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# The Evolution of the International Tax Rules

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**KEYWORDS:** INTERNATIONAL TAXATION ■ FOREIGN INCOME ■ FOREIGN AFFILIATES ■ TAX REFORM

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## INTRODUCTION

The purpose of this article is to briefly consider how the Canadian international tax system has evolved throughout the span of Justice Bowman's long career in tax, with a focus on the taxation of foreign income.<sup>1</sup>

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1 A comprehensive history of the evolution of the international tax rules and the policy considerations surrounding that evolution is beyond the scope of this article, as is a detailed

One of our colleagues, an esteemed international tax practitioner, also recently retired after a long and very successful career. On his retirement, he stated modestly that he was fortunate to have begun his career in tax at a time when Canada's tax system was in a state of great upheaval. Major reforms were being introduced, and with change came opportunity. He was an enthusiastic young man with a whole new set of rules to learn, and some older practitioners were perhaps less eager to "start over."

As mid-career practitioners, we can imagine how much more complex the tax system seemed after the tax reform of the early 1970s, but we must also shake our heads when we compare the scope of the foreign income provisions at that time with what confronts us today. We seem to be "starting over" on a regular basis! The foreign affiliate regime is constantly changing, making it difficult, if not impossible, for even the most eager new recruit to master all the rules (including the current rules, the various draft rules, the expected changes to the draft rules, etc.).

What began as a very simple system has evolved to the point where the foreign affiliate rules are among the most complex in the Income Tax Act.<sup>2</sup> How did this happen, and is it possible to eliminate some of this complexity without opening the door to erosion of the tax base? Today, we are once again at a crossroads, with an opportunity to change direction.

## A VERY BRIEF HISTORY OF THE FOREIGN AFFILIATE RULES

### Early Tax Reform

When Justice Bowman, and our colleague, began their careers in the 1960s, the taxation of foreign income was very simple, and confined to a few sections of the Act. Canadian residents were subject to tax on their worldwide income, as they are today, but it was very easy to avoid tax on foreign income. There was no concept of accrual taxation for certain income earned in offshore entities, such as exists today in the foreign accrual property income (FAPI) rules or the offshore investment fund (OIF)

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review of technical changes. For a more detailed discussion, see Angelo Nikolakakis, *Taxation of Foreign Affiliates* (Toronto: Thomson Canada Limited) (looseleaf); D.Y. Timbrell, "Policy and Structural Basis Underlying Canada's Foreign Income Rules," in *Report of Proceedings of the Twenty-Seventh Tax Conference*, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 834-50; James S. Hausman, "The Tax Implications of Controlled Foreign Affiliates Under the Canadian Foreign Accrual Property Income Rules," *ibid.*, at 850-59; Robert J. Dart, "Foreign Affiliates—Surplus Accounts and Reorganization Provisions," *ibid.*, at 859-92; 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; and Brian J. Arnold, "The Canadian International Tax System: Review and Reform" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1792-1818, among others.

2 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 or the regulations thereto.

property/foreign investment entity (FIE) rules.<sup>3</sup> Dividends from foreign corporations were not required to be included in income, with a credit for foreign taxes paid; instead, they were generally exempt if received by a Canadian corporate shareholder owning more than 25 percent of the voting shares of the foreign corporation. The details of the exemption evolved (to become less restrictive) over the years, but the basic rule remained in place for decades, and was simple and well understood.

In 1966, the Royal Commission on Taxation (the Carter commission) was tasked with a comprehensive review of the Canadian tax system. While the commission's goal was to ensure tax neutrality whenever possible,<sup>4</sup> the commission realized that “[i]n the international sphere, perfect tax neutrality is neither administratively feasible nor necessarily economically desirable.”<sup>5</sup>

Nevertheless, the commission's proposals represented an attempt to impose a more tax-neutral system. The commission recommended the withdrawal of the dividend exemption. Canadian taxpayers with foreign direct investments (generally a 10 percent ownership interest) would report annually the foreign income earned and income taxes paid in each jurisdiction. If the rate of foreign income tax paid on the foreign income was less than an arbitrary 30 percent, the difference would be paid in Canada as a special tax.<sup>6</sup> No distinction was proposed based on the nature of the foreign-source income (that is, business income versus income from property). The commission's report stated that this “would eliminate a major loophole in the present tax system through which some Canadians have in effect avoided the payment of their full Canadian tax on Canadian source income which has been diverted through companies in tax havens.”<sup>7</sup>

The requirement to pay tax, whether to a foreign jurisdiction or to Canada, on foreign income as it accrued was inconsistent with international norms, and the commission's proposals were not accepted. In 1969, the government issued a white paper<sup>8</sup> that resulted in the adoption of a combined exemption/credit system for

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3 There were rules applicable to “personal corporations” that were designed to prevent the deferral of tax on investment income. The income of a personal corporation was taxed to its shareholders directly, whether or not it was distributed. However, these rules were of limited scope (they did not apply to public corporations, for example, or corporations not controlled by an individual or family) and appear not to have been very effective (they could be avoided through a variety of techniques including the use of a non-resident trust). They were repealed in 1972.

