Outbound Foreign Direct Investment: 25 Years of Searching for the Right Balance—The Parameters of the Canadian Cone, the Canadian Hourglass, and the Canadian Tax Base

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Abstract
This article reviews the historical development over the last 25 years of the elements of Canada’s system of international taxation that are relevant in the context of taxing outbound foreign direct investment, both by Canadian-based multinational enterprises and by corporations resident in Canada that are controlled by non-resident multinationals.

Keywords: FOREIGN AFFILIATES ■ TAX POLICY ■ TAX AVOIDANCE ■ DEBT-EQUITY ■ SURPLUS ■ HISTORY

Contents
Introduction 312
Post-1987 Amendments 313
The 1994 Foreign Affiliate Amendments 313
The Mintz Committee 314
Interest Deductibility 315
Traditional International Tax Arbitrage and Hybrid Mismatch Arrangements 320
The Canadian Cone 325
The Advisory Panel 336
Foreign Affiliate Surplus Accounts 338
Looking to the Future 341

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INTRODUCTION

The last general Canadian tax reform occurred approximately 25 years ago, pursuant to a package of proposals to amend the federal Income Tax Act\(^1\) tabled on June 18, 1987.\(^2\) That package contemplated only a relatively modest set of changes specifically affecting outbound foreign direct investment (OFDI)—that is, non-portfolio investments and activities outside Canada of persons resident in Canada.\(^4\) The foreign affiliate and foreign accrual property income (FAPI) rules had already been introduced in 1972 and 1976, and had been modified in certain significant respects in 1981 and 1982.\(^5\)

The next 25 years also brought about a number of significant changes to Canada’s approach to taxing OFDI—in particular, to the foreign affiliate and FAPI rules, among other features of our system. However, none of these changes have reoriented our system in a fundamental way, although that does appear to be commencing.

The focus of this article is to consider at a relatively high level the various changes that have been introduced into Canada’s approach to taxing OFDI in the 25 years

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1. RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
3. Essentially, the proposed reforms would have dealt with the more administrative aspects of international taxation.
4. The focus of this article is on indirect investments and activities, not on those carried on directly or through a partnership as a foreign branch.
5. See the detailed discussion of the history of these rules in J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, “The Foreign Affiliate System in View and Review,” in *Tax Planning for Canada–US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72. Section 94.1 was also introduced in 1984, mainly as a backstop to the FAPI rules. Still today, if more than 10 unrelated Canadian residents form a non-resident corporation that has only one class of shares, that corporation will not be a foreign affiliate—and thus not a “controlled foreign affiliate” (CFA)—of any of them. In a sense, both the FAPI rules and section 94.1 are really aimed at foreign portfolio investments rather than OFDI, although currently FAPI can include income (and taxable capital gains from the disposition of assets used principally to earn income) that would otherwise be regarded under general principles as income from an “active business”—for example, where the income is recharacterized under various rules as “income from property,” income from a “non-qualifying business,” or “income from a business other than an active business.” See, in particular, the current rules on an “investment business” and a “non-qualifying business” (both defined in subsection 95(1)) and an “adventure in the nature of trade” (which is included in the definition of the expression “income from property” in subsection 95(1)), paragraph 95(2)(l), and the base erosion rules (under paragraphs 95(2)(a.1) through (a.4) and (b)). In 1987, these adverse recharacterization rules were much narrower, being confined to a more limited version of paragraph 95(2)(b). They have been steadily expanded since that time. See the discussion below under the heading “Post-1987 Amendments.” However, the tide may be starting to shift in that regard. Section 94.1 is not discussed further in this article, nor is there any discussion of the treatment of non-resident trusts, or the extensive debates and reform initiatives that have occurred in relation to those regimes over the past 25 years.
since 1987, with a view to commenting on the broader systemic implications of these changes, and the trends that may be observed or perhaps predicted.

**POST-1987 AMENDMENTS**

The 1994 Foreign Affiliate Amendments

The next high point in the level of discussion and debate surrounding OFDI in the 25 years since 1987 arose in 1992, as a result of that year's auditor general's report.6 The ensuing process culminated in the adoption of significant amendments to the foreign affiliate and FAPI rules in 1994. The main features of these changes would include the introduction of a series of definitions and rules designed to narrow the scope of “income from an active business,” including a new definition for that expression, as well as the definitions of “active business,” “investment business,” and “income from property,” and the addition of the base erosion rules in paragraphs 95(2)(a.1) through (a.4). These changes have been considered in detail in numerous publications.7

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The Mintz Committee

These rules were again considered in 1997, by the Technical Committee on Business Taxation (“the Mintz committee”), which recommended certain significant revisions, some of which were pursued only many years later, and only one of which has really ever been implemented. Those recommendations included

- restrictions on the deductibility of interest expense associated with foreign affiliate investments (attempted in 2007);9
- restrictions on the ability to derive “exempt surplus” (as defined and determined under part LIX of the Income Tax Regulations) through interaffiliate payments to a treaty-excluded foreign affiliate (never really implemented);10 and
- restrictions on the active business income recharacterization rules under paragraph 95(2)(a) for intercompany payments from related non-resident corporations that are held outside what has come to be referred to as “the Canadian cone” (that is, minimum share ownership through a corporation resident in Canada), which would apply at varying levels, depending on the specific rule in question (implemented in some respects).11

However, it should also be noted that the Mintz committee’s main observation was that

the existing regime—providing exemption in the case of active business income earned by foreign affiliates in treaty countries, deferral with credit in the case of such income earned in non-treaty countries, and accrual with credit or current taxation with respect to income earned by foreign branches and FAPI—is fundamentally sound and should be maintained.12

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9 Ibid., at 6.18.
10 Ibid., at 6.22. The report justifies this recommendation on the basis that the relevant provisions tend to “encourage tax-planning mechanisms that erode the Canadian tax base.” Ibid., at 6.21.
11 Ibid., at 6.22. The report justifies this recommendation on the basis that these provisions have encouraged the implementation of so-called second-tier financing transactions, which may erode the Canadian domestic tax base, in situations where a foreign parent company controls the Canadian corporation, and where the Canadian corporation has little if any economic interest in the foreign operations being financed.
12 Ibid., at 6.10.
Thus, the committee did not call for any significant expansion of the exemption aspects of the regime, or its general elimination in favour of a “credit” regime.13

**Interest Deductibility**

The 2007 federal budget proposed significant restrictions on the deductibility of interest and other expenses associated with foreign affiliate investments. This proposal morphed into an initiative against double-dip financing arrangements, and was enacted as section 18.2; however, the new provision was repealed before it ever took effect.14 Thus, it took the government 10 years to make any movement on this front after the Mintz committee presented its report,15 and even then the initiative became tremendously controversial and was ultimately withdrawn.

The initial 2007 proposals were very much in line with the recommendation of the Mintz committee. In contrast, section 18.2 would have compromised only double-dip financing arrangements; it would not have eliminated all second-tier financing and similar arrangements. For example, a Canadian subsidiary of a foreign parent corporation could have continued to borrow from its parent to acquire preferred shares of a foreign sister corporation (or the common shares of a foreign subsidiary that held preferred shares of a foreign sister corporation).16


16 Indeed, none of the Mintz committee’s recommendations would have compromised those types of arrangements. This fact pattern was and continues to be a matter of debate under the rubric of tax avoidance, but there was not much formal guidance until many years later, and still today there is no clear guidance. See the discussion below.
The main difficulty with these proposals was that they would have been applicable to all corporations resident in Canada, and they would have been inconsistent with the effective tax treatment of OFDI by other significant jurisdictions, which continued to permit their multinationals (whether formally or informally) to deduct interest expense associated with exempt (or perpetually deferred) foreign investments and even to implement double-dip financing arrangements, thereby compromising the competitiveness of Canadian multinationals.  

The matter was taken up by the Advisory Panel on Canada’s System of International Taxation (“the advisory panel”) in its December 2008 report, where the panel recommended that section 18.2 be repealed. Although the advisory panel did not recommend the adoption of any more general limitations on interest deductibility, it did recommend that targeted measures should be adopted to curtail debt dumping by foreign multinationals. The panel highlighted the example of a Canadian subsidiary of a foreign parent corporation borrowing from its parent to acquire preferred shares of a foreign sister corporation, but noted that these types of arrangements could be addressed mechanically either through a narrow restriction on

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17 See the discussion in Slaats, supra note 14, and in the report of the Advisory Panel on Canada’s System of International Taxation, infra note 18.


19 See ibid., at 53, recommendation 4.7. Although this recommendation was not quite within the advisory panel’s initial mandate, it should be recalled that the government of the day had also struck a separate Competition Policy Review Panel (“the competition panel”) under the minister of industry, which had released its own report in June 2008, ahead of the release of the advisory panel’s report. In addition to the creation of an “International Tax Panel,” the competition panel had made the following recommendations with reference to international taxation:

21. The International Tax Panel should give particular attention to an assessment of tax provisions disadvantaging Canadian companies relative to non-Canadian companies in Canadian acquisitions, with the objective of recommending ways to allow Canadian-based companies to compete on an equal footing.

22. The International Tax Panel should assess the provisions of Canadian tax legislation limiting interest deductibility by Canadian companies in respect of foreign acquisitions to ensure that Canadian companies seeking to compete globally enjoy every advantage relative to their foreign competitors.

