The Foreign Affiliate Rules: The 1995 Amendments

Sandra E. Jack*

PRÉCIS

Un avant-projet révisé de modification de la Loi et du Règlement portant sur les règles applicables aux sociétés étrangères affiliées a été publié le 23 janvier 1995. Ces modifications constituent le troisième avant-projet de modifications proposées aux dispositions sur les sociétés étrangères affiliées. Le deuxième avant-projet, qui avait été publié le 23 juin 1994, a été révisé en profondeur et a fait l'objet de commentaires dans cette revue et dans d'autres publications. L'avant-projet de janvier 1995 a encore été modifié par suite des changements contenus dans le projet de loi C-70 (partie II), déposé à la Chambre des communes le 16 février 1995. Cet article comprend une analyse détaillée des modifications de 1995. Plus particulièrement, il fournit un système de référence pour l'application des nouvelles règles et l'établissement de leur importance selon des circonstances précises. Les plus importantes des dernières modifications sont les suivantes :

- le champ d'application de la disposition anti-évitement contenue dans le paragraphe 95(6) est élargi;
- la définition du terme «entreprise de placement» est révisée, et une disposition distincte traitant du commerce de créances est mise en place;
- de nouvelles dispositions visant à assurer que certaines opérations en devises ne donnent pas lieu à un revenu étranger accumulé, tiré de biens, sont mises en place;
- selon le nouvel alinéa 95(2)a.4), certains revenus provenant du financement d'une société de personnes par le truchement d'un membre résidant au Canada sont réputés être un revenu tiré d'une entreprise non exploitée activement;
- le nouvel alinéa 95(2)k) est mis en place, dans lequel sont prévues des règles sur le début de l'assujettissement à l'impôt lorsqu'une société affiliée commence à être exploitée activement ou est réputée exploiter une entreprise distincte, autre qu'une entreprise exploitée activement; et
- l'alinéa 95(2)a), encore révisé, de sorte qu'il y est maintenant prévu qu'une société étrangère affiliée d'un contribuable peut considérer le

* Of Felesky Flynn, Calgary and Edmonton. Comments provided by D. Blair Nixon of Felesky Flynn are gratefully acknowledged.

revenu de biens comme un revenu provenant d'une entreprise exploitée activement uniquement si le contribuable a une «participation admissible» dans la filiale.

ABSTRACT

Revised draft legislation and regulations amending the rules applicable to foreign affiliates were released on January 23, 1995. These amendments constitute the third draft of proposed changes to the foreign affiliate provisions. (The second draft, which was released on June 23, 1994, has been thoroughly reviewed and commented on in previous issues of this journal and other publications.) The January 1995 amendments were further modified by minor changes contained in Bill C-70 (part II), tabled in the House of Commons on February 16, 1995.

This article presents a detailed analysis of the 1995 amendments. In particular, it provides a frame of reference for applying the new rules and determining their significance in particular circumstances. The most important of the latest amendments are the following:

- a much broader anti-avoidance rule in subsection 95(6);
- revision of the definition of "investment business" and the implementation of a separate provision dealing with trading and dealing in indebtedness;
- new provisions that are intended to ensure that certain currency transactions do not give rise to foreign accrual property income;
- new paragraph 95(2)(a.4), which deems certain income from financing a partnership with a Canadian resident member to be non-active business income;
- new paragraph 95(2)(k), which provides fresh start rules that apply where an affiliate commences carrying on an investment business or is deemed to commence carrying on a separate business other than an active business; and
- further revision of paragraph 95(2)(a), which now provides that property income of a foreign affiliate of a taxpayer may be recharacterized as income from an active business only where the taxpayer has a "qualifying interest" in the affiliate.

INTRODUCTION

On January 23, 1995, Finance Minister Paul Martin released revised draft legislation[1] relating to foreign affiliates and foreign accrual property

[1] Canada, Department of Finance, "Revised Draft Legislation on Foreign Affiliates," *Release*, no. 95-005, January 23, 1995; and "Revised Draft Legislation and Technical Notes, Foreign Affiliates," January 23, 1995 (herein referred to as "the January 1995 amendments"). Both reproduced in *Canadian Tax Reports*, Special Report no. 1193, extra ed. (North York, Ont.: CCH Canadian, 1995).

income (FAPI).[2] The January 1995 amendments constitute the third draft of proposed changes to the foreign affiliate provisions; the first draft was contained in the February 22, 1994 budget,[3] and the second was released on June 23, 1994.[4] The January 1995 amendments themselves have been further modified by minor changes contained in Bill C-70 (part II), which was tabled in the House of Commons on February 16, 1995.[5]

The 1995 amendments make substantial changes to the 1994 draft legislation. This article presents a detailed analysis of those changes. In addition, it provides an overview of the other foreign affiliate provisions that have been amended but not substantially altered from the 1994 draft.[6] The discussion is intended to provide a frame of reference for applying the amendments and determining their significance in particular circumstances.

EFFECTIVE DATE OF THE 1995 AMENDMENTS

The foreign affiliate amendments in Bill C-70 are generally effective for taxation years of foreign affiliates of taxpayers that begin after 1994.[7] This effective date is consistent with the coming-into-force provisions in the 1994 draft legislation. However, if the taxation year of an affiliate has

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[2] "Foreign accrual property income" is defined in subsection 95(1) of the Income Tax Act, 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 and the regulations thereunder, as amended by Bill C-70, tabled in the House of Commons February 16, 1995.

[3] Canada, Department of Finance, Budget Papers, "Supplementary Information and Notices of Ways and Means Motions on the Budget," in *Tax Measures: Supplementary Information*, February 22, 1994.

[4] Canada, Department of Finance, "Draft Legislation and Regulations—Foreign Affiliates and Divisive Corporate Reorganizations" (herein referred to as "the 1994 draft legislation"), reproduced in *Canadian Tax Reports*, Special Report no. 1163, extra ed. (North York, Ont.: CCH Canadian, June 23, 1994).

[5] Canada, Department of Finance, "Bill C-70 and Technical Notes," February 16, 1995, reproduced in *Canadian Tax Reports*, Special Report no. 1197, extra ed. (North York, Ont.: CCH Canadian, 1995). The January 1995 amendments and Bill C-70 are herein referred to collectively as "the 1995 amendments"; the technical notes to Bill C-70 are referred to as "the explanatory notes."