4 “A neutral tax system would contribute most to the efficient allocation of resources, and hence to the greatest output of goods and services [that] Canadians want, and is also a prerequisite of an equitable tax system”: Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), 481.

5 *Ibid.*

6 *Ibid.*, at 487.

7 *Ibid.*, at 489.

8 E.J. Benson, Minister of Finance, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969) (herein referred to as “the white paper”).

dividends from foreign affiliates and FAPI rules to prevent the use of tax havens to defer Canadian tax on passive income.

The white paper recommendations formed the basis for Canada's unique "hybrid" system for relieving double taxation on foreign income: the exemption for dividends would be retained, but only for dividends paid out of active business income earned in countries with which Canada had a tax treaty; other dividends would be eligible for credits for withholding tax and foreign tax paid on the underlying earnings. The advantages of the former system appeared to be competitiveness and simplicity.<sup>9</sup> The passive income of controlled foreign corporations would be taxed to Canadian shareholders on a current basis, similar to rules in the United States.<sup>10</sup>

The white paper proposals, and the associated legislation,<sup>11</sup> were controversial, resulting in the evolution of the details of the proposals and the postponement of the introduction of the new system until 1976.

### Continuing Reform of the Rules

While the basic structure of our foreign affiliate rules has remained the same since 1976, since at least the early 1990s we have seen a constant battle between a desire to have a tax system that allows Canadian companies to compete effectively abroad and a concern about their ability to use the outbound tax rules, along with the interest deductibility rules, to erode tax otherwise payable on domestic income.<sup>12</sup> Simplicity, which usually tags along as goal for the tax system on the side of competitiveness, has definitely been the loser in this battle. A long series of amendments has introduced layers of complexity and uncertainty into what was a fairly simple system.

### *1992 Auditor General's Report and 1995 Legislative Response*

The 1992 auditor general's report<sup>13</sup> raised concerns about the ability to deduct interest in respect of investments in foreign affiliates, the ability to earn exempt surplus

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9 Ibid., at paragraphs 6.15-6.17.

10 The rules were proposed to prevent abuse through the diversion of certain types of income such as "dividends, interest, royalties and trans-shipment profits" to tax havens. Ibid., at paragraphs 6.20-6.21.

11 Bill C-259, An Act To Amend the Income Tax Act and To Make Certain Provisions and Alterations in the Statute Law Related to or Consequential upon the Amendments to That Act; royal assent, December 23, 1971: SC 1970-71-72, c. 63.

12 The players in this battle include businesses, tax advisers, tax academics, and the auditor general. The Department of Finance for many years took a strong stand in favour of competitiveness, but more recently, it appears to have been more concerned with tax base erosion. See the discussion in Sandra Slaats, "Financing Foreign Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries," Corporate Tax Planning feature (2007) vol. 55, no. 3 *Canadian Tax Journal* 676-712.

13 Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992).

in low-tax treaty countries, and the lack of a definition of active business income for the purpose of determining FAPI. Case law had established a very low threshold for income to qualify as active business income. The Standing Committee on Public Accounts of the House of Commons (PAC) met in December 1992 and early 1993 to consider the auditor general's report. The PAC's conclusions and recommendations included the following:<sup>14</sup>

- exempt surplus treatment should be restricted to treaty countries;
- the concept of "active business income" should be defined; and
- foreign active business losses should not be available to reduce FAPI.

The government responded with a significant package of amendments to the rules, effective in 1995, which largely adopted the PAC's recommendations. The amendments broadened the scope of the FAPI rules by, inter alia, introducing definitions of "active business," "income from an active business," "income from property," and "investment business." In respect of surplus accounts, the concept of a "listed country"<sup>15</sup> was replaced with that of a "designated treaty country." As a result, exempt surplus treatment was now fully aligned with Canada's tax treaties.

### *Mintz Committee Report*

In 1996, the government appointed the Technical Committee on Business Taxation (generally known as the Mintz committee) to conduct an overall study of business taxation, including international taxation. The Mintz committee reported in 1998 that the existing regime "is fundamentally sound and should be maintained."<sup>16</sup> However, it did recommend further tightening of the rules, including increasing the threshold for foreign affiliate status, restricting the ability of certain tax-privileged entities resident in treaty countries to earn exempt surplus, restricting the deductibility of interest traceable to investments in foreign affiliates, and tightening certain aspects of the exempt surplus rules, such as the "deeming rule" in paragraph 95(2)(a). While the government adopted very few of these recommendations initially, some were adopted in subsequent years, and the report has formed the basis for significant ongoing debate within the tax community.

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

15 Prior to this reform, in order for earnings to qualify as exempt surplus, the foreign affiliate had to be resident in a country included in a list contained in the regulations. The list was intended to mirror the countries with which Canada had a tax treaty, but was not always updated to include all such countries. On the other hand, the list did include a number of "tax havens" in the Caribbean and elsewhere that did not have a tax treaty with Canada, but were included for historical reasons (for example, ties to the Commonwealth).

16 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), 153.

### *Technical Bills*

Over time, a number of issues arose with the 1995 amendments. The Department of Finance issued a long series of “comfort letters” in which relieving amendments were proposed to address those issues. Draft legislation containing those amendments was eventually released on December 20, 2002.<sup>17</sup> However, the technical bill also contained restrictive amendments that could not be considered purely technical in nature, including amendments that would create FAPI in certain related-party transactions.<sup>18</sup> The proposals were designed to preclude the recognition and possible duplication of exempt surplus.