Canada, Report of the Competition Policy Review Panel: Compete To Win (Ottawa: Industry Canada, June 2008), at 66. It had become understood by then that the tide had shifted against the so-called anti-tax-haven initiative.

20 This was because of competitiveness considerations; see the advisory panel’s report, supra note 18, at 47-53, paragraphs 4.144-4.167.

21 See ibid., at 69, recommendation 5.3. The panel also recommended tightening the thin capitalization rules in subsection 18(4) and related provisions. See ibid., at 65, recommendations 5.1 and 5.2.

22 See ibid., at 68, figure 5.2.
interest deductibility or through a provision that would produce a deemed dividend in the targeted circumstances, and that a consultation in that regard should be undertaken. Thus, while the panel also made several other recommendations in relation to OFDI, it did not endorse any of the central recommendations of the Mintz committee.

A further five years would elapse before an alternative measure was proposed, and it came in the form of the foreign affiliate dumping provisions announced as part of the 2012 federal budget, a revised version of which has since been enacted pursuant to Bill C-45. The main feature of this regime is a deemed dividend mechanism introduced as new section 212.3, and in that regard (and otherwise) these measures take their inspiration from the advisory panel’s recommendations. However, these measures are broader than what was described in the advisory panel’s report, in that they apply whether or not there is any borrowing by the relevant corporation resident in Canada (referred to as a “CRIC”). A CRIC can be affected by the new rules if it is (or as part of the relevant series of transactions becomes) controlled by a non-resident corporation (the parent) and it makes pretty much any form of investment in a non-resident corporation that is (or as part of the relevant series of transactions becomes) a foreign affiliate of the CRIC, subject to certain exceptions. This is in part to deal with surplus stripping and in part to deal with surplus stripping.

23 These are discussed below.
24 By that time, even Mintz had put forward an alternative position, advocating the adoption of a comprehensive domestic thin capitalization rule—one that would apply equally to Canadian multinationals and Canadian subsidiaries of foreign multinationals. See Allan R. Lanthier and Jack M. Mintz, “Policy Forum: Seeking a More Coherent Approach to Interest Deductibility” (2007) 55:3 Canadian Tax Journal 629-54.
25 Enacted as SC 2012, c. 31.
26 Along with several companion provisions targeting variations on the theme.
27 The advisory panel’s recommendations are mentioned in the related budget materials.
28 In the period between the advisory panel’s report and the 2012 federal budget, the courts had made somewhat inconsistent pronouncements on surplus stripping; see, in particular, Canada v. Collins & Aikman Canada Inc., 2010 FCA 251, where the taxpayer was successful, and Coptborne Holdings Ltd. v. Canada, 2012 SCC 63, where the taxpayer was not successful, and where the Supreme Court did not comment directly on the outcome in Collins & Aikman. There is also the earlier decision in Desmarais v. The Queen, 2006 TCC 44, which reached new heights, of sorts, in conceptualizing surplus stripping as a function of cash or other value being extracted from the transferee corporation rather than the transferred corporation (that is, by getting around a paid-up capital [PUC] deficiency relative to the value of the shares of the transferee corporation, or by converting to PUC or non-share consideration corporate surplus, whether or not realized but allocable to the transferee corporation). All of the existing surplus-stripping rules—including subsections 84(1), (2), and (3); sections 84.1 (which was relevant in Desmarais), 212.1 (relevant in Collins & Aikman), and 219.1; and even subsection 87(3) (as interpreted in Coptborne)—focus exclusively on the existence of a difference between the PUC and the value of the shares being disposed of (or otherwise affected) compared to such a difference on substitute consideration (or continuing holdings). For example, neither section 84.1 nor section 212.1 looks to the existence of any such difference between the PUC and the value of the assets of a
other arrangements affecting the paid-up capital (PUC) of a CRIC—for example, a transfer to a CRIC of the shares of a foreign affiliate by the parent in exchange for shares of the CRIC (that would otherwise have high PUC), as a means of increasing PUC for the purposes of the debt-to-equity ratios applicable under the thin capitalization rules in subsection 18(4) and related provisions. The new measures are also broad in that they apply to both preferred share investments and common share investments in foreign affiliates, whether or not the investments give rise to exempt surplus dividends. These measures will apply even if the foreign affiliate investment gives rise to FAPI, and will even apply in respect of a loan to or other indebtedness of a foreign affiliate, whether or not interest-bearing, unless an election is made to treat the indebtedness as a “pertinent loan or indebtedness” (PLOI) with the consequence of having a minimum interest income inclusion at a prescribed rate amounting to the government of Canada treasury bill rate plus 4 percent, under new section 17.1.

While these measures do not directly affect the deductibility of interest associated with a foreign affiliate investment, it is intended that they will substantially discourage debt-dumping transactions and other arrangements that are perceived to result in inordinate leveraging of CRICs controlled by non-resident parent corporations, or the deployment of their liquid resources in a way that is not effectively an extension of their Canadian business activities. In this regard, it should be noted that no adverse consequences will arise under section 212.3 if the investment meets the “strategic

transferee corporation before the transfer, since in theory they remain unaffected regardless of the consideration given (be it shares or cash or other non-share consideration) as long as any such differential on the transferred shares (versus the substitute consideration) is addressed. In Desmarais, the conception of surplus stripping was extended to the extraction of cash from a transferee corporation, even though equivalent value was put into the corporation, and even though there was no relevant differential between the PUC and the value of the transferred shares because the corporations were not “connected,” so that the relationship between the transferee’s existing PUC and its value before the transaction did not change because of an extraction of value or an increase in PUC exceeding the value of new contributed property. Section 212.3 is inspired in part by similar logic, which equates a distribution to an exchange of a liquid asset for an illiquid asset of equivalent value. It is difficult sometimes to separate the outbound issues from the inbound issues. Although surplus stripping is more of an inbound issue, it does come up again in the outbound context later in this article, in relation to the stripping of taxable surplus (as defined in regulation 5907(1)) or capital gains in respect of the shares of a foreign affiliate. Also, the treatment of outbound issues is increasingly intertwined with the treatment of inbound issues more generally because of the increasing globalization of equity capital markets, as discussed below.

29 This is not to suggest that the advisory panel’s recommendation was restricted to preferred share investments.

30 This is one of the exceptions to the application of section 212.3, in the sense that a PLOI is excluded from being a relevant investment under subsection 212.3(10).

31 The applicable rate is the higher of this rate and the rate on any indebtedness related to funding the investment.

32 See the broad definition of “investment” in subsection 212.3(10).
business expansion” tests in subsection 212.3(16). Essentially, these tests turn on whether the business activities of the investee foreign affiliate (and lower-tier corporations) are (and are expected to remain) “more closely connected” to the Canadian business activities of the CRIC (and other non-arm’s-length Canadian-resident corporations) than they are to the business activities of a relevant non-arm’s-length non-resident corporation—that is, excluding the investee group and any existing “controlled foreign affiliate” (CFA) of the CRIC. For this purpose, “CFA” has the somewhat narrower meaning applicable under section 17\(^\text{34}\) (rather than the usual meaning in subsection 95(1)), which ignores control by non-residents not at arm’s length with the CRIC and so requires Canadian control (a “CCFA,” rather than just a CFA). The tests also turn on whether the officers of the CRIC had and exercised, and were expected to continue to have and exercise, the “principal decision-making authority” in respect of the investment; in addition, a majority of those officers must be resident and working principally in Canada (or a qualifying foreign country), and the performance evaluation and compensation of the members of that majority must be based on the results of operations of the investee foreign affiliate “to a greater extent” than that of any officer of a relevant non-arm’s-length non-resident corporation (with certain exclusions).

In brief, the foreign affiliate dumping measures are not targeted at all foreign affiliate investments by a CRIC controlled by a non-resident corporation; however, only very narrow exceptions are permitted, and those relate mainly to circumstances in which the affiliate’s business is “most closely connected” with the business carried on in Canada by the CRIC and the investment in the affiliate is principally managed by a majority of Canadian residents.\(^\text{35}\) Whether these measures will achieve their purpose as a practical matter remains to be seen. The Canadian corporate tax rate is currently relatively low by comparison with the rates for other significant economies; in addition, the thin capitalization measures were tightened by the 2012 federal budget, and interest rates remain low. So perhaps there will be less incentive and less capacity to engage in debt dumping, unless and until things change. As for the surplus-stripping elements of these measures, it should be noted that these would not be important if Canada did not have non-resident withholding taxes on dividends, and further that these measures are not aimed at the deployment of foreign liquid resources—that is, at the deployment of cash generated by a foreign affiliate—since they do not apply to an investment made by a foreign affiliate of a CRIC.\(^\text{36}\) The implications of these observations are considered below.

\(^{33}\) There are also a number of exceptions for reorganizations and other specific transactions set out in subsection 212.3(18).

\(^{34}\) Section 17 and changes to that provision are discussed below in greater detail.

\(^{35}\) These requirements are in theory consistent with the discussion in the advisory panel’s report, supra note 18, at 69, paragraphs 5.53 and 5.54, but in practice will be very difficult to meet.