[6] The 1994 draft legislation is thoroughly reviewed in the following papers and articles: Sandra E. Jack, "The 1994 Amendments to the Foreign Affiliate Rules," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, forthcoming); Iain D.M. Morris, "Primer on the Taxation of Foreign Affiliates," in *1994 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1994), tab 3; Brian J. Arnold, "An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules" (1994), vol. 42, no. 4 *Canadian Tax Journal* 993-1036; Robert J. Dart and David G. Broadhurst, "Foreign Affiliates: Proposed Amendments," International Tax Planning feature (1994), vol. 42, no. 4 *Canadian Tax Journal* 1115-27; Brian J. Arnold and F. Brent Perry, "An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules" (Spring 1995), 8 *Canadian Petroleum Tax Journal* 1-25; and Kathleen O'Neill and Fred Borgmann, "The Use of Captive Insurers and the Effect of the 1994 Budget," International Tax Planning feature (1994), vol. 42, no. 5 *Canadian Tax Journal* 1344-60.

[7] The effective date of the amendments to the regulations is discussed below.

been changed in 1994 and after February 22, 1994, the amendments will apply to taxation years of such affiliates that end after 1994. Apparently, the Department of Finance was concerned that a foreign affiliate could change its taxation year to, say, November 30 from December 31 and thereby postpone the effect of the new rules. The coming-into-force provisions do not require any avoidance intention to accelerate the application of the new rules. Therefore, the implications of any change of a taxation year of a foreign affiliate in 1994 and after February 22, 1994 must be considered carefully.

Bill C-70 has added two relieving provisions to the proposed coming-into-force provisions in the January 1995 amendments. For an affiliate that requested, in writing and before February 22, 1994, a change in its taxation year from the income tax authority of the country in which the affiliate was resident and subject to income tax, the amendments in Bill C-70 will generally apply to taxation years of the foreign affiliate that begin after 1994. In addition, Bill C-70 will continue generally to be effective for taxation years that begin after 1994 where the first taxation year of the affiliate that began after 1994 commenced earlier than it would have if the taxation year had not been changed.

DEFINITION OF FOREIGN AFFILIATE

In previous versions of the draft legislation, the definition of "foreign affiliate" was amended to provide that a particular non-resident corporation is a foreign affiliate of a taxpayer resident in Canada (other than a non-resident-owned investment corporation) if the taxpayer's equity percentage[8] is at least 1 percent and the aggregate equity percentages of the taxpayer and each person related to the taxpayer are at least 10 percent. No further substantive changes have been made to this definition since the 1994 draft legislation.

ANTI-AVOIDANCE RULE

Subsection 95(6) is an anti-avoidance rule intended to prevent taxpayers from using rights to acquire shares or causing a foreign affiliate or other non-resident corporation to issue shares where one of the main reasons for the rights or issuance is to reduce or postpone the amount of tax that would otherwise be payable under the Act. Substantial changes have been made to this provision since the 1994 draft legislation. Indeed, the earlier drafts had not proposed any changes. Subsection 95(6) will now apply for purposes of subdivision i,[9] other than section 90. In addition, the purpose test in the provision has been amended from "one of the main reasons" to "principal purpose."

Paragraph 95(6)(a) continues to deal with rights under a contract, in equity or otherwise, either immediately or in the future and either

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[8] "Equity percentage" is defined in subsection 95(4).

[9] Subdivision i of division B of the Act is entitled "Shareholders of Corporations Not Resident in Canada" and includes sections 90 through 95.

absolutely or contingently, to, or to acquire, shares of a corporation. The provision, however, is expanded to include any person *or partnership* holding such rights. Other revisions in the 1995 amendments also have expanded certain provisions to contemplate the existence of partnerships in foreign structures.[10]

Revised paragraph 95(6)(a) will apply in two sets of circumstances. The first is the situation where the principal purpose for the existence of the right is to cause corporations to be related for the purpose of paragraph 95(2)(a). Paragraph 95(2)(a) causes certain income that would otherwise be property income to be characterized as income from an active business, thereby avoiding characterization as FAPI. If the principal purpose test in paragraph 95(6)(a) is met, the corporations are deemed not to be related for the purpose of paragraph 95(2)(a) with the result that the income will likely be characterized as FAPI.

The second set of circumstances is an expanded version of those described in current paragraph 95(6)(a). New subparagraph 95(6)(a)(ii) deems shares to be owned by a person or partnership where the principal purpose for the existence of the right is to permit any person to avoid, reduce, or defer the payment of tax or any other amount that would otherwise be payable under the Act.

Revised paragraph 95(6)(b) will apply where a person or partnership acquires or disposes of shares of a corporation, either directly or indirectly, and the principal purpose of the acquisition or disposition is tax avoidance. Again, the reference to a partnership is new. In addition, whereas the current paragraph 95(6)(b) deals only with shares that have been issued, the new provision will potentially apply whenever there is an acquisition, including an issuance, or a disposition of shares.

The reference in paragraph 95(6)(b) to a person or partnership that acquires or disposes of shares "*either directly or indirectly*" is curious, and its use raises some uncertainty. The provision applies where the principal purpose of the acquisition or disposition of shares by *any* person or partnership is to permit *any* person to avoid, reduce, or defer payment of Canadian tax. Since the actions of any person or partnership can be considered, a "lookthrough" of entities is not required; consequently, the words "directly or indirectly" appear to be unnecessary.

The words "directly or indirectly" occur frequently in the Act—for example, in references to direct or indirect control,[11] receipts or payments that are made directly or indirectly,[12] and property used directly or indirectly in a certain manner[13] or received directly or indirectly from a

[10] For example, see subparagraph 95(2)(a)(ii) and paragraph 95(2)(m).

[11] See, for example, subsections 85(4), 256(1), and 256(5.1) and the current version of paragraph 95(6)(b).

[12] See, for example, section 67.3, paragraph 115(2)(c), and subsections 246(1) and 260(8).

[13] See, for example, clause 110.6(15)(a)(ii)(B) and paragraph 112(2.4)(a).

particular person.[14] There are also numerous references to transfers that are directly or indirectly to or for the benefit of a particular person.[15]

The dictionary definitions of "indirect" include "roundabout."[16] Such a meaning ascribed to an acquisition from, or a disposition to, a particular person is appropriate since the transfer could be accomplished via a circuitous route. However, where the identity of the transferor or the transferee is irrelevant, as in new paragraph 95(6)(b), there appears to be no consequential difference between a direct and an indirect acquisition or disposition. The practical problem with the inclusion of these unnecessary words in the proposed provision is that Revenue Canada may assert that they have a specific meaning, with detrimental consequences for the taxpayer, in a particular audit scenario. This concern is further heightened by the fact that legislation is presumed to be meaningful and accurate.[17]

These views seem to be supported by *Army and Navy Department Stores v. MNR*.[18] In that case, the Supreme Court of Canada considered whether shares could be owned directly or indirectly by persons not dealing at arm's length where the shares in issue were owned by a corporation one of whose shareholders was the relevant person. In the court's view, "I do not think that shareholders, either individually or collectively, have any ownership direct or indirect in the property of the company in which they hold shares."[19] It is suggested that a similar result would occur if a court considered whether a person could acquire a share indirectly. Therefore, if the phrase "directly or indirectly" in paragraph 95(6)(b) is intended to be applied to acquisitions or dispositions of shares by subsidiary corporations, it appears to be ineffective.[20]

Under paragraph 95(6)(b), where it can reasonably be considered that the principal purpose for the acquisition or disposition of the shares is to permit a person to avoid, reduce, or defer the payment of tax or any other amount that would otherwise be payable under the Act, those shares are deemed not to have been acquired or disposed of, as the case may be. Where the shares were unissued by the corporation immediately before the acquisition, the shares are deemed not to have been issued. In this

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[14] See, for example, subsection 107(4.1).