After significant criticism, revised proposals were released in February 2004. Rather than creating FAPI on internal transfers, the revised amendments would defer the recognition of surplus.<sup>19</sup> Other proposed amendments included changes to the foreign affiliate liquidation and merger rules, new rules affecting the calculations required for section 93 deemed dividend elections, and changes to the “fresh start” rules.<sup>20</sup>

Some of the February 2004 amendments were finally passed in December 2007,<sup>21</sup> when the government agreed to split the draft legislation and proceed with the less controversial amendments. However, many of the amendments, particularly as they relate to surplus suspension and reorganization transactions, remain outstanding at the time of writing, some six years later. These proposals have been the subject of further comfort letters and government pronouncements. Further consideration of the suspended surplus rules has led to musings by the department that it will be necessary to establish several new surplus pools (for example, suspended exempt surplus, suspended taxable surplus) in order to make the rules work, particularly where distributions are made from affiliates that have suspended surplus. No draft legislation or specific comfort letters have been issued in respect of these ideas, and thus it is not clear whether the department is still pursuing this approach.

On the basis of the comfort letters and statements by Finance officials, it appears that the government is also seriously considering introducing a concept of “foreign paid-up capital,” which will apply to all distributions between a foreign affiliate and a Canadian shareholder and between two foreign affiliates. While the details of the

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17 Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, December 2002).

18 Angelo Nikolakakis, Wallace G. Conway, Brian Mustard, and Nick Pantaleo, “Foreign Affiliates: A Review of the Proposed Rules,” in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 24:1-15, at 24:2.

19 For a discussion of these proposals, see Sandra Jack, Brian Mustard, Angelo Nikolakakis, Nick Pantaleo, and Sandra Slaats, “International Taxation: The February 27, 2004 Draft Proposals on Foreign Affiliates,” in *Report of Proceedings of the Fifty-Sixth Tax Conference*, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 20:1-105, at 20:10-19.

20 See Geoffrey S. Turner, “Foreign Affiliate Liquidation and Merger Rollovers: Where Are We Now and Where Should We Be?” (2005) vol. 53, no. 3 *Canadian Tax Journal* 640-84, at 647-55.

21 Budget and Economic Statement Implementation Act 2007, SC 2007, c. 35.

proposal are not known at this time, we can be sure that this will not be a tax simplification measure.<sup>22</sup>

A package of legislation released on December 18, 2009<sup>23</sup> abandoned or replaced some of the 2004 draft amendments<sup>24</sup> but was silent with respect to the rest. The 2009 legislation also introduced new proposed rules, particularly on the acquisition of control of a Canadian company owning foreign affiliates. The package also included new versions of draft regulations that have an “effective date”<sup>25</sup> of more than a decade ago.

The 2009 report of the auditor general strongly criticized the Department of Finance for the inordinate amount of time it takes to introduce and pass technical amendments.<sup>26</sup> The auditor general’s concerns were echoed by the PAC in April 2010. The foreign affiliate amendments are the worst example of this issue.

### *Interest Deductibility Proposals*

The government has continually tightened the foreign affiliate rules over the years—for example, by increasingly restricting access to the paragraph 95(2)(a) “deeming rule.” The most significant attempt to tighten the rules, however, was ultimately a disaster. The March 2007 federal budget announced dramatic proposals to reform the taxation of business income earned by foreign affiliates of Canadian taxpayers.<sup>27</sup>

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22 It is difficult to understand the rationale for this proposal. There have been interpretive issues over the years associated with the return of capital from foreign affiliates, particularly where the “capital” would be considered contributed surplus rather than paid-up capital for Canadian tax purposes. Proposed paragraph 88(3)(e) of the 2004 draft legislation was intended to address these issues but raised more questions than it answered. In addition, it is understood that the Department of Finance would prefer that taxpayers be required to recognize taxable surplus of foreign affiliates prior to recognizing a gain on the disposition of the foreign affiliate shares. (Currently, taxpayers can decide not to make a section 93 election in respect of taxable surplus to the extent that the tax payable on the dividend would exceed the tax payable on a capital gain.) But do these considerations require the adoption of an entirely new system for distributions from foreign affiliates? See Sandra Slaats, “Repatriation from Foreign Affiliates: Selected Issues,” Corporate Tax Planning feature (2005) vol. 53, no. 3 *Canadian Tax Journal* 858-84, for a discussion of some of these issues.

23 Canada, Department of Finance, *Draft Legislation, Regulations, and Explanatory Notes Re: Foreign Affiliates* (Ottawa: Department of Finance, December 18, 2009).

24 For example, the 2004 proposal to require that deficits must be netted against positive surplus balances as part of a subsection 93(1) election has been replaced with a proposed “fill-the-hole” rule that applies only if the interest of a deficit affiliate in a lower-tier surplus affiliate is diluted. While this change is welcome, taxpayers have been coping with and filing tax returns based on the 2004 draft legislation for six years, and that legislation is now apparently irrelevant. (The Canada Revenue Agency encourages taxpayers to file returns based on draft legislation.)