\(^{36}\) If a CRIC makes an investment in a foreign affiliate that would otherwise be saved by the strategic business expansion exception in subsection 212.3(16), and if as part of the same series
Traditional International Tax Arbitrage and Hybrid Mismatch Arrangements

As part of the 1994 amendments to the foreign affiliate rules, the list of countries and other jurisdictions in regulation 5907(11) (which is key to deriving exempt surplus on a foreign affiliate’s income from an active business, including income that benefits from the active business income recharacterization rules for interaffiliate payments under paragraph 95(2)(a)) was replaced with the current approach to include only jurisdictions (or parts of them) to which an income tax convention is applicable. Moreover, regulation 5907(11.2) was introduced, which represented to some extent a step in the direction of limiting the ability to derive exempt surplus through interaffiliate payments to a treaty-excluded foreign affiliate. Regulation 5907(11.2)(a) introduced a “residence for treaty purposes” requirement, which could not be met under certain tax treaties by tax-privileged entities that were excluded from the relevant treaties. The most prominent example would be the Barbados international business company, which until recently was excluded from Canada’s treaty with Barbados by virtue of article XXX(3) of that treaty.37 However, a transitional rule was provided in regulation 5907(11.2)(c), which salvaged an affiliate that “would . . . be a resident of that country for the purpose of the agreement or convention but for a provision in the agreement or convention . . . that provides that the agreement or convention does not apply to the affiliate.”38 This provision applies only where the tax treaty entered into force before 1995, and only provided that the specific “kickout” provision has not been amended after 1994.

Thus, to some extent, the Mintz committee’s recommendation was already reflected in the 1994 amendments, but it was not being pursued with much vigour by

37 Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Bridgetown on January 22, 1980, as amended by the protocol signed on November 8, 2011 (herein referred to as “the Canada-Barbados tax convention”). Article XXX(3) is discussed further below.

38 There was also a separate special rule for hybrid entities like US limited liability companies, in regulation 5907(11.2)(b), which salvaged an affiliate that “would . . . be a resident of that country for the purpose of the agreement or convention if the affiliate were treated, for the purpose of income taxation in that country, as a body corporate.” This was, of course, before the controversial decision in TD Securities (USA) LLC v. The Queen, 2010 TCC 186, where it was held that a hybrid LLC could claim the benefits of the Canada-US tax convention, as a resident, and before the 2007 fifth protocol to that treaty (see infra note 43 and the accompanying text).
1997. It might be recalled that the Organisation for Economic Co-operation and Development (OECD) had released reports on “base companies” and “conduit companies” at least 10 years earlier, around the time of Canada’s 1987 tax reform.39

The last 15 years have featured continuing and even increasing debate over the use of such financing and similar intragroup arrangements (including licensing, leasing, and other intercompany legal arrangements, which may be hybrids for tax purposes) involving entities (which may also be hybrids) that are resident for tax purposes in a country other than one where the parent company is resident or where the external business revenues or expenses arise.40 The issues discussed above relating to interest deductibility (and, in particular, circumstances involving double-dip financing) are a subset of this issue area, which is much broader, because the concerns include whether even a single deduction or revenue item falls within the “right” tax base, or arises at all.

The main protagonists (or antagonists, depending on one’s perspective) in what has been something of a campaign to eradicate such arrangements have been the European Union and the OECD, along with the United States. A number of initiatives have been undertaken. For example, commencing in 1997, the United States made revisions to its withholding tax regulations and section 894(c) of the Internal Revenue Code,41 to deal with payments to and from hybrid entities,42 and started incorporating provisions in this regard into its income tax conventions, including the addition of paragraphs 6 and 7 to article IV of the Canada-US tax convention, under


41 Internal Revenue Code of 1986, as amended.

the fifth protocol signed in 2007.\textsuperscript{43} Also in 1997, the European Union commenced its project on a code of conduct for business taxation,\textsuperscript{44} and more in 2012 it issued a series of documents (through the European Commission), including a consultation paper on double non-taxation cases within the European Union,\textsuperscript{45} recommendations on aggressive tax planning,\textsuperscript{46} and recommendations regarding the application by third countries of minimum standards of good governance in tax matters.\textsuperscript{47}


\textsuperscript{44} See Commission of the European Communities, A Package To Tackle Harmful Tax Competition in the European Union, COM(97) 564 final (Brussels: CEC, November 5, 1997). See also the discussion in Malcolm Gammie, “Developments in EU Taxation,” in the 2007 Conference Report, supra note 14, 26:1-18.


OECD, for its part, released its first report on “harmful tax competition” in 1998, \(^{48}\) in 1999 released its report on “hybrid partnerships,” \(^{49}\) and then in 2000 and 2003 incorporated certain of the views reflected in those and prior reports into the commentaries on the OECD model tax convention. \(^{50}\) More recently, in 2012, the OECD released its report on “hybrid mismatch arrangements,” and in 2013 released an even broader report aimed at addressing base erosion and profit shifting (BEPS). \(^{51}\) The BEPS report seems to some extent to be a fusion of many previous initiatives, but also raises the spectre of greater coordination among countries in substantive (and not just administrative) aspects of their systems (as a means of addressing mismatches and double non-taxation), as well as of changes to traditional concepts and applications relating to jurisdiction to tax—including the “permanent establishment” principle and standards (as a means of shifting the allocation of greater jurisdiction to countries where external revenues arise).

The Canadian perspective on these various developments is difficult to discern. Although Canada seems to formally endorse the international initiatives, it continues to adopt a very autonomous and competitiveness-oriented international tax policy perspective. For example, in 2011, Canada and Barbados concluded a protocol to their income tax convention that amended article XXX(3). The former language was as follows:

3. This Agreement shall not apply to companies entitled to any special tax benefit under the Barbados International Business Companies (Exemption from Income Tax) Act, Cap 77 or to companies entitled to any special tax benefit under any similar law enacted by Barbados in addition to or in place of that law [underline added].

As noted above, the saving clause for treaty-excluded entities in regulation 5907(1)(a)(b) does not apply where a kickout treaty provision has been amended after 1994. Thus, it no longer applies to entities subject to the Canada-Barbados tax convention. However, the protocol to that convention now provides the following:


3. The provisions of Articles VI to XXIV of this Agreement shall not apply to any person or other entity entitled to any special tax benefit:

(a) in Barbados, under the International Business Companies Act, the Exempt Insurance Act, the Insurance Act, the International Financial Services Act, the Society With Restricted Liability Act, or the International Trusts Act, or any substantially similar law subsequently enacted; or

(b) in either Contracting State, under a law of that State which has been identified in an Exchange of Notes between the Contracting States [underline added].

Accordingly, it seems to be the intention and expectation of the parties to this agreement that the tax-privileged entities referred to shall be capable of being regarded as residents of Barbados for the purposes of the convention. Coupled with developments in the administrative practice concerning the determination of treaty residence in general under the traditional “liable-to-tax” test, as well as the expansion of Canada’s exempt surplus regime to non-treaty jurisdictions with which Canada has a tax information exchange agreement (TIEA) (also introduced under the 2007 federal budget), this does not quite sound the death knell for the use of tax-privileged entities in the outbound context.

Indeed, the bigger threat to these practices may be potential developments in the domestic laws of various jurisdictions to tax the direct receipt of interest, rents, royalties, and other such items from foreign affiliates at preferential rates. For example, the United Kingdom has its new “patent box” regime (and a new participation exemption regime for international income), and the United States is effectively considering the same sort of low-rate approach for income from intangibles (also as part of a broader potential reform of its international tax regime, including the introduction of a participation exemption regime). In Canada, although the advisory panel did not recommend the adoption of such an approach, it did recommend

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52 See, for example, Income Tax Technical News no. 35, February 26, 2007, in which the Canada Revenue Agency (CRA) stated that the liable-to-tax test “does not necessarily mean that a person must pay tax to a particular jurisdiction. There may be situations where a person’s worldwide income is subject to a contracting state’s full taxing jurisdiction but that state’s domestic law does not levy tax on a person’s taxable income or taxes it at low rates. In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive (e.g. treaty shopping where the person is in fact only a ‘resident of convenience’). Such could be the case, for example, where a person is placed within the taxing jurisdiction of a Contracting State in order to gain treaty benefits in a manner that does not create any material economic nexus to that State.”

53 See regulation 5907(11).

54 Even the foreign affiliate dumping measures try to accommodate such arrangements for financing qualifying investments, under subsection 212.3(24).

55 See the discussion in Angelo Nikolakakis, “Credit Versus Exemption—An Evolving Constellation of Constellations” (http://online.ibfd.org/kbase/) (database available to subscribers only).

56 See the advisory panel report, supra note 18, at 44-53, paragraphs 4.126-4.167, which includes a discussion of double-dip financing arrangements; and ibid., at 34, paragraphs 4.74-4.78, concerning the treatment of income from foreign branches.
that consideration be given to it.\textsuperscript{57} This would be taking a direction exactly opposite to that recommended by the Mintz committee.