[15] See, for example, the income attribution rules in sections 74.1 through 74.4, paragraph 88(1)(d), and subsection 160(1).

[16] *The Shorter Oxford English Dictionary*, 3d ed.

[17] Ruth Sullivan, *Driedger on the Construction of Statutes*, 3d ed. (Toronto: Butterworths, 1994), 104 and 105.

[18] 53 DTC 1185 (SCC).

[19] Ibid., at 1193.

[20] In *R.A. Jodrey Estate v. Min. of Finance (NS)*, [1980] CTC 437 (SCC), the majority of the Supreme Court of Canada held that a corporation became "beneficially entitled" to property of the testator that was devised to a subsidiary of the corporation. Since the court recognized a distinction between "beneficial owner" and "beneficially entitled," the analysis in *Jodrey Estate* suggests that the use of the words "either directly or indirectly" in paragraph 95(6)(b) does not add anything to the provision.

latter instance, other taxpayers, including those dealing at arm's length with the person attempting to avoid tax, could be affected. For example, if certain shares of a non-resident corporation are deemed not to have been issued, the other, arm's-length shareholders of the corporation will be deemed to own a greater percentage of the non-resident corporation. Those other shareholders will not necessarily know that certain shares are deemed not to have been issued and therefore may not calculate their Canadian income tax correctly.[21] This creates uncertainty at best and a blind sense of confidence at worst. Even if those shareholders are aware of the circumstances, in most cases those circumstances will not be within the control of an arm's-length shareholder. It appears that it would be more appropriate to deem the shares not to have been issued only in respect of the person who is attempting to avoid, reduce, or defer tax. This alternative legislative approach would eliminate the traps and inequities that might otherwise arise.

CHARACTERIZATION OF INCOME EARNED BY FOREIGN AFFILIATES

For purposes of the foreign affiliate provisions, income earned by a foreign affiliate is generally characterized as one of three types:

1) income from an active business,
2) income from a business other than an active business, or
3) income from property.

The latter two types of income constitute FAPI.[22] Appendixes 1 through 3 to this article provide a structure for characterizing income earned by a foreign affiliate. Appendix 4 sets out the statutory provisions that are relevant to the concepts discussed here. This summary of statutory cross-references will be useful to practitioners and others in working through the legislation.

Foreign Accrual Property Income

Definition

Parts A and D of the definition of "foreign accrual property income" in subsection 95(1) have been clarified in the 1995 amendments. The revised language makes it clear that any amount paid or payable by the affiliate to another foreign affiliate of the taxpayer, or a person with whom the taxpayer does not deal at arm's length, where such amount was deemed to be income from an active business to that other affiliate pursuant to clause 95(2)(a)(ii)(D), will not be taken into consideration in computing the FAPI of the affiliate. Clause 95(2)(a)(ii)(D) (discussed

[21] For example, a foreign affiliate may become a controlled foreign affiliate if certain issued shares are ignored. A taxpayer resident in Canada must include in income its appropriate share of FAPI of a controlled foreign affiliate.

[22] Capital gains may be treated as FAPI or in a manner consistent with active business income, depending upon the type of property giving rise to the gain.

below), treats as income from an active business certain interest payments received by a foreign affiliate from another related foreign affiliate in respect of debt used to acquire shares of a third foreign affiliate. In other words, the affiliate ("Aco") will not be able to reduce its FAPI in respect of any amounts paid to another foreign affiliate ("Bco") that have been treated as income from an active business to Bco.

It should be noted that the new debt forgiveness rules[23] will affect the calculation of FAPI for taxation years ending after February 22, 1994.

Part A of the definition of FAPI is amended to exclude the application of section 80 in calculating the foreign affiliate's income from property or from a business other than an active business.[24] However, new part A.1 of the definition of FAPI contemplates the inclusion of the forgiven amount. For these purposes, a "commercial debt obligation" is one in respect of which the interest thereon was or would have been deductible by the affiliate in computing its FAPI.[25] In addition, the reduction of the tax attributes of the foreign affiliate and the debt-parking and statute-barred debt rules are not applicable.[26]

New parts A.2 and G of the definition of FAPI effectively cause a reduction of the affiliate's losses rather than the actual inclusion of the forgiven amount in FAPI. Part A.2 is the amount G for the affiliate's preceding taxation year. Part G allows a deduction in computing FAPI to the extent that parts A.1 and A.2 exceed the affiliate's losses for that year, including losses from property and businesses other than active businesses, certain allowable capital losses, and deductible losses.

In summary, if the foreign affiliate is subject to a forgiveness of debt that relates to FAPI, the forgiven amount effectively reduces losses in the year and in future years until the forgiven amount is absorbed. These amendments have not been revised since the December 20, 1994 version of the debt forgiveness rules.

Deductible Losses for FAPI Purposes

In computing the amount of FAPI, a reduction is allowed to the extent of the affiliate's "deductible loss" for the year and the five immediately preceding years. Regulation 5903 sets out the rules for computing the affiliate's deductible loss. The current definition of deductible loss includes both FAPI losses and active business losses incurred by the affiliate while it was a foreign affiliate of the taxpayer or certain non-arm's-length corporations. Pursuant to the 1994 draft legislation, active business losses will no longer form part of the deductible loss of the foreign affiliate. As

[23] Amendments to the debt forgiveness rules were announced in the 1994 budget. Draft legislation was released on July 12, 1994 and December 20, 1994. These amendments are included, for the most part, in part I of Bill C-70; see, in particular, clauses 32 and 78.

[24] Clause 78 of Bill C-70.

[25] New subparagraph 95(2)(g.1)(i).

[26] New subparagraph 95(2)(g.1)(ii).

a result, transactions such as those implemented in *Mark Resources Inc. v. The Queen*,[27] where passive income is created in the foreign affiliate to absorb business losses, will not be effective to reduce FAPI after 1994. In addition, the 1994 draft legislation provides that deductible losses of a foreign affiliate will include only losses incurred while the affiliate is a *controlled* foreign affiliate of the taxpayer or certain non-arm's-length corporations. Previously, it was required only that the affiliate be a foreign affiliate of such persons.

The January 1995 amendments do not make any significant changes to the 1994 draft legislation in respect of regulation 5903.