25 It is anticipated that the draft legislation will be retroactive to the proposed effective date once it is ultimately passed.

26 Canada, *Report of the Auditor General of Canada Fall 2009* (Ottawa: Minister of Public Works and Government Services Canada, 2009), chapter 3, “Income Tax Legislation.”

27 Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 420-21.

As a part of the government's "international tax fairness initiative," the budget proposed to effectively eliminate taxpayers' ability to deduct interest on funds borrowed to invest in foreign affiliates that earn exempt surplus. The government reasoned that it was "inappropriate" that Canadian taxpayers were able to claim interest deductions on debt used to invest in foreign affiliates whose underlying income was not fully taxable in Canada.

As a result of the strong outcry against the proposals from business and the tax community, in May 2007 the Department of Finance announced revised proposals that substantially narrowed the scope of the new rules.<sup>28</sup> Instead of denying the deductibility of any interest expense, the revised proposals targeted certain types of "tax-avoidance" structures that enabled taxpayers to produce interest deductions in more than one jurisdiction. Section 18.2 was pushed through the legislative process and enacted in December 2007,<sup>29</sup> albeit with a 2012 effective date. However, after continued criticism from business and the tax community, and in light of the recommendations of both the Competition Policy Review Panel<sup>30</sup> and the Advisory Panel on Canada's System of International Taxation ("the advisory panel"),<sup>31</sup> section 18.2 was repealed.<sup>32</sup> This was a rare victory for international competitiveness (and simplicity) in recent years.

### *Expansion of Exempt Surplus System for Certain Foreign Affiliates*

The 2007 budget and subsequent legislation introduced changes to extend the longstanding rule that limits the ability of a foreign affiliate to earn "exempt earnings" to an affiliate that is resident in and carrying on business in a country with which Canada has concluded a double tax treaty. This privilege will be extended to foreign affiliates resident in and carrying on business in countries with which Canada has concluded a tax information exchange agreement (TIEA).<sup>33</sup> If another country does not agree to enter into a TIEA within 60 months of a request from Canada, active business income earned in that country will be deemed to be FAPI.<sup>34</sup>

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28 Canada, Department of Finance "Canada's New Government Improves Tax Fairness with Anti-Tax Haven Initiative," *Press Release* no. 2007-041, May 14, 2007.

29 *Supra* note 21.

30 Competition Policy Review Panel, *Compete To Win* (Ottawa: Public Works and Government Services Canada, June 2008), 66, recommendation 22.

31 Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008), 53, recommendation 4.7.

32 SC 2009, c. 2, section 6(1).

33 See new regulations 5907(11) and (11.11).

34 The definition of "foreign accrual property income" in subsection 95(1) now includes income from a non-qualifying business.

Currently, Canada has no TIEAs in effect, although one agreement has been signed (with the Netherlands in respect of the Netherlands Antilles) and several others are under negotiation. The policy rationale for this extension is difficult to understand, and the advisory panel has recommended that all active business income should be included in exempt earnings, wherever earned.<sup>35</sup> We understand that the intent of these rules was to encourage tax havens to enter into TIEAs with Canada and that Finance likes having this tool at its disposal,<sup>36</sup> and hence an outright repeal of this requirement in the near future appears unlikely.

## OFFSHORE INVESTMENT FUND AND FOREIGN INVESTMENT ENTITY RULES

The complexity of the foreign affiliate regime is compounded by the overlaying of another anti-avoidance regime, known as the offshore investment fund or foreign investment entity rules. These rules have a lengthy and rather sorry history. The original OIF rules were introduced in 1984 and came into effect in 1985. The purpose of the rules was to deal with the avoidance or undue deferral of income tax through the use of non-resident investment funds. The rules apply where a taxpayer has an interest in a non-resident entity (other than a controlled foreign affiliate), the interest may reasonably be considered to derive its value from portfolio investments in a listed category of asset types (covering shares, debt, commodities, real estate, currency, etc.), and it may reasonably be concluded that one of the main reasons for acquiring, holding, or having the interest is to derive a benefit from portfolio investments in a manner that reduces the tax on the underlying income, as compared with the tax in respect of a direct investment in the underlying assets. Factors to be considered in evaluating whether the purpose test is met include the nature of the foreign entity, the extent of foreign tax on the entity's income, and the extent to which the income is distributed on a timely basis. Where the rules apply, the taxpayer is required to impute income at the (lowest) prescribed rate based on the cost of the investment.

Until recently, the government proposed to replace these rules with the FIE rules. We understand that the government's main concern with the OIF rules was that the onus is effectively on the minister to prove that the main purpose test is met and, more generally, that purpose-driven anti-avoidance rules are less effective than mechanical rules that apply on the basis of purely factual criteria. That said, the only case involving the application of these rules was decided in favour of the minister.<sup>37</sup> The case involved an investment in shares of a Bermuda company, whose assets were invested in two investment funds operated by a local bank. The company

35 *Supra* note 31, at 26, recommendation 4.1.

36 However, the increased use of TIEAs is primarily driven by the G20 anti-tax-haven initiative in 2009 and related threats of sanctions by the United States and the European Union.