\textbf{The Canadian Cone}

As noted above, the Mintz committee recommended that restrictions be introduced on the active business income recharacterization rules under paragraph 95(2)(a) for intercompany payments from related non-resident corporations held outside the Canadian cone.\textsuperscript{58} This recommendation was arguably implemented in stages, and in certain respects even more broadly than the Mintz committee had recommended, beginning with the 1998 changes to the income imputation rules of section 17,\textsuperscript{59} and including the more direct changes introduced under the 2007 federal budget, whereby the “qualifying interest” standard was imposed in respect of the non-resident payer or originator of the income or instrument in question, as well as certain subsequent developments. These subsequent developments include the upstream loan proposals first released on August 19, 2011, and later revised and included in Bill C-48,\textsuperscript{60} as well as the foreign affiliate dumping measures enacted in 2012.

Under the new regime for the active business income recharacterization rules for intercompany payments, which only took effect after 2009, the rules are effectively restricted to payments from “another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest.”\textsuperscript{61} It is no longer possible for these rules to apply in respect of payments from a payer that is merely a related non-resident corporation, with the result that second-tier financing arrangements will generate FAPI if the Canadian corporate group under the foreign parent corporation does not have at least a “qualifying interest” in the payer corporation. Under paragraph 95(2)(n), a deemed qualifying interest arises for each corporation resident in Canada within a related group provided that such an interest is held by any Canadian-resident member of the group. Thus, a non-resident corporation that is wholly owned by the Canadian taxpayer’s Canadian-resident parent corporation is permitted,

\begin{itemize}
  \item \textsuperscript{57} Ibid., at 97-98, paragraphs 8.8-8.16. The panel noted, ibid., at 98, paragraph 8.14, that “[w]hile this policy allows Canadian businesses to reduce foreign tax costs without reducing Canadian tax otherwise payable, it encourages Canadian companies to establish complicated structures in other countries, incurring the costs and administrative burden of setting up and maintaining companies or branches, hiring and managing employees, and engaging and paying professional advisors.” See also Brian Mustard, Nick Pantaleo, and Scott Wilkie, “Why Not Kenora? Reflections on What Canada’s Approach to Taxing Foreign Business Income Is and Could Be,” in the 2009 Conference Report, supra note 43, 6:1-48.
  \item \textsuperscript{58} See supra note 11 and the accompanying text.
  \item \textsuperscript{59} See SC 1999, c. 22, section 8, applicable to taxation years that begin after February 23, 1998.
  \item \textsuperscript{60} Bill C-48, An Act To Amend the Income Tax Act, the Excise Tax Act, the Federal-Provincial Fiscal Arrangements Act, the First Nations Goods and Services Tax Act and Related Legislation, first reading in the House of Commons November 21, 2012.
  \item \textsuperscript{61} Clause 95(2)(a)(ii)(B).
\end{itemize}
but a non-resident corporation that is wholly owned by the Canadian taxpayer's non-resident parent corporation is not permitted.

The qualifying interest standard is consistent with a legislative intent to permit access to the recharacterization rules in the context of bona fide joint venture arrangements (where a “related foreign affiliate” standard would be problematic), but it is nevertheless a somewhat curious one in the context of dealing with second-tier financing arrangements, given the 1998 changes to section 17. Under those changes, the rules were expanded considerably, including the introduction of an indirect loan rule in subsection 17(2). As noted above, these rules also feature a modified definition of “controlled foreign affiliate.” For these purposes, the main definition in subsection 95(1) is modified, as follows:

“[C]ontrolled foreign affiliate,” at any time, of a taxpayer resident in Canada, means a corporation that would, at that time, be a controlled foreign affiliate of the taxpayer within the meaning assigned by the definition “controlled foreign affiliate” in subsection 95(1) if the word “or” were added at the end of paragraph (a) of that definition and

(a) subparagraph (b)(ii) of that definition were read as “all of the shares of the capital stock of the foreign affiliate that are owned at that time by persons resident in Canada who do not deal at arm’s length with the taxpayer”; and

(b) subparagraph (b)(iv) of that definition were read as “all of the shares of the capital stock of the foreign affiliate that are owned at that time by persons resident in Canada who do not deal at arm’s length with any relevant Canadian shareholder” [emphasis added].

The effect of restricting these provisions to persons resident in Canada is that Canadian control is required (although this is de jure control, and there is no relative value test) in order to qualify as a “controlled foreign affiliate” (in other words, a CCfA) for the purposes of section 17. This would not include a non-resident corporation in which the Canadian corporate group under the foreign parent corporation had only a qualifying interest in the payer corporation (unless the qualifying interest represented 10 percent of the value but, say, 51 percent of the votes). Again, though, we see the same pattern, in that subsection 17(13) provides that “where . . . two corporations resident in Canada are related (otherwise than because of a right referred to in paragraph 251(5)(b)), any corporation that is a controlled foreign affiliate of one of the corporations at that time is deemed to be a controlled foreign affiliate of the other corporation.” Thus, a non-resident corporation that was wholly owned by the taxpayer’s Canadian-resident parent corporation would qualify, but one that was wholly owned by the taxpayer’s non-resident parent corporation would not. This is important because the exclusion under paragraph 17(3)(a) from the indirect loan rule in subsection 17(2) and the exclusion for direct loans in subsection 17(8) apply only where the relevant entities are CCFAs.

There are other important differences between the scope of section 17 and that of paragraph 95(2)(a), but mainly section 17 applies only to loans and other forms of indebtedness, whereas paragraph 95(2)(a) can apply to any type of income. Thus, until the changes were made to paragraph 95(2)(a), a second-tier financing arrangement involving payments from a non-resident corporation that was wholly owned by the Canadian taxpayer’s non-resident parent corporation would be problematic under section 17 if structured as a loan or other indebtedness, but not if structured as a lease, and both arrangements remained feasible under paragraph 95(2)(a). After the changes to paragraph 95(2)(a), both arrangements are problematic under that provision, unless the Canadian members of the corporate group hold a qualifying interest in the payer, but the payer need not be a CCFA unless the arrangement is structured as a loan or other indebtedness.

The CCFA standard was also adopted for the exclusion from the proposed new upstream loan rules in Bill C-48. These rules would apply where a foreign affiliate makes a loan or extends other indebtedness to a “specified debtor,” defined under proposed subsection 90(15) as the taxpayer or a non-arm’s-length person other than a CCFA. This would, of course, include a non-resident ultimate parent corporation above the Canadian corporate taxpayer, or a non-resident sister corporation, unless it was a CCFA, and it would include the taxpayer, which could not be a CCFA. Where the rules apply, the taxpayer may get a reversible income inclusion under proposed subsection 90(6), subject to a number of exceptions. The rules (and exceptions) are designed to discourage the deployment of the liquid resources of a foreign affiliate either in or around Canada where a distribution to the taxpayer would have been taxable either as income or as a capital gain. For example, a distribution of taxable surplus (or the new hybrid surplus, discussed below) would be taxable unless there was sufficient underlying foreign tax applicable (as defined and allocated under the regulations), and/or sufficient adjusted cost base (ACB) in the relevant shares, to cover the income inclusion under subsection 90(1) with deductions under subsection 113(1). In contrast, a distribution of exempt surplus would always be covered by subsection 113(1) deductions. A distribution of preacquisition surplus would be covered by deductions under paragraph 113(1)(d) but would produce ACB reductions under subsection 92(2) and paragraph 53(2)(b), and could produce a capital gain (or a mandatory deemed dividend), depending on the amount of the ACB of the relevant shares.

The Canada Revenue Agency (CRA) previously granted rulings on upstream loans to the taxpayer, and on loans to related non-resident corporations under a non-resident ultimate parent corporation where the liquid resources originated with the

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63 The income inclusion may be reversed under proposed subsection 90(14) on repayment of the indebtedness other than as part of a replicating series.

64 See the discussion infra note 67.

65 See, for example, CRA document no. 9830143, 1999, and the more recent CRA document no. 2007-0243301C6, October 5, 2007.
Canadian taxpayer.66 The two situations are very different with reference to a focus on whether a distribution to the taxpayer would have been taxable, since liquid resources originating with the taxpayer that found their way into a foreign affiliate would give rise to ACB in the shares of the foreign affiliate, which would then permit a tax-free distribution back to the taxpayer;67 but it is understood that the Department of Finance did not want to accommodate second-tier financing arrangements even if FAPI would arise on the income, the desire presumably being to “force” these arrangements to be unwound and restructured as direct loans from Canada (under the new high-rate PLOI rules, discussed below) or as actual distributions from Canada. Thus, mechanically, there is a difference between the operation of the upstream loan rules where indebtedness goes back to Canada versus around Canada: if the indebtedness goes back to Canada, the income inclusion that would otherwise arise can be reduced with reference to the ACB on the relevant shares; if, however, the indebtedness goes around Canada, then the income inclusion cannot be so covered with ACB.68 In other respects, the rules are essentially parallel, in permitting reductions for the inclusion that would otherwise arise to the extent of the exempt surplus and other “good” tax attributes in the foreign affiliate group (including partly covered taxable surplus and fully covered hybrid surplus).69

Another interesting feature of these rules is that, although the CCfA standard is used, the effect is not necessarily “all or nothing,” as with section 17. That is, where the rules apply, they require an inclusion equal to the “specified amount,”70 which is determined by a formula that is designed to measure what may be referred to as “economic leakage.” This is measured with reference to a difference between the taxpayer’s “surplus entitlement percentage” (SEP)71 in the creditor foreign affiliate and its SEP in the “specified debtor” (assuming that it is not a CCfA and thus not otherwise completely excluded). Essentially, SEP is a measure of a taxpayer’s relative