The amendments to regulation 5903 will be applicable to taxation years of a foreign affiliate that begin after 1994, except where there has been a change in a taxation year of a foreign affiliate in 1994 and after February 22, 1994. In the latter case, the amendments will apply to taxation years of the affiliate that end after 1994.[28]

Active Business and Income from an Active Business

"Active business" and "income from an active business" are both defined in subsection 95(1). The 1995 amendments continue to define "active business" of a foreign affiliate of a taxpayer to mean any business carried on by the taxpayer other than an investment business carried on by the affiliate or a business that is deemed by subsection 95(2) to be a business other than an active business of the affiliate.

The definition of "business" in subsection 248(1) remains unchanged from the version in the 1994 draft legislation. A business, for the purposes of subsection 95(1), excludes an adventure or concern in the nature of trade. Income from an adventure or concern in the nature of trade continues to be specifically included in the definition of "income from property" in subsection 95(1). The amendment to the definition of "business" applies to taxation years ending after 1994. This amendment could therefore apply earlier than the other amendments. For example, if an affiliate has a November 30 year-end, income arising from an adventure or concern in the nature of trade in the November 30, 1995 taxation year will not be income from a business by virtue of the definition of "business." Presumably, it will constitute property income (and therefore FAPI), although the new definition of "income from property" will not apply until the taxation year of the affiliate that begins after 1994—that is, the November 30, 1996 taxation year.

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[27] 93 DTC 1004 (TCC). This decision is currently under appeal. Note that the *Mark Resources* transactions did not succeed because the interest expense in Canada was denied. Revenue Canada did not challenge the calculation of FAPI in the foreign affiliate. See also the discussion in Jack, supra footnote 6; and Arnold, supra footnote 6, at 1029-30.

[28] Presumably, the coming-into-force provision will be amended to be consistent with the exceptions to changes in taxation year-ends introduced in Bill C-70, discussed above under "Effective Date of the 1995 Amendments."

The definition of "income from an active business" in the 1995 amendments has been changed to an expansive definition through the use of the word "includes." In contrast, the definition contained in the 1994 draft legislation was an exhaustive definition, using the word "means." This change, however, has not altered the intent of the definition.

The revised definition of "income from an active business" includes, for greater certainty, any income of the affiliate for the year that pertains to or is incidental to the active business carried on by the affiliate. This is consistent with the definition proposed in the 1994 draft legislation. The revised definition, however, specifically excludes

- *other income* that is the affiliate's income from property for the year, and
- the affiliate's income for the year from a business that is deemed by subsection 95(2) to be a business other than an active business carried on by the affiliate.

The exclusion of "other income" (which is income from property) is intended to eliminate an apparent contradiction in the earlier draft, which included in income from an active business any income that pertained to or was incident to that business but did not include income from property. Since most incidental income, such as interest, will be passive income, it will be income from property. Therefore, there was a question whether the wording of the definition in the 1994 draft accomplished what it was intended to do.[29]

The new wording appears to correct the difficulty by stating that income that pertains to or is incident to the business is included within the meaning of income from an active business but any *other* income that constitutes income from property is excluded. While this revised wording should clarify matters, the borders of this legislative framework are not definitive. Judgments will still have to be made to determine what, inter alia, is included in "other income" and what is meant by income that "pertains to or is incident to" the business.

"Pertains to or Is Incident to"

This article will not discuss the meaning of the phrase "pertains to or is incident to" in the context of the definition of "income from an active business."[30] However, it is worthwhile to note that the Department of Finance, in its explanatory notes to Bill C-70, considers the phrase to include "income from assets at risk in or essential to that business (such as interest from the investment of temporarily surplus funds)."[31] The explanatory notes also state that "[a]ssets will be considered to be at risk in a business where the permanent removal of such assets would have a

[29] See Jack, supra footnote 6.

[30] For such a discussion, see Jack, ibid.

[31] Explanatory notes, supra footnote 5, at 101.

destabilizing effect on the business."[32] These comments are consistent with the jurisprudence.[33]

Income from Property

Income from Property Definition

"Income from property" is defined in subsection 95(1) to include the affiliate's income for the year from an investment business and its income for the year from an adventure or concern in the nature of trade. This portion of the definition has not changed from the 1994 draft legislation. The 1995 amendments, however, add that, for greater certainty, income from property of a foreign affiliate does not include its income that is included in income from an active business or income from a business other than an active business as a result of subsection 95(2). Although this "for greater certainty" clause does not appear necessary, it does provide completeness.

New paragraph 95(2)(l) (discussed below)[34] will also deem certain business income to be property income.

Investment Business

The definition of "investment business"[35] is a critical element in characterizing the income of a foreign affiliate. The purpose of the definition is to include in FAPI certain income that would generally be thought of as income from property but instead is treated as income from a business because of the level of activity and, to a certain extent, the presumption that income of a corporation is business income.[36]

The preamble to the definition of "investment business" now specifically identifies several sources of income, in addition to income from property, that are swept into the definition. In the 1994 draft legislation, a business carried on by a corporation whose principal business was trading or dealing in debt obligations on its own account or on account of persons with whom it did not deal at arm's length was excluded from the exclusions in the definition of "investment business."[37] As a result, income from such a business was always included in the definition of "income from property" and therefore constituted FAPI. The 1995 amendments remove this specific inclusion (that is, the "exclusion from the exclusions"). Instead, income from trading or dealing in debt obligations is dealt with in a much more restricted fashion in new paragraph 95(2)(l), discussed below. While the income of such a business may still be FAPI,

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[32] Ibid., at 106.

[33] See, for example, *Ensite Ltd. v. The Queen*, 86 DTC 6521, at 6525-26 (SCC).

[34] See "Trading in Debt: Paragraph 95(2)(l)."

[35] Subsection 95(1).

[36] See Jack, supra footnote 6.

[37] Preamble of paragraph (a) of the definition of "investment business" in subsection 95(1) of the 1994 draft legislation.

the proposed legislation effects that result through another route. (See appendixes 1 through 3 for an overview.)

Furthermore, the "more than five full-time employees" test has been expanded in the 1995 amendments to accommodate services provided by related parties. This is a welcome addition to the legislative framework.

The first step in determining whether a foreign affiliate is carrying on an investment business is to determine whether the affiliate carries on a business whose principal purpose is to derive

• income from property (including interest, dividends, rents, royalties, or other similar returns or substitutes therefor);

• income from the insurance or reinsurance of risks;

• income from the factoring of accounts receivable; or

• profit from the disposition of investment property.[38]

The definition of "investment business" in the 1994 draft legislation attempted to force insurance premiums into the income from property characterization. The revisions in the 1995 amendments specifically contemplate deriving income from the insurance or reinsurance of risks. In addition, the amendments specifically include, in the preamble, a business that derives its income from the factoring of accounts receivable.

