCLUSION**

The recent amendments to section 55 place a bigger magnifying glass on the computation of safe income of a corporation. Since safe income can potentially include surplus pools of a foreign affiliate, there is even more importance in not only regularly updating and maintaining both safe-income and foreign affiliate surplus pools, but also understanding the interaction of the foreign affiliate surplus and safe-income regimes.

These regimes share many common aspects. In addition to certain conceptual similarities, the computation of the surplus pools of a foreign affiliate, like that of the safe income of a corporation, is often not an exact science. Furthermore, under both regimes, there are many exceedingly complicated and unexpected interpretational issues that require the use of appropriate professional judgment. This complexity is further compounded by the limited administrative and judicial interpretational guidance available in respect of these each of these regimes.

There are also many notable differences that can be difficult to identify without an intricate understanding of both regimes. Since each of these regimes was designed for a specific legislative purpose, it is not surprising that there are differences in their detailed mechanics. Furthermore, the detailed mechanics of, or administrative practices involving, one regime may not always be consistent with the objectives of the other regime.

Given that each of the safe-income and foreign affiliate surplus regimes is, in and of itself, a separate specialty requiring in-depth knowledge, the interaction of these regimes can be particularly challenging. To meet this challenge in the context of the recent amendments to section 55, it is prudent for tax practitioners to better understand the similarities, differences, and interactions of the two regimes.

In the meantime, and in light of the closer alignment of the purposes of the foreign affiliate surplus and safe-income regimes resulting from the recent amendments to section 55, it is perhaps time to question, once again, whether the absence of a detailed legislative framework for the computation of safe income is good policy. As an integral part of such a review, it is important that consideration be given to better harmonizing the foreign affiliate surplus and safe-income regimes.