66 See, for example, CRA document no. 2010-0353141R3, 2010.
67 Under proposed regulation 5901(2)(b), the taxpayer would be permitted to treat the distribution as a dividend out of preacquisition surplus even if there was taxable surplus (or hybrid surplus) in the way, thereby leaping over these other accounts and getting cost-recovery treatment under paragraph 113(1)(d), subsection 92(2), and paragraph 53(2)(b), provided that negative ACB did not arise. In the event of negative ACB, a second round of deemed dividends would arise under the mandatory deemed dividend rules in proposed paragraph 93(1.1)(b), and these other accounts would then be dragged out—a result that is curious in itself, in that an extraction of value on a redemption of shares or a liquidation of the affiliate would never give rise to a mandatory deemed dividend (though an elective one would be available under subsection 93(1)) even if a capital gain would result. See the discussion below under the heading “Foreign Affiliate Surplus Accounts.”
68 See proposed subsection 90(9).
69 Ibid.
70 See the definition in subsection 90(15).
71 See regulation 5905.
outbound foreign direct investment

economic entitlement to distributions from the relevant foreign affiliate. If the taxpayer’s SEP in the specified debtor is at least as high as its SEP in the creditor affiliate, then there is no economic leakage; if it is lower, then the leakage is determined as the taxpayer’s SEP in the creditor affiliate minus the taxpayer’s SEP in the specified debtor, which is the net percentage by which the loan amount is then multiplied to determine the specified amount (ranging from 100 percent where SEP in the creditor affiliate is 100 and SEP in the specified debtor is nil, to nil if the two SEPs are at least the same). This is a somewhat odd combination of features, since the economics are not directly tested in determining CCFA status, and in theory (and subject to anti-avoidance rules) there can be CCFA status in the debtor with essentially nil economic interest.

Where does this take us when it comes to determining the parameters of the Canadian cone? The confusion gets even more intense in the broader context of a survey of the standards applicable under other potentially relevant rules and regimes.

- Beginning with the foreign affiliate regime in general, the standard that emerges from the application of the definition of “foreign affiliate” in subsection 95(1) and the definitions of “equity percentage” and “direct equity percentage” in subsection 95(4) is commonly considered to be 10 percent of the shares of any class, but really all that the Canadian taxpayer in a multinational group must hold is 1 percent of any class of shares if another 9 percent is held by a related person, even a non-resident. This relates to income from actual active business operations, and is relevant in the context of arrangements such as those highlighted by the advisory panel in relation to debt dumping, as well as other arrangements targeted by the foreign affiliate dumping measures.

- Under subsections 15(2) and 80.4(2), a similar standard is required, for exclusion from adverse consequences. Subsection 15(2) can apply (together with paragraph 214(3)(a) and subsection 212(2)) to produce a deemed dividend where a corporation resident in Canada makes a direct loan (or extends other indebtedness) to a non-resident shareholder or a “connected” person, and subsection 80.4(2) can impute a benefit to the debtor in respect of insufficient interest payable under the debt, but those rules do not apply where the debtor is a foreign affiliate of the taxpayer or of another person resident in Canada with which the taxpayer does not deal at arm’s length. This relates only to indebtedness, and it should be noted that a new exception was introduced as

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a companion to the foreign affiliate dumping measures in relation to a PLOI owing by a non-resident other than a foreign affiliate, which would get the same treatment under new section 17.1 as a foreign affiliate PLOI. That treatment, which is elective, is a minimum income inclusion at a relatively high rate.

- However, as noted, the active business income recharacterization rules in paragraph 95(2)(a) require a qualifying interest (which is 10 percent of votes and value) to be held by the Canadian-resident members of the group on the creditor side (or that the non-resident corporation be a CFA, but not a CCFA), and on the debtor side. This relates to any type of income that requires recharacterization under paragraph 95(2)(a), as is relevant in the context of a second-tier financing arrangement.

- Interestingly, under part IV of the Act, a refundable tax may apply on dividends received by a “private corporation” or a “subject corporation” from a foreign affiliate unless the affiliate is “connected” for these purposes. In this context, a foreign affiliate is connected if the taxpayer, alone or together with non-arm’s-length persons, controls the foreign affiliate (control, for this purpose, being defined under subsection 186(2) to mean holding more than 50 percent of the affiliate’s issued share capital having full voting rights under all circumstances) or the taxpayer owned more than 10 percent of the votes and value of the issued shares. This relates to any type of income flowing through a share of a foreign affiliate, but would typically not be a concern in the context of a second-tier financing arrangement.

- Under subsection 258(5), which extends some of the preferred share rules into the foreign affiliate context, and can have the effect of recharacterizing dividends on the shares of a foreign affiliate as interest income, the standard for exclusion is a “substantial interest” as defined under subsection 191(3)—that is, either the foreign affiliate is “related” to the taxpayer or the taxpayer holds, essentially, at least 25 percent of the affiliate’s shares by votes and value, including imputed ownership from “related” persons (whether or not residents). Again, this relates to any type of income flowing through a share of a

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73 There would be two definitions of a PLOI—the one in respect of investments in a foreign affiliate under subsection 212.3(11), and a separate one under subsection 15(2.11) for the purposes of the exclusion from the deemed dividend rules in subsection 15(2).

74 A “private corporation” is defined in subsection 89(1) essentially as “a corporation that . . . is not a public corporation and is not controlled by one or more public corporations (other than prescribed venture capital corporations) or prescribed federal Crown corporations or by any combination thereof.”

75 A “subject corporation” is defined in subsection 186(3) as “a corporation (other than a private corporation) resident in Canada and controlled, whether because of a beneficial interest in one or more trusts or otherwise, by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts).”
foreign affiliate, but would typically not be a concern in the context of a second-tier financing arrangement.\textsuperscript{76}

- The FAPI rules require a de jure control standard to be satisfied in order for attribution to arise.\textsuperscript{77} However, actual control is not required by a particular person or group, and it is sufficient if the relevant taxpayer would hypothetically control the affiliate if it held the shares that it holds and certain imputed shares, including those owned by not more than four other arm’s-length persons resident in Canada. Thus, a foreign affiliate can be a CFA of a taxpayer resident in Canada if it is controlled by a non-resident ultimate parent corporation, or if enough of its voting shares are held by even arm’s-length Canadian residents, and there can be a CFA with which the taxpayer is dealing at arm’s length. Although this definition does not test relative economic entitlement, for FAPI purposes that is dealt with under the “participating percentage” rules that determine FAPI attribution.\textsuperscript{78}

- Section 17 requires the CCFA standard to be satisfied by the Canadian-resident members of the group—that is, hypothetical Canadian de jure control with no particular relative value threshold, except to the extent that an exclusion under subsection 17(8) might require the qualifying interest standard to be met.\textsuperscript{79} This relates only to indebtedness, including indirect indebtedness. This is a concern in the context of a second-tier financing arrangement.

- The upstream loan proposals also require the CCFA standard to be satisfied with respect to non-resident debtors. Interestingly, though, if this standard is not met, the rules switch focus to economic leakage. This relates only to indebtedness, whether funded with liquid resources originating from a foreign affiliate or from the Canadian taxpayer, and is thus a concern in the context of a second-tier financing arrangement.

- The foreign affiliate dumping measures do not have any main exception that depends on ownership thresholds, whether based on votes or on value.\textsuperscript{80} The main focus of that regime is on testing functional business and management

\textsuperscript{76} See also subsections 258(3) and (4), but there the exclusions depend on whether the shares in question were acquired in the ordinary course of the business carried on by the taxpayer corporation.

\textsuperscript{77} See the definition of “controlled foreign affiliate” in subsection 95(1).

\textsuperscript{78} See the definition of “participating percentage” in subsection 95(1) and the rules in regulation 5904, the operation of which is based on relative annual distribution entitlements where there is more than one class of shares outstanding.

\textsuperscript{79} See clause 17(8)(a)(i)(B) and subparagraph 17(8)(a)(ii).

\textsuperscript{80} There are lower-order design features that depend on some such elements, such as the exclusions from being able to meet the strategic business expansion tests in general, or certain reorganization exceptions, in relation to preferred share investments unless the issuer affiliate is wholly owned by the CRIC (see subsection 212.3(19), and certain aspects of the strategic business expansion tests under paragraphs 212.3(16)(a), (b), and (c)).
connections between any Canadian business and management of the CRIC and the investee foreign affiliate. The tests (and exceptions), in general, are designed to find not economic leakage, but rather what may be viewed on certain assumptions as undesirable leakage to the Canadian tax base from deployments outside Canada of liquid resources originating in Canada (whether or not from borrowings). This explains both the breadth of these measures, in applying to all forms of investment by CRICs, even investments in their wholly owned subsidiaries (these being, of course, indirect subsidiaries of the non-resident ultimate parent corporation), and their narrowness, in not applying to investments by foreign affiliates. Whether or not those assumptions are valid is controversial.