A business whose principal purpose is the earning of profits from the disposition of investment property is also potentially included in the definition of "investment business." When the 1994 draft legislation was issued, concern was expressed regarding the breadth of the definition of "investment property." In particular, the inclusion of "commodities" was troubling because the term could be given a very broad meaning. Taken literally, it could include virtually any good or product.[39] Investment property, as defined in subsection 95(1) pursuant to the 1995 amendments, now includes the following:[40]

• shares, other than excluded property;[41]

• interests in partnerships or trusts (other than excluded property), or interests in funds and entities other than corporations, partnerships, and trusts;

• indebtedness or annuities;

• commodities or commodities futures purchased or sold, directly or indirectly in any manner whatever, on a commodities or commodities

[38] "Investment property" is defined in subsection 95(1).

[39] See Arnold, supra footnote 6, at 1004.

[40] The definition, which is similar to the definition of "offshore investment fund property" in section 94.1, remains an inclusive definition (and is therefore not exhaustive). Consequently, property need not be one of the specified properties listed in order to be considered investment property. The ordinary meaning of investment property could still be very broad. See Arnold, supra footnote 6, at 1004.

[41] "Excluded property" is defined in subsection 95(1).

futures exchange, except commodities manufactured, produced, grown, extracted, or processed by the affiliate or by a person to whom the affiliate is related (otherwise than because of a right referred to in paragraph 251(5)(b)) or commodities futures in respect of such commodities;

- currency;
- real estate;
- Canadian and foreign resource properties; and
- interests or options in respect of any of the above.

The new restriction on the inclusion of commodities in investment property should prevent income from bona fide active business operations from being inadvertently characterized as FAPI.[42] In addition, it will help to ensure that offshore marketing and sales corporations will be viable.[43]

Exclusions

There are two exclusions from the definition of "investment business."

1) Deemed Non-Active Business Income

The first exclusion, which appeared also in the 1994 draft legislation, is included in the preamble of the definition of "investment business." The preamble states that any business deemed by subsection 95(2) to be a business other than an active business carried on by the affiliate is excluded from the definition of "investment business." A business of this kind is also specifically excluded from the definition of "active business," and the income from the business is specifically excluded from the definition of "income from an active business." Income may be deemed to be income from a business other than an active business under the provisions of paragraphs 95(2)(a.1), (a.2), (a.3), (a.4), and (b). Proposed paragraphs 95(2)(a.1) through (a.3) deal with the sale of goods, insurance of Canadian risks, and Canadian debt and lease obligations, respectively. New paragraph 95(2)(a.4) has been introduced with the 1995 amendments and expands the scope of paragraph 95(2)(a.3) to include certain income derived by a partnership from indebtedness and lease obligations. Paragraph 95(2)(b) has not been amended by any of the proposals.

The most significant effect of these deeming rules is that these businesses may not qualify as an active business, *even if* the foreign affiliate employs more than five full-time employees in the conduct of the business. Therefore, income from these businesses will always constitute FAPI and be included in taxable surplus.

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[42] Provided that an extremely broad approach is not taken with respect to the ordinary meaning of investment property: see supra footnote 40.

[43] See the discussion below under "Property Sales in Affiliates—Exclusions—2) Canadian Goods."

2) *Qualifying Business and More Than Five Full-Time Employees*

Two categories of qualifying businesses, described in subparagraphs (a)(i) and (ii) of the definition of "investment business," are potentially excluded from an investment business, and as a result the income from the business could be income from an active business. For a business to be excluded, two tests must be satisfied throughout the period in the taxation year of the affiliate during which the business (which would otherwise be an investment business) was carried on by the affiliate. The 1995 amendments specifically require that the satisfaction of these tests must be established by the taxpayer or the affiliate.[44]

The two tests are

1) whether the affiliate carries on a qualifying business, and
2) whether the affiliate employs more than five full-time employees.

• *Qualifying business*

The affiliate must carry on a business that is specifically contemplated in subparagraph (a)(i) or (ii) of the definition of "investment business." The criteria for qualification are essentially the same as those listed in the 1994 draft legislation. However, the 1995 amendments remove the requirements that the *only* business be that of a regulated foreign financial institution and that the *principal* business of a foreign affiliate be that of the specified non-regulated business. As a result, each business[45] carried on by a foreign affiliate that meets the principal business requirement will be examined separately to determine whether it may be excluded from the definition of "investment business."

To be a qualifying business, the business must be other than a business conducted principally with persons with whom the affiliate does not deal at arm's length. For these purposes, new subsection 95(2.1) provides that a foreign affiliate of a taxpayer and the taxpayer will be considered to be dealing at arm's length in respect of certain agreements that provide for the purchase, sale, or exchange of currency. The taxpayer (that is, the Canadian shareholder in respect of which the non-resident corporation is a foreign affiliate) must be

- a bank,
- a trust company,
- a credit union,[46]

[44] It appears that this reference to the party that bears the burden of proof is unnecessary, since the taxpayer generally has the burden of proof unless the legislation otherwise provides. See, for example, *Johnston v. MNR* (1948), 3 DTC 1182 (SCC).

[45] See *Interpretation Bulletin* IT-206R, October 29, 1979, for comments regarding the determination of separate business operations. See also *Utah Co. of the Americas v. MNR*, 59 DTC 1275 (Ex. Ct.); and *Frankel v. MNR*, 59 DTC 1161 (SCC).

[46] "Credit union" is defined in subsection 137(6).

- an insurance corporation,[47] or
- a trader or dealer in securities or commodities

resident in Canada, whose business activities are subject by law to the supervision of a regulating authority such as the superintendent of financial institutions or a similar authority of a province.[48] Bill C-70 has added that, alternatively, the taxpayer may be a "subsidiary wholly-owned corporation"[49] of a regulated Canadian financial institution.

The agreements referred to must be swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, options or rights agreements, or similar agreements,[50] which are entered into in the course of a business carried on by the affiliate principally with persons with whom the affiliate deals at arm's length in the country where the affiliate is governed and in which the business is principally carried on. Further, the terms and conditions of the currency agreements must be substantially the same as the terms and conditions of similar agreements made by persons dealing at arm's length.[51]

In addition to a business that is conducted principally with arm's-length persons, to be a qualifying business for possible exclusion from the definition of "investment business," the business must be either of the following:

1) A business carried on by the affiliate as
   a) a foreign bank,[52]
   b) a trust company,
   c) a credit union,[53]
   d) an insurance corporation,[54] or
   e) a trader or dealer in securities or commodities

[47] "Insurance corporation" is defined in subsection 248(1) as a corporation that carries on an insurance business.

[48] A taxpayer meeting these criteria is referred to in this article as a "regulated Canadian financial institution."

[49] "Subsidiary wholly-owned corporation" is defined in subsection 248(1).

[50] In this article, all such agreements are collectively referred to as "currency agreements."