37 *Walton v. The Queen*, 98 DTC 1780 (TCC).

did not carry on any other activity. The only issue in the case was whether the purpose test was met. The corporation in question was incorporated by the taxpayer and his non-resident partner who each owned 50 percent of the voting shares; as a result, the entity was not a controlled foreign affiliate. The court held that the purpose test was met because (1) the structure was set up on the advice of a tax lawyer; (2) there was no evidence of any compelling non-tax business reasons to select Bermuda as the jurisdiction of incorporation of the company; and (3) while there appeared to be an intention that at some point the company would acquire an active business, this subjective intention was not sufficient to overcome the objective conclusion that tax benefits were the major economic advantage of the structure selected. On the basis of this case, it is not obvious that the minister faces an excessive burden in convincing a court that offshore investment entities established in tax havens meet the purpose test and are thus “caught” by the existing rules.

Another potential concern with the existing rules is that they target only portfolio investments and are thus not as broad as the FAPI rules, which also apply to other income with a connection to Canada, such as insurance of Canadian risks and other activities that are considered to erode the Canadian tax base. However, most of these types of businesses would have been exempt under the latest version of the FIE proposals,<sup>38</sup> so it is not clear that the difference in scope was a determining factor. The most significant differences between the current OIF rules and the FIE proposals were as follows:

- Although the tax-avoidance motive test was retained, it was refined and also could be relied upon only if the foreign entity met certain restrictive criteria. For example, the entity had to be fairly widely held and actively traded (or redeemable at net asset value); the taxpayer could not have a significant interest in the entity; and the entity had to be either listed on a designated stock exchange or resident in a treaty country, as well as meeting other tests.
- The “portfolio investment” test was replaced by an asset test and an “investment business” test. Because these tests were very broad, specific and detailed exemptions for “good” assets and businesses were provided.
- The rules provided for three different taxation methods: prescribed rate (using the “middle” prescribed rate) and, by election and if stringent conditions were met, mark-to-market taxation or income accrual (imputation based on actual income earned by the entity).
- Specific rules for “tracking interests” were included to prevent taxpayers from circumventing the main rules by investing in an entity whose primary business and assets constitute an active business where such investment would

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38 See the definition of “exempt business” in formerly proposed subsection 94.1(1). That provision would have excluded regulated banks and insurance corporations, development of resource properties, leasing of manufacturing/processing equipment, real estate development, and real estate rentals managed by the entity or related entities from being considered a “bad” business for the purposes of the FIE rules.

create certain types of tracking interests that would allow investors to benefit indirectly from passive investments.

The FIE proposals were first announced in the February 1999 federal budget,<sup>39</sup> followed by the release of draft legislation in August 2001,<sup>40</sup> the tabling of a notice of ways and means motion in October 2003,<sup>41</sup> and the release of revised draft legislation in July 2005.<sup>42</sup> In November 2006, the proposed amendments were tabled in Bill C-33,<sup>43</sup> which died on the order paper in September 2007, and tabled again the next month in Bill C-10,<sup>44</sup> which died on the order paper with the federal election call in October 2008.

In the 2009 federal budget, the government announced that it would review the existing proposals in light of submissions from various parties, including the advisory panel, before proceeding with them.<sup>45</sup> Finally, in the 2010 federal budget, the government announced that, *after more than 10 years*, it has decided to abandon the FIE proposals altogether. Instead, it intends to make the following “limited enhancements” to the existing OIF rules:<sup>46</sup>

- increase the prescribed rate applicable in computing the imputed income by two percentage points;
- extend the reassessment period in respect of interests in OIF property by three years; and
- expand the foreign property reporting requirements (form T1135) so that more detailed information is available for audit use.

The new rules are proposed to apply to taxation years ending after March 4, 2010. Taxpayers who “voluntarily” complied with the previous versions of the FIE

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39 Canada, Department of Finance, 1999 Budget, Budget Plan, February 16, 1999, 194-99.

40 Canada, Department of Finance, *Legislative Proposals and Explanatory Notes on Taxation of Non-Resident Trusts and Foreign Investment Entities* (Ottawa: Department of Finance, August 2001).

41 Canada, Department of Finance, *Legislative Proposals Relating to the Income Tax Act: Taxation of Non-Resident Trusts and Foreign Investment Entities* (Ottawa: Department of Finance, October 2003).

42 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005).

43 Bill C-33, An Act To Amend the Income Tax Act, Including Amendments in Relation to Foreign Investment Entities and Non-Resident Trusts, and To Provide for the Bijural Expression of the Provisions of That Act, passed by the House of Commons on June 15, 2007.

44 Bill C-10, An Act To Amend the Income Tax Act, Including Amendments in Relation to Foreign Investment Entities and Non-Resident Trusts, and To Provide for the Bijural Expression of the Provisions of That Act, passed by the House of Commons on October 29, 2007.

45 Canada, Department of Finance, 2009 Budget, Canada's Economic Action Plan: Budget 2009, January 27, 2009, 325.

46 Canada, Department of Finance, 2010 Budget, Tax Measures: Supplementary Information, March 4, 2010, 335-89, at 371-72.

proposals will have the option of either having the previous taxation years reassessed or claiming a deduction in the current year for the cumulative excess income reported in prior years under the FIE proposals relative to the income that would have been reported under the current rules.