Income tax systems are forever attempting to make distinctions between taxpayers or events as a function of relationships, residence, and tax status, among other factors. We are, of course, dealing here largely with legal and tax fictions, which play out against the backdrop of legal constructs like the “corporation” and its “separate existence”; thus, it is not surprising to find features of the tax system that drive off the underlying legal characteristics, such as de jure control, “debt” versus “equity,” and even the separateness of the corporation, which is at once recognized and then often displaced through a deeming rule or a special regime. There is also an evident tension between adopting such legalistic reference points versus others more focused on the economic or functional characteristics of a particular set of circumstances.

The treatment of OFDI is no different in this regard. Some of the rules or regimes described above focus on legal characteristics, while others focus more on economic or functional considerations, and some focus on both. Whether or not the focus, or the consequence, is appropriate to the specific context, and the policy concern being addressed, is not always evident. This can give rise to “scheme confusion,” which is not good in general because it creates uncertainty, but it also raises questions as to the applicability of the general anti-avoidance rule (GAAR) in section 245, which requires considerable clarity on the questions of “scheme” and “abuse.”

The Canadian cone is an informal construct designed to measure what is “under” the Canadian taxpayer and thus is inside or “under” Canada, as opposed to not just being outside Canada but also leaking economic value “around” Canada. Where all relevant arrangements or events are either inside or under Canada, there is no Canadian tax base erosion because of economic leakage, and no tax base erosion at all except to the extent that one posits the relocation outside Canada (and into forms that yield exempt surplus treatment or at least deferral) of investments, activities,
and income that would otherwise have been taxable in Canada, or the relocation (or location) into Canada of investments, activities, and deductions that would otherwise not have been in Canada. This is the premise of the FAPI rules in general, and of the foreign affiliate dumping measures in particular.

What the foreign affiliate dumping measures also have in common more generally with the foreign affiliate rules and the qualifying interest rules, as well as certain premises of part IV tax, is that all are seeking to set standards as a function of the taxpayer’s connections with underlying income (assuming that it is active business income). They just do so in different ways. The foreign affiliate rules in general simply look to a minimal ownership interest—just enough to be noticed by the corporation. The qualifying interest rules raise the bar but do not radically change the focus—a holder of 10 percent of votes and value would be noticed, and would have some influence, but would not have legal control. Part IV nudges the bar a bit higher, but still has the same focus. Section 17 and the upstream loan rules use the CCfA standard, which focuses more on legal control than on ownership, though the upstream loan rules also focus on relative ownership. The foreign affiliate dumping rules are different in that they require factual proof of the actual business and management connections; they are not prepared to assume such connections on the basis of legal control or ownership percentage—not even when the CRIC is a public corporation, or when the CRIC holds 100 percent of the de jure control and economic interest in the investee foreign affiliate—because of the presence of the non-resident ultimate parent corporation, but they are still testing for the same thing, which is the CRIC’s connections with the underlying investment. However, what else is different about these rules is that the focus is not so much on what is or is not under Canada, but on what should be under Canada. In that sense, they delineate the Canadian cone more from a normative and functional perspective than from a measurement of legal control or ownership perspective.

Section 17 and the upstream loan rules also posit the possibility of a non-resident ultimate parent corporation, but this aspect of the upstream loan rules is designed mainly to find economic leakage, as is subsection 15(2) to some extent (at least traditionally, before the PLOI exception), though neither the traditional subsection 15(2) nor the upstream loan regime drives off whether the indebtedness yields income taxable in Canada at a reasonable rate. This distinction between these regimes and section 17 is explained in part by the reversible features of subsection 15(2) and the upstream loan rules. What is being taxed in the main is the deployment of the resources, not the return on that deployment as such. The reversal of the tax makes its economic cost its time value, which should in theory relate to the time value of the deployment. In that sense, the focus is not on economic leakage but on tax leakage (that is, the withholding tax that would have been paid on an actual distribution by the Canadian-resident corporation or the part I tax that would have been paid on an actual distribution to the Canadian-resident corporation). While the exclusions for foreign affiliates and for CCfAs do seem to test to some extent for pure economic leakage, it is measured by reference to legal ownership or control. In contrast, section 17 taxes the return, which is why the inclusion is reduced by any related FAPI
being generated,\(^8\) and why the impact is not reversible. The conception of economic leakage underlying section 17 is thus mainly based on concern relating to the return from the deployment (since tax leakage through transformation to exempt surplus is permitted where the debtor is a CCfA earning active business income), although the indirect loan rule in subsection 17(2) is closer in focus to subsection 15(2), despite the differences in the standards for exclusion (CCfA versus foreign affiliate) and the differences in impact (income imputation versus deemed dividend). What is confusing is that both section 17 and the upstream loan rules adopt the CCfA standard, which does not test the economics,\(^8\) although the administrative practice of the CRA in relation to applying the anti-avoidance rule in paragraph 95(6)(b) for the acquisition or disposition of foreign affiliate shares does test the economics, including the economic value of related tax benefits.\(^8\) However, so far the courts have not been very sympathetic to the CRA’s approach to the application of paragraph 95(6)(b) in the context of a second-tier financing arrangement.\(^8\)

The foreign affiliate dumping measures also seek to tax the deployment of liquid resources, but there are circumstances in which they can give rise to a permanent adverse consequence even on what is a temporary deployment. In other words, these measures can give rise to double taxation in contexts where they are triggered by the deployment of liquid resources originating in the CRIC (other than borrowed funds)—specifically, an investment can give rise to a deemed dividend without any adjustment to PUC with the result that there will be another dividend on the actual distribution of the relevant economic value from the CRIC. Where the foreign affiliate dumping measures are triggered by the deployment of borrowed funds, one could argue that there is no double taxation in the same sense because the tax is intended as compensation for the interest deduction, not for the deployment of the resources. Thus, the tax on the actual subsequent distribution, if any (after repayment of the debt), will be a first tax levied as a distribution tax (or a proxy for such tax). The problem is that these measures are trying to do two very different things at the same time: to tax debt dumping, the focus of which is the deduction; and to tax surplus stripping, the focus of which is the extraction or deployment of resources. Both are displaced by a PLOI (whether to a foreign affiliate or to another non-resident), which undercuts both debt dumping, by producing a taxable return that offsets any corresponding deduction,\(^8\) and surplus stripping, in that it keeps a

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82 See subparagraph 17(1)(b)(iii).
83 The upstream loan rules do test for SEP differentials, if CCfA status is failed.
85 See Univar Canada Ltd. v. The Queen, 2005 TCC 723.
86 It should be noted that the rate applicable under subsection 17.1(1) in respect of a PLOI is the higher of the specified prescribed rate and the rate applicable under any debt funding incurred in relation to the PLOI, thereby precluding a negative spread.
reasonable return from a deployment (if not the deployment of the resources as such) within the Canadian tax base, without actually waiving the tax on a future actual distribution. This appears to reflect an evolution of the conceptions of both tax and economic leakage, and an acceptance that the Canadian tax base is not entitled to tax a return from a deployment in excess of that rate. The acceptance of a relatively high minimum taxable inclusion accepts this as the absence of economic leakage (and excludes consideration of who gets the benefit of any residual return or growth), but there is also a further insistence on having an absence of tax leakage (that is, net interest deductions or tax-deferred deployments). On the other hand, if the investment is not a PLOI, there is no guarantee that the tax cost will bear a strong relationship to any resulting tax benefit,87 in either direction.88 This is one of the more controversial aspects of these measures.

The upstream loan rules are also trying to do two things at the same time. They are aimed primarily at taxing deployments of liquid resources originating in foreign affiliates (whether the indebtedness arises in or around Canada) but also, for some reason, at taxing the return from deployments of liquid resources originating in Canadian corporate taxpayers. Consequently, there is no coverage against inclusion for paragraph 113(1)(d) deductions and ACB where the debtor is a non-resident. Arguably, such coverage should be available at least where the indebtedness results in the same tax consequences in Canada as a PLOI—that is, a relatively high-rate inclusion. Indeed, it is not at all obvious in principle why a PLOI mechanism could not have been a condition for accessing coverage against inclusion for paragraph 113(1)(d)

87 The foreign affiliate dumping measures do try to permit the deemed dividend that would otherwise arise to be offset against PUC that may be available to be reduced (under subsections 212.3(6) and (7)), and also to reinstate that PUC at the time of a subsequent distribution of certain foreign affiliate investments (under subsection 212.3(9)). This mechanism is intended to permit a CRIC that is controlled by a non-resident parent to be capitalized with equity by the foreign parent and to use that equity to make a non-PLOI investment. In such a case, there would be no tax leakage, even if the investment yielded exempt surplus, and under current rules there could even be tax on any subsequent gain to the CRIC or on any subsequent distribution of the return or gain by the CRIC as dividends to the non-resident parent. A PLOI can be funded with borrowings by the CRIC, and there cannot be a negative spread, so again the idea is that a CRIC can be used by a non-resident parent as an intermediate vehicle—although if the debt capital of the CRIC comes from the parent (or another “specified non-resident”), then the thin capitalization rules in subsection 18(4) and related provisions may limit the deduction, creating inefficiencies. Inefficiencies can also arise because of withholding taxes, although the treaty rate is nil from Canada to the United States. Where the funding comes from retained earnings of the CRIC (in the sense that there is no PUC available to offset), a non-PLOI investment yields a deemed dividend, and a PLOI yields a compromise treatment—the deferral of the deemed dividend in exchange for the continuation of a taxable income stream in the CRIC.