[51] Note that the January 1995 amendments required the currency agreements to be similar to agreements made by the *taxpayer* with arm's-length persons. The wording has been modified by Bill C-70.

[52] "Foreign bank" is now defined in subsection 95(1).

[53] A credit union, as defined in subsection 137(6), relies substantially on revenues from debt obligations of a government in Canada or an entity owned by such a government. In this respect, the definition appears to be inappropriate for the purposes of the foreign affiliate rules.

[54] Supra footnote 47.

whose activities are regulated in the country in which the business is principally carried on.[55] For purposes of exclusion from the "investment business" definition, it does not matter where the affiliate is governed[56] as long as it is regulated in the country in which the business is principally carried on.

2) A business that is engaged in

a) the development of real estate for sale,

b) the lending of money,[57]

c) the leasing or licensing of property,[58] or

d) the insurance or reinsurance of risks.

With respect to the latter specified businesses, the 1995 amendments deleted the reference to "a combination of the above" because each business is now examined in its own right.

"Lending of money" is defined in subsection 95(1). This definition has been substantially expanded in the 1995 amendments. Lending of money by a person ("the lender") includes each of the following:

• The acquisition by the lender of trade accounts receivable[59] (or an interest therein) from another person.[60] For these purposes, it will not include trade accounts receivable owing by a person with whom the lender does not deal at arm's length. Therefore, a business carried on by a foreign affiliate that factors trade accounts receivable of non-arm's-length parties will not be within the definition of "lending of money."[61]

• The acquisition by the lender of a foreign resource property of another person.[62] For this purpose, it will exclude a foreign resource property that is a rental or royalty payable by a person with whom the lender does not deal at arm's length.

[55] In this article, an affiliate meeting these criteria is referred to as a "regulated foreign financial institution."

[56] Infra footnote 69 and the accompanying text.

[57] "Lending of money" is defined in subsection 95(1), discussed below.

[58] "Licensing of property" is defined in subsection 95(1), discussed below.

[59] The meaning of "trade accounts receivable" is discussed below under "Trading in Debt: Paragraph 95(2)(l)—Exclusions—1) Certain Indebtedness."

[60] Paragraph (a) of the definition of "lending of money" in subsection 95(1).

[61] However, new subparagraph 95(2)(a)(iii) may apply to include income from such business, which is an investment business, in income from an active business.

[62] Paragraph (c) of the definition of "lending of money" in subsection 95(1). The Department of Finance stated in *Release*, no. 95-005, supra footnote 1, that the words "acquisition of" have been substituted for the words "purchasing of" used in the 1994 draft legislation to accommodate the original granting of a foreign resource property for funds.

• The acquisition or sale by the lender of loans made by, and lending assets[63] of, another person (or an interest therein).[64] For these purposes, it will not include loans or lending assets owed by a person with whom the lender does not deal at arm's length. (This provision has been added by the 1995 amendments.)

Under this expanded definition, more businesses will qualify for the investment business exclusion than would have been the case under the 1994 draft legislation.

"Licensing of property" also is defined in subsection 95(1). There are no changes from the 1994 draft legislation. Licensing of property includes authorizing the use or the production or reproduction of property, including information or any other thing. As a result, it will include technology licensing agreements.

• *More than five full-time employees*

Provided that the foreign affiliate's business is one of the qualifying businesses described above, the business will be excluded from characterization as an investment business if the foreign affiliate—or partnership, if the foreign affiliate carries on the business through a partnership—also satisfies the "more than five full-time employees" test.

Paragraph (b) of the definition of "investment business" has been expanded in the 1995 amendments to accommodate services provided to the affiliate by employees of a related party. This is in addition to the test set out in the 1994 draft legislation that the affiliate—or, where the affiliate carries on the business as a member of a partnership, the partnership—must employ more than five employees full time in the active conduct of

[63] "Lending asset" is currently defined in subsection 248(1) to mean a bond, debenture, mortgage, note, agreement of sale, or any other indebtedness or a prescribed share, but does not include a prescribed security. Regulation 6209(a) specifies that "a share owned by a bank is a prescribed share for a taxation year where it is a preferred share of the capital stock of a corporation that is dealing at arm's length with the bank that may reasonably be considered to be, and is reported as, a substitute or alternative for a loan to the corporation, or another corporation with whom the corporation does not deal at arm's length, in the bank's annual report for the year to the relevant authority or, where the bank was throughout the year subject to the supervision of the relevant authority but was not required to file an annual report for the year with the relevant authority, in its financial statements for the year." Regulation 6209(b) defines a security to be a prescribed security where, in the case of a security held by a bank, the security is reported as part of the bank's trading account in its annual report for the year to the relevant authority or, where no such report is required, in its financial statements for the year; and in the case of a security held by a taxpayer other than a bank, the security is at any time in the year a property described in an inventory of the taxpayer. The explanatory notes, supra footnote 5, at 150, state that regulation 6209 will be amended to prescribe mark-to-market property of financial institutions and inventory of other taxpayers.

[64] Paragraphs (b) and (c) of the definition of "lending of money" in subsection 95(1).

the business.[65] The "more than five full-time employees" test is not relevant to a partnership where the affiliate is a specified member[66] of the partnership in a fiscal period of the partnership that ends in the taxation year of the affiliate.

Under the 1995 amendments, the affiliate, or the partnership, must employ more than five full-time employees in the active conduct of the business; or, alternatively, the affiliate, or the partnership, must employ the equivalent of more than five employees full time in the active conduct of the business, taking into consideration only the services provided by its own employees and the services provided to the affiliate, or the partnership, by the employees of

- a corporation related to the affiliate (otherwise than because of a right referred to in paragraph 251(5)(b)), or
- members (other than a specified member) of the partnership.

The services that are provided by the corporation or members referred to above must be provided outside Canada. In addition, if compensation is received from the affiliate or the partnership, the value of such compensation must not be less than the corporation's or member's cost of the compensation paid or accruing to the benefit of the employees that performed the services during the time the services were performed.

Summary

If the particular business of the foreign affiliate is an investment business, the income from the business is income from property. If the particular business is not an investment business, the income from the business could still be characterized as income from property pursuant to new paragraph 95(2)(l).

Trading in Debt: Paragraph 95(2)(l)

New paragraph 95(2)(l) provides that in computing the income from property of a foreign affiliate, there shall be included the income of the affiliate for the year from a business (other than an investment business) where the principal purpose of the business is to derive income from trading or dealing in indebtedness, which income includes the earning of interest on the indebtedness. The Department of Finance has stated that this wording

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[65] See *Interpretation Bulletin* IT-73R4, February 13, 1989, paragraphs 14 to 16 for guidelines in respect of the employment test for a specified investment business. See also *The Queen v. Hughes & Co. Holdings Ltd.*, [1994] 2 CTC 170, at 179 (FCTD), where the court stated that to have more than five full-time employees, the corporation must have at least six full-time employees.