The history of the FIE proposals highlights the issue of having purportedly retroactive legislation sitting around for many years and encouraging taxpayers to file on the basis that it applies.

Finally, the budget promises that the current proposals will be subject to a detailed consultation process, with a two-month comment period. After this, a panel of “respected tax practitioners” will be formed to work with Finance in reviewing any issues identified in the comments and making recommendations on the design of the draft legislation.<sup>47</sup> The draft legislation will also be released for public commentary. The reason for this process is presumably that, although the changes to the OIF rules are minor and (with the possible exception of the expanded T1135 reporting requirements) likely uncontroversial, the proposals also contain extensive amendments to the non-resident trust rules (which, unlike the FIE rules, are not being dropped), which presumably will generate more comments by interested parties. While the extensive consultation process and the involvement of external advisers is a welcome change from the previous practice of dropping hundreds of pages of draft legislation onto taxpayers and their advisers without warning, and often during inconvenient times, the flip side is that the final legislation will likely not be forthcoming anytime soon.

In summary, the abandonment of the FIE proposals and their replacement with limited changes to the existing rules is a welcome development, and one of the few victories for simplicity in recent years (another being, as noted, the repeal of section 18.2). The limited case law to date suggests that the existing rules should be effective in deterring most tax-driven structuring of offshore portfolio investments; more sophisticated structures (for example, using captive banks or insurance companies established in jurisdictions providing for simplified regulatory regimes applicable to “captive” entities)<sup>48</sup> can presumably be targeted with specific rules, preferably by expanding the existing FAPI rules, which are better understood by taxpayers and their advisers.

## THE CURRENT STATE OF CANADA’S INTERNATIONAL TAX REGIME

There is a general consensus that, over the years, Canada’s international tax rules have evolved into one of the world’s better international taxation regimes. The advisory

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47 Ibid., at 378.

48 A “captive” bank is typically one that does not take deposits from the general public. Similarly, a captive insurance company only insures the risks of related parties or a predefined group (such as its shareholders and persons related to them), as opposed to the general public. Most “offshore” jurisdictions have established a separate (and much less onerous) regulatory regime for captives as opposed to “regular” banks and insurance corporations.

panel concluded that Canada's "current international tax system is a good one and requires only some improvements."<sup>49</sup> The advisory panel also noted that other countries are looking at incorporating certain features of Canada's system into their own international tax regimes.<sup>50</sup>

While we acknowledge that the system is essentially sound, we also agree that improvements are required to simplify and streamline the system, and to ensure that it accommodates modern business practices.

### Legislative Uncertainty

An overriding concern with Canada's international tax system is that it has become far too complex, making it difficult for taxpayers to understand and comply with the rules. Canada's foreign affiliate system has been in a state of uncertainty for a number of years. Draft tax rules affecting foreign affiliates have been outstanding for six years or more. Changes in this area included in draft tax legislation released in 2002<sup>51</sup> and 2004<sup>52</sup> will, if enacted, greatly increase the complexity of the foreign affiliate rules. Since 2004, the Department of Finance has issued more than 20 comfort letters to address concerns about unintended results arising from the draft proposals. International tax changes announced in the 2007 budget have compounded this complexity and added to the legislative uncertainty in this area.

In the 2009 federal budget, the government indicated that further changes to these rules may be forthcoming. In particular, the government said that it would not proceed with the outstanding 2004 proposals until it had considered recommendations regarding the foreign affiliate regime in the advisory panel's report.<sup>53</sup> While the government's decision to review the outstanding legislation in light of the panel's recommendations is laudable, taxpayers have been relying on the draft proposals for many years in planning their transactions; it is hoped that, whatever rules are eventually adopted, generous transition relief will be provided to ensure that no taxpayer is worse off as a result of relying on the draft rules or comfort letters.

### Implications of Legislative Uncertainty for Taxpayers

The current status of the foreign affiliate rules is hampering the ability of Canadian businesses to plan, report, and comply with the tax obligations arising from their foreign business transactions. Taxpayers are obliged to plan their business transactions on the basis of draft proposals, but they must report the tax effects of those transactions in their financial statements on the basis of existing legislation. This

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49 *Supra* note 31, at 19.

50 *Ibid.*, at 23.

51 Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, December 2002).

52 Canada, Department of Finance, *Legislative Proposals and Draft Regulations Relating to Income Tax* (Ottawa: Department of Finance, February 2004).

53 *Supra* note 45, at 324.

situation increases the workload for Canadian companies by requiring two sets of analyses for all material transactions: one that assesses the tax impact under proposed legislation and another that assesses that same tax impact under current law. Further, the financial statements do not reflect “tax reality.” Shareholders are given financial information based on legislative provisions that will not ultimately govern a particular transaction.

Planning for transactions is difficult because it must be based on draft legislation that is subject to change and on comfort letters that outline changes in general without specific detail. No assurance exists that the proposed changes will ultimately apply to the transactions undertaken.

