Back to Basics "FAPI-tizers"

Little tidbits you should know on Canada's FA regime

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The Basics – Foreign Affiliates

Why is FA status significant?

- Participation exemption for "exempt surplus" dividends rec'd by a Canadian corporation from a foreign affiliate (FA)
- Foreign accrual property income (FAPI) earned by a controlled foreign affiliate (CFA) is taxable on a current basis in Canada
- Reorganizations of FAs subject to particular rules

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The Basics - Foreign Affiliates

Relevant definitions

- Foreign affiliate (FA)
  - Non-resident corporation
  - Cdn and related taxpayers own ≥ 10% equity percentage
- Controlled foreign Affiliate (CFA)
  - FA controlled by Cdn taxpayer, NAL persons or up to four other Cdn residents
- “Equity percentage” ss 95(4)
  - Direct and indirect ownership of shares of any class

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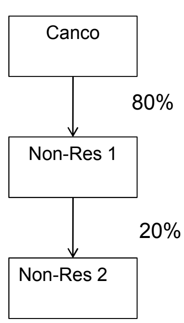
FA and CFA – Example #1



NR1:
Direct Equity = 80%
Indirect equity = nil
Equity % = 80%
NRI is a FA and CFA

NR2:
Direct equity = nil
Indirect equity = 80% x 20%
Equity % = 16%
NR2 is a FA, not a CFA

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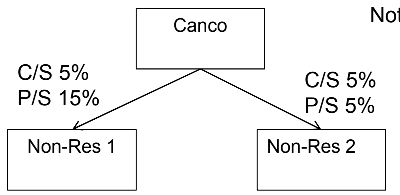
FA and CFA – Example #2

NR1:
Direct Equity = 15%, NR1 is a FA, Not a CFA

NR2:
Direct equity = 5%, therefore NR2 is not FA

Note: Do not add share classes!



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How the FA regime works

Overview of FA regime

Concepts of FAPI and surplus are separate, but linked:

- Active business earnings earned in treaty / TIEA country → no FAPI, exempt surplus
- Active business earnings, non-treaty / TIEA country → FAPI and taxable surplus
- Passive earnings → FAPI, taxable surplus

FAPI rules designed to preserve Canadian tax base

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How the FA regime works

Foreign affiliate surplus

- FA earnings generate surplus pools
- Exempt surplus repatriated to Canada without incremental Canadian tax
  - Withholding taxes may apply
- Taxable surplus repatriated to Canada on a credit system
  - Dividends taxed if Canadian rate > foreign rate
- Remaining balance is pre-acquisition surplus
  - ACB adjustment, potential gain if dividend > ACB
- New type of surplus – "hybrid" surplus
  - August 19, 2011 amendments

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FA residency

Resident in "designated treaty country"

Resident under Canadian common law ("central management and control")
<u>and</u>
Resident under tax treaty with Canada

OR

Would be a resident of DTC if were treated as a corporation in that country (i.e. US LLCs) or if the treaty did not specifically exclude such entities (i.e., Barbados IBC)

Also consider TIEA countries (none in force yet)

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FAPI – The Big Picture

What is FAPI?

- FAPI is only relevant for CFAs
    - taxable to Canadian taxpayers ss. 91 (1)
- Income inclusion based on “participating percentage”
    - watch if multiple classes of shares
- Deduction available for foreign accrual tax (FAT)
    - FAT x relevant tax factor
- FAPI is a net amount computed under Canadian tax rules in Canadian dollars
    - exceptions if 261 election made
    - no “template” for calculation

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FAPI – The Big Picture

Rules of thumb

- Rules designed to prevent tax on “passive” income from being deferred or avoided in low-tax foreign jurisdictions
    - if income is not taxed in another jurisdiction, chances are FAPI will apply
- Passive income can be deemed “active”
    - but active income can also be deemed FAPI!
- Certain Canadian-source income included

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FAPI – The Big Picture

Consequences of FAPI

- ACB adjustments for net FAPI
- FAPI increases “taxable earnings” and underlying foreign tax (UFT) for surplus purposes
- If the FAPI is earned by a FA and not a CFA, no FAPI inclusion in income but impacts surplus calculations
- New rules to stream “income” and “capital” FAPI
- Negative FAPI (“FAPLs”)
  - Cannot offset income from other sources in Canada
  - Shelters FAPI only – 7 year carryforward, 3 years back (Reg. 5903); proposed to extend to 20 years

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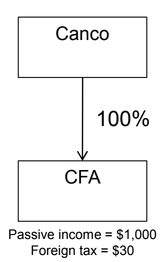
FAPI – Example #1

FAPI Inclusion - Example

100% CFA of Canadian taxpayer
FAPI of $1,000 in 2007, 30% foreign tax



Income inclusion – ss. 91 (1)	$1000
95(1) FAT applicable (assume $300)	
95(1) Relevant tax factor	
1/22.12% = 4.52	
FAT deduction – ss. 91(4)	(1,000)
FAT cannot exceed FAPI	
Net FAPI inclusion	$ NIL

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FAPI – What’s Included?