[66] Very generally, a specified member is defined in subsection 248(1) as a member of the partnership who is a limited partner (defined in subsection 96(2.4)) at any time in the fiscal period of the partnership; or a member of the partnership other than a member who is, on a regular, continuous, and substantial basis, either actively engaged in the activities of the partnership business (excluding financing of the business) or directly carrying on a business similar to that carried on by the partnership.

is intended to include moneylenders who are not otherwise traders of or dealers in debt instruments. If this interpretation is upheld, to avoid FAPI treatment the very stringent requirements of paragraph 95(2)(l) must be satisfied even if the money-lending business is not an investment business.

Paragraph 95(2)(l) will not apply where the business of trading or dealing in indebtedness is an investment business as defined in subsection 95(1), discussed above. However, if the business of trading or dealing in indebtedness is not an investment business (because, inter alia, the "more than five full-time employees" test is satisfied), income from the business will be property income if paragraph 95(2)(l) applies. New paragraph 95(2)(l) has been introduced to allow such trading activities of bona fide financial institutions to avoid characterization as FAPI.[67]

Exclusions

1) Certain Indebtedness

Paragraph 95(2)(l) will not apply to indebtedness that is

• indebtedness owing by persons with whom the affiliate deals at arm's length that are resident in the country in which the affiliate was formed or continued, and exists and is governed, and in which the business is principally carried on; or

• accounts receivable owing by persons with whom the affiliate deals at arm's length.

Whereas the 1994 draft legislation referred to foreign affiliates that are "formed or organized" under the laws of a particular country,[68] the 1995 amendments adopt the expanded concept of an affiliate or other non-resident corporation that is "formed or continued and exists and is governed"[69] under the laws of a particular country.[70] The Department of Finance was presumably concerned with arrangements that could avoid the intention of the "governing country" rules by incorporating an affiliate in one country and then continuing[71] the affiliate into another country.

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[67] *Release*, no. 95-005, supra footnote 1.

[68] See subparagraph 95(2)(a.1)(ii) in the 1994 draft legislation.

[69] In this article, the shorter term "governed" is substituted for this phrase.

[70] See subparagraphs 95(2)(a.1)(ii), 95(2)(l)(i) (although there is no reference to "under whose laws"), and 95(2)(l)(iii); paragraphs 95(2.1) (c), 95(2.4)(a), and 95(2.4)(b); and paragraph (c) of the meaning of "indebtedness" and paragraph (b) of the meaning of "specified deposit" in subsection 95(2.5).

[71] Continuance is a concept whereby a corporation may change the jurisdiction under which its corporate affairs are governed. In such a case, the corporation is regarded as being originally incorporated in the first jurisdiction. When a corporation is continued into another jurisdiction, the identity and existence of the corporation do not change; however, the corporation becomes subject to the corporate legislation of the continuing jurisdiction. (See *Canada Corporations Law Reporter* (North York, Ont.: CCH Canadian) (looseleaf), paragraph 10,270.) See, for example, section 187 of the Canada Business Corporations Act, RSC 1985, c. C-44, as amended, and sections 181 and 182 of the Alberta Business Corporations Act, SA 1981, c. B-15, as amended.

The conditions for determining the "governing country" were made more detailed in the 1995 amendments so that the affiliate or non-resident corporation, as the case may be, must also exist in, and be governed by the laws of, the particular governing country. In circumstances where a corporation is continued into another jurisdiction, the governing country will be that other country.

As indicated above, added to the requirement that the affiliate be governed by the laws of a particular country is the condition that the affiliate's business be principally carried on in that country.[72] It appears that certain "dual incorporated" corporations that are governed by laws in two countries could be considered to have two "governing countries." However, since the relevant provisions also contemplate that the affiliate's principal business is carried on in a particular country, it appears that only one governing country will be permitted under the amended rules.[73]

In summary, paragraph 95(2)(l) will not apply to income arising from amounts owing to the affiliate by arm's-length persons who are resident in the same country in which the affiliate is governed and principally carries on its business, whether or not the principal purpose of the affiliate's business is to derive income from trading or dealing in indebtedness, including the earning of interest on that indebtedness.

There is a difficulty with paragraph 95(2)(l) in respect of the determination of the country of residence of arm's-length persons. For purposes of the Act, the common law concept of "central management and control" is relevant in determining the residence of a corporation.[74] To further

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[72] Supra footnote 70.

[73] Ibid.

[74] See, for example, *De Beers Consolidated Mines Limited v. Howe*, [1906] AC 455, at 458 (HL), in which the place where the central management and control of the corporation was located was based upon a determination of fact:

> In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. . . . [A] company resides for purposes of income tax where its real business is carried on . . . and the real business is carried on where the central management and control actually abides. . . .
>
> This is a pure question of fact to be determined, not according to the construction of this or that regulation or by-law, but upon a scrutiny of the course of business and trading.

See also *Capitol Life Insurance Company v. The Queen*, 84 DTC 6087 (FCTD), aff'd. 86 DTC 6164 (FCA).

With respect to the residence of an individual, in *Thomson v. MNR* (1945), 2 DTC 685 (Ex. Ct.), aff'd. (1946), 2 DTC 812 (SCC), the court, after reviewing English jurisprudence, stated a number of principles, including the following: a taxpayer need not have a fixed place of abode to be resident in the jurisdiction (*Reid v. CIR* (1926), 10 TC 673 (Scot. Ct. of Sess.); and *The Queen v. Reeder*, 75 DTC 5160 (FCTD)); constant personal presence in a place is not essential to residence there, and a person may continue to be resident in a place although physically absent from it (*In re Young* (1875), 1 TC 57 (Scot.

(The footnote is continued on the next page.)

complicate matters, a person may have more than one country of residence.[75] Presumably, the test of residence referred to in new subparagraph 95(2)(l)(i) would be satisfied if the subject person were resident in the same country as the affiliate, even if that person were also resident in another jurisdiction.

The determination of residence is a subjective test based upon many factors, and the information needed to make such a determination in respect of an arm's-length person may not be readily accessible to the foreign affiliate. As a practical matter, the ability of a foreign affiliate to establish that an arm's-length person is resident in any particular country may depend largely or entirely upon the cooperation of that person. Given these difficulties, the residency test applicable to arm's-length persons appears to be neither reasonable nor appropriate.

The second exclusion from the application of paragraph 95(2)(l) is indebtedness that represents accounts receivable owing by persons with whom the affiliate deals at arm's length. In this context, the residence of the debtor is irrelevant. Since this exclusion depends on the distinction between indebtedness and accounts receivable, it is useful to review the meaning of these terms.