### **Increasing Need for Specialized Skills**

As the quantity and complexity of international tax legislation mounts, taxpayers, their advisers, and Canada Revenue Agency (CRA) auditors are being challenged to develop deeper, more specialized technical skills in order to cope with these changes. For taxpayers, increased time and resources must be spent on compliance, owing to the increasing need for specialized tax planning and compliance advice. For tax advisers, the growing complexity creates challenges in training and retaining a sufficient complement of tax professionals specialized in various international tax niches to fill clients’ needs. Rising complexity in international tax has also strained the CRA’s enforcement abilities.

In 2007, the auditor general observed that the CRA had improved its ability to identify potential non-compliance with the tax rules on international transactions; however, further improvements were needed to provide international tax auditors with better information on global business issues in specific industry sectors and to ensure that sufficient international tax audit expertise exists in all of the CRA offices handling high-risk files.<sup>54</sup>

The advisory panel’s report suggests that the CRA still requires more resources and improved technical skills in the international taxation area.<sup>55</sup> As the CRA’s international tax capabilities continue to improve, assessments and litigation in this area can be expected to increase accordingly. Significant additional training will also likely be necessary for auditors to keep up with the exponential increase in complexity arising from the non-resident trust and proposed foreign affiliate rules.

### **Changing Business Environment**

Just as taxpayers, advisers, and CRA auditors are challenged to keep up with Canada’s international tax rules, the rules themselves have not kept up with changing business practices and models in the increasingly globalized economy.

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54 Office of the Auditor General of Canada, *2007 February Status Report of the Auditor General of Canada* (Ottawa: Office of the Auditor General of Canada, February 2007), chapter 7, “International Taxation—Canada Revenue Agency.”

55 *Supra* note 31, at 80.

The base erosion<sup>56</sup> and investment business<sup>57</sup> rules under Canada's FAPI regime are cases in point. These rules are designed to limit the exemption for foreign income to commercially driven active business income and to prevent the erosion of the Canadian tax base that results when taxpayers divert income from Canadian-source passive income-earning activities to foreign jurisdictions. Such activities include the earning of income from the sale of property, interest and leasing income, insurance income, and income from providing certain services.

In some cases, the policy underlying these rules is outdated and unfairly penalizes businesses in some industries more than others, limiting the ability of these businesses to develop their products and services outside Canada.

Especially onerous is the "more than five full-time employees" test that must be met by a controlled foreign affiliate that carries on a real estate development business in order for the affiliate's income not to be considered FAPI.<sup>58</sup> It is often not realistic for a small real estate development company to meet the test throughout the life cycle of a typical real estate development project. For example, the employee test could be met in the development phase but perhaps not in the sales phase. In such circumstances, the test seems both arbitrary and contrary to a tax policy of assisting Canadians in exporting their entrepreneurial skills and expertise to foreign markets. Even for larger real estate development companies, it is often very difficult to meet the employee test because such companies are commonly required, owing to liability concerns, to hold projects in separate companies or partnerships. Thus, while the business as a whole may employ a significant number of employees, each individual entity may not require the services of more than five employees. While relieving rules for this type of situation exist, they do not apply in all cases, and further, they are interpreted restrictively by the CRA.<sup>59</sup> In our view, it would make much more

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56 Paragraphs 95(2)(a.1) to (b) include in FAPI certain types of income that are considered to have sufficient "nexus" to Canada, including certain purchasing and resale functions, Canadian insurance risks, Canadian debt and lease obligations, and services provided where the payments are deductible in Canada or reduce FAPI of another affiliate, or the services are provided by certain Canadian residents.

57 "Investment business" is defined in subsection 95(1) to mean a business "the principal purpose of which" is to derive income from property (including interest, rents, royalties, dividends, insurance/reinsurance, and profits from the disposition of certain property). There are specific exceptions for "regulated" financial businesses and certain other types of businesses (for example, property development), if both an arm's-length test and a "more than five full-time employees" test are met.

58 See the definition of "investment business" in subsection 95(1), paragraph (c).

59 The recharacterization rule under subparagraph 95(2)(a)(i) has been used to deal with this type of situation. This rule allows otherwise passive income to be treated as active if the activities of the affiliate are "directly related" to the active business of another foreign affiliate and such income would be active if it had been earned directly by that other affiliate. The CRA has tended to interpret this rule narrowly, requiring a very high degree of nexus between the income and the related active business. Further, in the real estate context, the CRA has drawn an arguably artificial distinction between a real estate development or rental business and a

sense to apply the full-time employee test at the level of a group of foreign affiliates that meet minimum common ownership and unity-of-business thresholds.<sup>60</sup>

Other aspects of the FAPI rules need to be refreshed in recognition of the growing reliance of the global economy on the provision of services as opposed to goods. The current rules unfairly penalize exporters of services as compared with exporters of products. For example, if a Canadian manufacturing company sells its products to its controlled foreign affiliate for resale to non-residents of Canada, the margin or spread earned by the controlled foreign affiliate is generally not FAPI. In contrast, if a Canadian engineering services company provides services to its controlled foreign affiliate, which, in turn, utilizes such services to provide engineering services to non-residents of Canada, the margin or spread earned by the controlled foreign affiliate is generally considered to be FAPI pursuant to recently enacted changes to the FAPI rules.<sup>61</sup> In both cases, the transfer-pricing rules arguably would limit any leakage from the Canadian tax base, so it is not clear why the export of services should be treated any differently than the export of products.