88 A further element here is that the tax rate will depend on the possibility of treaty-reduced rates of dividend withholding tax, such that there will be a greater possibility of variance between the cost and the value of any resulting Canadian tax benefits.
deductions and ACB where the indebtedness is incurred by a non-resident. That would have resulted in greater coherence between the upstream loan rules and the foreign affiliate dumping measures, including the revisions to subsection 15(2), as well as between these provisions and section 17 and the qualifying interest restrictions to the active business income recharacterization rules in paragraph 95(2)(a).

THE ADVISORY PANEL

The advisory panel had a lot more to say about substantive aspects of the treatment of OFDI than what has been mentioned above. In particular, the panel recommended a significant expansion of the exemption regime, to cover active business income from all jurisdictions (thereby abandoning the treaty/TIEA country requirements), and to cover capital gains from the disposition of shares of foreign affiliates (but not foreign branch profits). The panel also recommended a review of Canada’s base erosion and investment business rules, as well as a gradual and bilateral approach to eliminating non-resident withholding taxes on dividends and other payments.

As it stands, a foreign affiliate’s liquid resources can be deployed to acquire equity in another foreign affiliate (that is not a CFA or CCFA, and in which the taxpayer does not have a “qualifying interest”), which would yield exempt surplus, without adverse consequence under the foreign affiliate dumping measures or the upstream loan rules, or under section 17 (since it does not pick up indirect equity investments); however, the acquiring affiliate cannot make a PLOI to a non-CCFA without the upstream loan rules applying, even though this would yield income that is taxable in Canada. That seems odd. It is also interesting that the upstream loan rules do not contain a rule that equates preferred shares with debt in any circumstances (even though the foreign affiliate dumping measures do contain a preferred share rule for certain purposes), but seem to be intended to rely instead on a “GAAR warning” set out in the explanatory notes accompanying Bill C-48, the text of which reads as follows:

**GAAR warning**

It should also be noted that any attempts at circumventing subsection 90(6) or fitting into one of the exceptions in subsection 90(8) or the deduction in subsection 90(9) that are not within the scope of the intended application of these rules, as set out in these notes, will be subject to review under the general anti-avoidance rule in section 245 of the Act. Among other things, it is intended that back-to-back loans, and similar financial arrangements, that frustrate the intent of subsection 90(7) and the use of debt-like equity interests, such as preferred shares, or synthetic lending arrangements—such as the factoring of receivables or the sale of securities at a discount—in order to avoid the application of subsection 90(6) would be considered a misuse of these new provisions and an abuse of the Act (including its Regulations) read as a whole for the purposes of section 245.


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89 As it stands, a foreign affiliate’s liquid resources can be deployed to acquire equity in another foreign affiliate (that is not a CFA or CCFA, and in which the taxpayer does not have a “qualifying interest”), which would yield exempt surplus, without adverse consequence under the foreign affiliate dumping measures or the upstream loan rules, or under section 17 (since it does not pick up indirect equity investments); however, the acquiring affiliate cannot make a PLOI to a non-CCFA without the upstream loan rules applying, even though this would yield income that is taxable in Canada. That seems odd. It is also interesting that the upstream loan rules do not contain a rule that equates preferred shares with debt in any circumstances (even though the foreign affiliate dumping measures do contain a preferred share rule for certain purposes), but seem to be intended to rely instead on a “GAAR warning” set out in the explanatory notes accompanying Bill C-48, the text of which reads as follows:

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90 See the advisory panel report, supra note 18, at 26, recommendation 4.1, and 28, recommendation 4.2.

91 See ibid., at 30, recommendation 4.3.

92 See ibid., at 34, paragraphs 4.74-4.78.

93 See ibid., at 44, recommendation 4.6.

94 See ibid., at 77, recommendation 6.1.
To date, there has not been a great deal of progress toward any such revisions to the treatment of OFDI and other aspects of our international tax system, although there has been considerable debate. This is somewhat surprising in light of the recent developments along those lines in other countries, and in light of the foreign affiliate dumping measures and other regimes. One might argue that the recognition underlying the foreign affiliate dumping measures that the CRIC essentially is an instrument of its non-resident ultimate parent corporation (which is no different really than the proposition that a CFA essentially is an instrument of its Canadian-resident shareholder(s)) should have come with the acknowledgment that the foreign-source income derived by the CRIC should be treated as the foreign-source income ultimately of a non-resident person, and thus should not be taxable in Canada either under part I (because of a narrow exemption system) or under part XIII (because such income flows through Canada to the non-resident shareholder(s)).

95 One exception in the context of base erosion is the set of proposals released on November 27, 2012 to loosen up some of the rules in relation to the deployment of liquid resources in the banking sector. See Canada, Department of Finance, Legislative Proposals Relating to Income Tax (Ottawa: Department of Finance, November 2012).


97 See Nikolakakis, supra note 55.

98 In a sense, the strategic business expansion tests impose a standard that is similar to that which would be applicable in determining whether the foreign affiliate investment should be regarded as part of the Canadian business operations of the CRIC—and thus as part of the Canadian branch operations (conducted through the CRIC) of the non-resident ultimate parent corporation.

99 At a minimum, it is difficult to reconcile a permanent deemed dividend in relation to the deployment outside Canada of liquid resources originating in the CRIC (other than from borrowings) with continued taxation of any return from that deployment, as well as an additional layer of taxation on an actual subsequent distribution, since there would not be any continued taxation of the return or any subsequent layer of taxation had there been an actual distribution in the first place. Even subsections 15(2) and 80.4(2) acknowledge this, in that subsection 80.4(2) does not result in an additional benefit for the return on the deployment if subsection 15(2) gives rise to an inclusion for the deployment itself. See paragraph 80.4(3)(b). See also subsection 17(7), which excludes the application of subsection 17(1) if the deployment has given rise to part XIII tax.
This would have represented a real shift toward a paradigm for international taxation that gets beyond the notion of the Canadian cone and is grounded in a notion that is better described as “the Canadian hourglass,” in recognition of the increasing globalization of equity capital markets (and therefore of Canadian corporations having non-resident shareholders, “above Canada”) and of multinational business enterprises (and therefore of Canadian corporations having non-Canadian business activities, “below Canada”), and thus the increasing relevance of the observation that the taxation of such income by Canada in the hands of CRICs constitutes, in substance, the taxation by Canada of non-resident stakeholders in respect of foreign-source income, and the consequent decreasing relevance of corporate residence as a sound foundation for the formulation of international tax policy. In the modern context, it is submitted that the focus of business taxation should be reoriented toward the Canadian tax base, for both resident and non-resident taxpayers alike, and personal taxation should be reoriented toward the taxation of residents only. Such a clear paradigm shift has yet to occur in Canada, but it may be starting to come together incrementally.

**FOREIGN AFFILIATE SURPLUS ACCOUNTS**

People often say that the foreign affiliate rules are complicated and, in particular, that the most complicated parts are the regulations applicable to the determination of foreign affiliate surplus accounts. It is not clear why that is. There are many rules in these regulations, and they have formulas and such, but they are there to serve the same function as the rules in the Act that apply to the determination of “income,” as well as the rules and principles applicable in determining “safe income.” They are there to determine the realized earnings of a foreign affiliate, as a measure of when a corporate distribution should be given income treatment (for example, where a dividend is paid out of exempt surplus or taxable surplus) rather than cost-recovery or capital gains treatment (where a dividend is paid out of preacquisition surplus), and as a measure of the amount by which what would otherwise be proceeds from the disposition of shares of the corporation can effectively and legitimately be reduced by an actual or deemed predisposition dividend. Somewhere along the road—indeed, at various points—these rules became controversial, in that concerns arose that foreign affiliate surplus accounts were prone to mismeasurement of realized earnings, because of “internal dispositions” and

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101 Indeed, foreign affiliate surplus accounts can be included in safe income under paragraph 55(5)(d).

102 See Angelo Nikolakakis, “Yes, Virginia... Reconciling a Broader Exemption System with Continued Taxation of FAPI and Domestic Gains,” International Tax no. 45, April 2009, 12-15.
other transactions that could give rise to the realization of exempt surplus in the absence of third-party transactions,\textsuperscript{103} or even the duplication or other inflation or exaggeration of exempt surplus viewed from a consolidated perspective.\textsuperscript{104} In addition, there was little coordination of the relationship between exempt surplus (and other valuable foreign affiliate tax attributes) and the ACB or the fair market value of a foreign affiliate’s shares, in the context of an acquisition of control of a corporation resident in Canada holding foreign affiliates, and the application of the bump rules under paragraph 88(1)(d).

This led to a lengthy process of reform proposals, followed by consultations, followed by further reform proposals, and so on, beginning with the legislative proposals released on December 20, 2002 and continuing with those released on February 27, 2004, December 18, 2009, August 27, 2010, and August 19, 2011.\textsuperscript{105} These proposals generated considerable debate,\textsuperscript{106} and have now been subsumed by Bill C-48.

The 2002 proposals were perhaps the most controversial, because their approach was to trigger FAPI on an “internal disposition” of shares of a foreign affiliate that were “excluded property,” as a deterrent to internal dispositions that would otherwise

\textsuperscript{103} Despite the more traditional blockers in regulations 5907(2)(f) and (5.1).