FAPI Defined – ss. 95(1)

Components of definition:

- Income from property
- Income from business other than active business
- Income from non-qualifying business
- Taxable gains from dispositions of other than “excluded property”

less

- Losses from property and business other than active business
- Allowable capital losses from dispositions of other than “excluded property”

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FAPI – What’s Included?

What is not FAPI:

- dividends from another FA
- dividends that would be deductible under s. 112 if received by Canadian taxpayer
- amounts of income or gain that can reasonably be considered to have accrued or been realized prior to becoming a FA

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FAPI – What’s included?

Active Business – ss. 95(1)

“Active Business”

- Any business other than an investment business or a business deemed to be a business other than an active business

“Income from an Active Business”

- Includes income that pertains to or is Incidental to an active business
- Excludes income from property or businesses other than active businesses

Consider if CFA has more than one business?

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FAPI – What’s Included?

“Income from Property”

Includes

- Income from an “investment business”
- Income from an adventure in the nature of trade

Excludes

- Deemed active business income – p. 95(2)(a)

Can include dividends, rents, royalties, interest….depends on the facts and circumstances!

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FAPI – What’s Included?

“Investment Business” – ss. 95(1)

Business carried on other than a business deemed to be an active business

Principal purpose to derive income from:

- property (i.e., interest, rents, royalties, dividends)
- reinsurance or factoring of A/R
- profits from disposition of “investment property”

But, exclusion if certain conditions met

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FAPI – What’s Included?

Investment Business Exception

Business carried on principally w/ arm’s length parties

AND

FA employees at least 6 full time employees (or 6 FT equivalents of a related entity) in the active conduct of the business

AND

FA is a foreign FI or dealer in securities and/or Commodities, or carries on a “qualifying business”:

- Development of real estate for resale
- Lending of money
- Leasing or licensing of property
- Insurance / reinsurance

FAPI – What’s Included?

Deemed Active Business Income – 95(2)

Deems income from property to be active business income (ABI) and therefore not FAPI

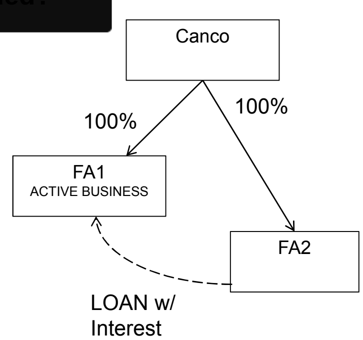
Must have “qualifying interest in FA” throughout the year

- 10% votes and value test

General policy is that income that directly relates to the active business activity of a related non-resident should not be FAPI

FAPI – What’s Included?

Example – Deemed ABI – 95(2)(a)(ii)



- Canco has qualifying interests in FA1 and FA2
- FA2 earns interest income (ordinarily considered investment income)
- Interest deductible in computing FA1 active business income carried on outside Canada
- Therefore, FA2 interest income is deemed active and is not FAPI

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FAPI – What’s Included?

Business Other than Active Business

Limits “active” business that would ordinarily not be FAPI

95(2)(a.1) – (a.4)

- Sale of property where the cost of the property is relevant in computing income from a business carried on in Canada by taxpayer or NAL person
- Income from certain debt and lease obligations, and reinsurance
- Exception where > 90% of revenue derived from unrelated persons

95(2)(b)

- Certain services provided by CFA (no *de minimus* test

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FAPI – What’s Included?

Non-qualifying business

Income that would otherwise be active business, carried on through a PE in a “non-qualifying country”:

- neither has a treaty nor a TIEA with Canada
- has been invited to negotiate TIEA but not concluded within 60 months

No such category of income yet (no “non-qualifying” countries) – earliest application is 2012

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FAPI – Other tidbits

Streaming of FAPI income vs. capital gains

August 19, 2011 proposals

- Separately track income from capital gains and losses, as in the domestic context
- FAPI capital losses (FACLs) only deductible against FAPI capital gains
- FACLs to have same carry-over period as FAPLs but restricted in use
- Cannot use FACLs against capital gains triggered by Canadian resident

Increases administrative requirements for entities with FAPI

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FAPI – Other tidbits

Complexities

In practice, determining FAPI can be complex

- Interests in partnerships, trust and other entities can create anomalies
- Foreign entities may or may not be FAs – need to consider corporate status
- “Incidental” income
- Obtain proper facts

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FAPI – A Summary