The advisory panel expressed concern that the base erosion rules may prevent Canadian businesses from effectively managing their global supply chains, thus putting Canadian companies at a competitive disadvantage. The panel recommended continually revisiting the base erosion and investment business rules to ensure that they remain properly focused as international business practices evolve, but stopped short of recommending that these rules be eliminated altogether.<sup>62</sup> The panel did not accept the argument, expressed in many submissions, that the highly complex base erosion rules are unnecessary in light of Canada's transfer-pricing rules.<sup>63</sup> Rather, it suggested that the transfer-pricing rules pose administrative challenges, and that well-designed and properly focused base erosion rules complement the transfer-pricing rules and provide certainty about the types of income that should be subject to Canadian tax.

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property/asset management business, hence potentially denying this relief even where the overall foreign affiliate group has a significant number of employees.

For a more detailed discussion of these issues, see, for example, William R. Holms and Michael Shields, "Foreign Affiliate Rules: The Effect of the Investment Business Definition on Real Estate Developers," *International Tax Planning* feature (2006) vol. 54, no. 4 *Canadian Tax Journal* 937-67, at 948-54.

60 For example, the rules could provide that all foreign affiliates with common ownership of at least 50 percent votes and value, which carry on business in the same country, would be treated as a single entity for the purposes of applying this test.

61 Subparagraph 95(2)(b)(ii). Prior to the 2007 amendments, this rule applied only to services performed by an individual resident in Canada who is (or is related to) a controlling shareholder of the controlled foreign affiliate. This rule has now been expanded to services provided by any taxpayer of whom the affiliate is a foreign affiliate or another taxpayer who does not deal at arm's length with the affiliate or with such a taxpayer.

62 *Supra* note 31, at 40-44.

63 *Ibid.*, at 43.

Although this may be the case in some instances, it can be argued that some of the base erosion rules, such as certain aspects of the rules that deal with services, could be eliminated and the transfer-pricing rules could be relied on to limit any potential leakage from the Canadian tax base.

## ADVISORY PANEL RECOMMENDATIONS

Space does not permit a lengthy discussion of the advisory panel report. With respect to outbound direct investment, the panel made the following recommendations:<sup>64</sup>

- Recommendation 4.1: Broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.
- Recommendation 4.2: Pursue tax information exchange agreements (TIEA) on a government-to-government basis without resort to accrual taxation for foreign active business income if a TIEA is not obtained.<sup>[65]</sup>
- Recommendation 4.3: Extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate where the shares derive all or substantially all of their value from active business assets.<sup>[66]</sup>
- Recommendation 4.4: Review the “foreign affiliate” definition, taking into account the Panel’s other recommendations on outbound taxation, the approaches of other countries, and the impact of any changes on existing investments.
- Recommendation 4.5: In light of the Panel’s recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis.<sup>[67]</sup>

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64 *Ibid.*, at 100.

65 The government appears to be having some success in persuading other countries to engage in TIEA negotiations. One wonders whether the ability to obtain exempt surplus treatment for income earned in their countries is a motivating factor for our negotiating partners. If it is critical, perhaps this recommendation will be disregarded, despite the lack of a rational policy link between a TIEA and exempt surplus treatment and the possibility of simplifying the system by getting rid of the concept of taxable earnings.

66 This recommendation, in combination with recommendation 4.1, would greatly simplify the system if accepted. However, on December 18, 2009, the government released new proposed regulations for determining the maximum amount of a section 93 election on the disposition of the shares of a foreign affiliate (*supra* note 23). Given this, it seems unlikely that the government is seriously considering simplification measures that would eliminate the need to track exempt and taxable surplus.

67 The government appears to have taken this recommendation to heart in its decision to scrap the FIE proposals and make limited changes to the existing OIF rules instead.

- Recommendation 4.6: Review the scope of the base erosion and investment business rules to ensure they are properly targeted and do not impede bona fide business transactions and the competitiveness of Canadian businesses.
- Recommendation 4.7: Impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates and section 18.2 of the Income Tax Act should be repealed.

## **THE NEED TO UPDATE AND SIMPLIFY CANADA'S TAX RULES**

In summary, Canada's international tax system does an adequate job of protecting the Canadian tax base and ensuring that Canadian-source income is subject to tax. Many, if not most, of the reforms we have mentioned were necessary. Over time, however, the system has become unwieldy, placing increasingly onerous demands on taxpayers, their advisers, and the CRA. Draft legislation that remains outstanding for extended periods of time is compounding this problem.

With the establishment of the advisory panel in 2007, the government signalled its intention to review and potentially improve the competitiveness, efficiency, and fairness of the system. In the 2009 budget, the government indicated its willingness to consider the advisory panel's recommendations; it took a positive first step by adopting recommendation 4.7 and repealing section 18.2 of the Act, and a second positive step by abandoning the FIE proposals. However, there are still important decisions to be made about the future direction of the system. The advisory panel's report is a welcome call to consider reforms that would eliminate some of the existing complexity while preserving protections for the Canadian tax base.