\textsuperscript{104} See, for example, the decision in The Queen v. Breco Drilling Ltd., 99 DTC 5253 (FCA).

\textsuperscript{105} See, respectively, Canada, Department of Finance, Legislative Proposals and Explanatory Notes Relating to Income Tax (Ottawa: Department of Finance, December 2002); Canada, Department of Finance, Legislative Proposals and Draft Regulations Relating to Income Tax (Ottawa: Department of Finance, February 2004); Canada, Department of Finance, Legislative Proposals and Explanatory Notes Relating to the Income Tax Act (Ottawa: Department of Finance, December 2009); Canada, Department of Finance, Legislative Proposals Relating to the Income Tax Act, the Air Travellers Security Charge Act, the Excise Act, 2001 and the Excise Tax Act (Ottawa: Department of Finance, August 2010); and Canada, Department of Finance, Legislative Proposals in Respect of Foreign Affiliates (Ottawa: Department of Finance, August 2011).

give rise to exempt surplus.\textsuperscript{107} This approach was not viable because often such transactions are motivated by business or foreign tax considerations. In contrast, the 2004 proposals went in the opposite direction, precluding the realization of exempt surplus through an internal disposition by providing that instead the disposition would give rise to “suspended surplus,”\textsuperscript{108} which could later be “released” on the occurrence of certain events, along the lines of the stop-loss rules in subsections 40(3.3) and (3.4). This approach also was not viable because the suspension of surplus created imbalances between tax attributes and economic values, which the surplus rules are designed in general to keep in balance. The third approach, under the 2011 proposals, was somewhere in the middle, in that surplus would arise, and thus balance would be maintained between tax attributes and values, but the surplus would be “hybrid surplus,” which would not be valuable to a Canadian-resident corporate taxpayer as shelter to reduce what would otherwise be a capital gain from the disposition of the shares of a foreign affiliate.\textsuperscript{109}

As noted, this approach, and numerous other changes to the foreign affiliate rules inspired by similar logic, including changes to the reorganization rules, have now been incorporated into Bill C-48.\textsuperscript{110} This bill also incorporates the earlier proposals to better integrate the rules in sections 55, 88, and 111 with the foreign affiliate surplus account regime, through a new construct to be referred to as an affiliate’s “tax-free surplus balance” (TFSB),\textsuperscript{111} which for these purposes would be equated functionally with safe income or ACB. This would include the affiliate’s exempt surplus, the covered portion of its taxable surplus, and its hybrid surplus if fully covered, either consolidated or unconsolidated, depending on the application. For example, under the rule for safe income in proposed paragraph 55(5)(d), this determination would be made on an unconsolidated basis for each relevant affiliate in the chain. In contrast, for the purposes of limiting the paragraph 88(1)(d) bump (in accordance with proposed regulation 5905(5.4)), or for the purposes of eliminating “excess” TFSB (in accordance with proposed regulation 5905(5.2)), at the top of a chain of

\textsuperscript{107} See proposed subsection 93(1.4) in the December 2002 proposals, supra note 105.

\textsuperscript{108} See, for example, proposed paragraph 95(2)(c.2) in the February 2004 proposals, supra note 105.

\textsuperscript{109} The creation of hybrid surplus (which is half-exempt and half-taxable on distribution under proposed paragraph 113(1)(a.1)) as a means of distributing taxable surplus gives rise to better treatment than a direct distribution of taxable surplus, but not a better result than an extraction of taxable surplus through a redemption. The latter yields capital gains treatment, since there is no forced deemed dividend, and seems to be left open deliberately under Bill C-48, despite the effort to preclude that result by way of a preacquisition surplus dividend or a return of capital. See proposed paragraph 93(1.1)(b). This is perhaps another example of scheme confusion.

\textsuperscript{110} Reference may also be made to the changes to the calculating currency rules and the carve-out rules in paragraph 95(2)(f) and related provisions, which were largely enacted in 2009 with effect as of 2007 (see SC 2009, c. 2), and are being refined to some extent under Bill C-48.

\textsuperscript{111} This would be determined under proposed regulations 5905(5.5) and (5.6).
foreign affiliates, following an acquisition of control of the affiliates’ Canadian-resident corporate shareholder, this determination would be made on a generally consolidated basis (but would not pick up bottom-tier deficits).112

What is most interesting about these reforms, from a broader perspective, is that they are driving in the opposite direction rather than toward the expansion of Canada’s exemption regime to cover capital gains from the disposition of shares of a foreign affiliate, as the advisory panel had recommended. That is not to say that these reforms would be completely unnecessary if the advisory panel’s recommendations were adopted, since there is the question of how to deal with transitional issues, but the continued efforts on the part of the Department of Finance to complete this initiative have undoubtedly been viewed unfavourably by stakeholders and advocates of the adoption of a broader exemption regime.

LOOKING TO THE FUTURE

This article has focused on the highlights of the debates and discussions on reforming the substantive treatment of OFDI that have occurred in Canada in the 25 years since the 1987 general tax reform. The auditor general has been a relatively active participant in the process,113 as have certain professionals and academics, whose work and perspectives have been noted above. The Department of Finance has at times surprised the rest of the community, but has generally pursued a consultative approach, which is one of the reasons why it has taken so long to achieve enactment of certain legislative proposals in this area. But the proposals appear to be moving forward at this stage, so perhaps a new era may be dawning.

What the next 25 years will bring is anybody’s guess. However, it seems unlikely that Canada would move away from the exemption regime and toward a credit regime. In the modern age, those who advocate the adoption of a credit regime are

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112 This is because the same consolidation mechanism is used as for subsection 93(1) deemed dividend elections under regulation 5902, which levitates only positive surplus accounts and not deficit accounts (abandoning the earlier initiative in this regard), although surplus accounts that are levitated up to an affiliate with a deficit would be offset. An affiliate’s TfSB would also be relevant for the purposes of the new “fill-the-hole” rules in proposed regulations 5905(7.1) to (7.6), which are designed to block the shares of a “surplus affiliate” from being taken out from under a “deficit affiliate,” in order to preclude the magnification of consolidated surplus.

paying too much attention to what is below Canada and not paying enough attention to what (and, more importantly, who) is above Canada. Those who advocate a blanket denial of interest deductibility on foreign investments are also focusing on only part of the picture—the deduction to the borrower—and are not focusing enough on the impact of that deduction or its denial from a broader systemic perspective, including an appreciation of the impact of who gets the corresponding inclusion from the interest payment and who gets the sheltered earnings either as dividend distributions or as capital gains, and whether those stakeholders are related or unrelated, resident or non-resident, and taxable or non-taxable. It seems more probable, and appropriate, that Canada will expand the exemption regime, and that some form of interest deductibility will be retained.\textsuperscript{114} It may even be that the debt-equity distinction will be eliminated, and that deductions may some day be generally available for dividend distributions.\textsuperscript{115} That may sound like a huge paradigm shift, but if the corporate tax is designed to prevent deferral, it makes sense for it to be refundable like part IV tax. This would then shift the focus onto the taxation of corporate distributions, which would require some further changes in order to deal with the taxation of non-residents in respect of the distribution of Canadian-source income, including perhaps some changes to the framework of treaties based on the OECD model. However, it would help to usher in a new era of international taxation, which may be better able to produce permanent consequences only at the top and at the bottom of a multinational business enterprise, where the realities are located (that is, real people and real activities), and not in the middle, where the legal fictions are located, often in jurisdictions that are different from the jurisdictions at the top and at the bottom.

On a final note, one suggestion may be that a more detailed review be undertaken with respect to the various standards and factors applicable under the numerous rules and regimes that may be relevant in the context of OFDI, with a view to perhaps consolidating some of the regimes, or even deconsolidating some of them, and ensuring that their standards and factors are coherent (both internally and relatively) and appropriate to the objective being pursued. Complexity and redundancy are not the real causes of scheme confusion; the causes are obscurity and inconsistency. It is not confusing when standards and factors are different because they are testing for different things, but it does get confusing when standards and factors are very different even though they are testing for essentially similar things, or when there is an

\textsuperscript{114} There is also a structural flaw in the denial of interest deductibility, since the payment is legally owing and must be made as a commercial matter, so the denial of its deductibility can render the debtor insolvent if it is required to pay tax but does not have enough cash left after the interest payment.

\textsuperscript{115} This is currently available in exceptional circumstances, such as under subsection 137(4.1), and in certain other cases. Also, the elimination of this distinction in relation to payments by a Canadian-resident corporation is not much different from its elimination in relation to payments to the Canadian-resident corporation.
ambiguous or tenuous relationship between the standards or factors and the thing they are testing for. The incremental development of Canada’s international tax system has resulted in certain significant inconsistencies, only some of which have been considered above. Overall, however, the Canadian system remains grounded on a relatively solid foundation, although premised to some extent on continued competitiveness considerations, and a somewhat outmoded conception of the relevance of corporate residence. It may be due for some significant architectural modifications in light of the globalization of capital markets and, particularly, in the event that current international practices with respect to tax arbitrage are modified by any emerging consensus resulting from the OECD’s BEPS initiative.