"Indebtedness" is defined as "the sum owed" or "debts collectively."[76] "Debt" has been described as follows:

> One can say that the most common use of the word "debt" is to describe an obligation to pay a sum certain or a sum readily reducible to certainty. The obligation may or may not depend on an express or implied contract, depending on the context in which the word is used, but to this writer the essence of the term is that, if there is an obligation to pay a certain or an ascertainable sum, the courts should tend not to concern themselves with the precise nature of the cause of action. Claims for unliquidated damages will generally not be describable as debts unless the context suggests otherwise.[77]

Accounts receivable are generally defined as "[a]n amount owed by a debtor for delivered goods or completed services."[78] In other words,

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[74] Continued . . .
Ct. of Exch.)); and the number of days that a taxpayer spends within the jurisdiction in a taxation year is not crucial (*Reid*, supra; and *Levene v. CIR* (1928), 13 TC 486 (HL)). The determination of the fiscal residence of an individual is a pure question of fact, and the factors material in this determination include past and present habits of life, regularity and length of visits in the jurisdiction in which residence is asserted, ties within that jurisdiction, ties elsewhere, and permanence or otherwise or purposes of the stay abroad.

[75] See, for example, *Swedish Central Ry. Co. v. Thompson*, [1925] AC 495 (HL); *Lloyd v. Sully* (1884), 2 TC 37 (Scot. Ct. of Exch.); *Cooper v. Cadwalader* (1904), 5 TC 101 (Scot. Ct. of Exch.); and *Levene*, supra footnote 74.

[76] Supra footnote 16.

[77] C.R.B. Dunlop, *Creditor-Debtor Law in Canada* (Toronto: Carswell, 1981), 19-20.

[78] Derek French, *Dictionary of Accounting Terms* (London: Financial Trading Publications, 1985), 7. For similar definitions, see Stanley M. Beck, Frank Iacobucci, David L.
(The footnote is continued on the next page.)

accounts receivable arise in the ordinary course of business as a result of the provision of goods or services. They do not include other debts, such as those arising from the lending of funds. Accordingly, indebtedness, in this context, means all debts. Accounts receivable, on the other hand, are a subset of indebtedness.

The 1995 amendments also refer, in the definition of "investment business" and subparagraph 95(2)(a)(iii), to the factoring of "accounts receivable." As a result of these references to factoring and trading or dealing in such debts, the debt should not lose its character by being assigned by the original vendor to another party.

The definition of "lending of money" in subsection 95(1) refers to the acquisition of "trade accounts receivable." Since it is unlikely that "trade accounts receivable" has a different meaning from "accounts receivable," the reference to "trade" in the definition of "lending of money" should be deleted.

2) Regulated Financial Institutions

Paragraph 95(2)(l) will not apply to certain regulated financial institutions. The business of trading or dealing in indebtedness must be carried on by the foreign affiliate of a taxpayer as a regulated foreign financial institution,[79] whose activities are regulated in the country under whose laws the affiliate is governed and in which the business is principally carried on.[80]

In addition, the taxpayer (that is, the Canadian shareholder in respect of which the non-resident corporation is a foreign affiliate) must be a regulated Canadian financial institution[81] or a subsidiary wholly owned corporation.[82] As a result, the exception from paragraph 95(2)(l) applies only to regulated financial institutions resident in Canada that have foreign affiliates that carry on a regulated financial institution business in the foreign jurisdiction in which they are governed.

Deemed Non-Active Business Income

Paragraphs 95(2)(a.1) through (a.4) and (b) deem certain income that would otherwise be income from an active business to be income from a business other than an active business. This includes income derived from

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78 Continued . . .
Johnston, and Jacob S. Ziegel, *Cases and Materials on Partnerships and Canadian Business Corporations* (Toronto: Carswell, 1983), 777; *Black's Law Dictionary*, 6th ed.; and *Jowitt's Dictionary of English Law*, 2d ed.

79 Supra footnote 55 and the accompanying text.

80 Compare with subparagraph (a)(i) of the definition of "investment business" in subsection 95(1). However, under that definition, the business need not be regulated in the same country in which it is governed.

81 Supra footnote 48 and the accompanying text.

82 Supra footnote 49.

certain property sales, the insurance of Canadian risks, Canadian debt and lease obligations, indebtedness and lease obligations owed by partnerships, and the provision of certain services by controlled foreign affiliates. Whenever any of these provisions apply, the income will be characterized as FAPI and paragraph 95(2)(a) will not apply. In addition, since such businesses are excluded from the definition of "investment business," there is no opportunity to qualify the business through the employment of more than five persons.

As noted earlier, paragraph 95(2)(b) has not been changed under the amendments; the current provision will continue to apply. Paragraph 95(2)(a.2) was amended under the 1994 draft legislation and has not been further modified; however, additional changes have been made to paragraphs 95(2)(a.1) and (a.3). Paragraph 95(2)(a.4) is a new provision in the 1995 amendments.

Property Sales in Affiliates

Paragraph 95(2)(a.1) is the legislative reaction to *The Queen v. Irving Oil Limited*.[83] The conditions that must be fulfilled for paragraph 95(2)(a.1) to apply are as follows:

1) the income of the foreign affiliate of a taxpayer must be from the sale of property or the provision of services as an agent in relation to the purchase or sale of property; and

2) it must be reasonable to conclude that the cost to any person of the property is relevant[84] in computing the income from a business carried on

a) by the taxpayer (that is, the Canadian resident in respect of which the non-resident corporation is a foreign affiliate) or a person resident in Canada with whom the taxpayer does not deal at arm's length; or

b) in Canada by a non-resident person with whom the taxpayer does not deal at arm's length.

There are four circumstances, however, in which such income of an affiliate will be excluded from the application of paragraph 95(2)(a.1).

Exclusions

1) Subsection 95(2.3)

New subsection 95(2.3) will exclude the application of paragraph 95(2)(a.1) in respect of a sale or exchange of property where that property is currency or a right to purchase, sell, or exchange currency. This exclusion will apply where the taxpayer (that is, the Canadian shareholder in respect of which the affiliate is a foreign affiliate) is a regulated Canadian financial institution[85] or, as added by Bill C-70, a subsidiary wholly owned

[83] 91 DTC 5106 (FCA) (leave to appeal to SCC refused).

[84] See the discussion in Arnold, supra footnote 6, at 1010.

[85] Supra footnote 48 and the accompanying text.

corporation of a regulated Canadian financial institution. In addition, the sale or exchange of currency must have been made in the course of a business carried on by the affiliate principally with persons with whom the affiliate deals at arm's length in the country in which the affiliate is governed and in which the affiliate's business is principally carried on. Furthermore, the terms and conditions of the sale or exchange of currency must be substantially the same as the terms and conditions of similar sales or exchanges of such currency made by persons dealing at arm's length.[86]

As a result, subsection 95(2.3) will allow foreign affiliates of a regulated Canadian financial institution to carry on certain currency arrangements with a non-arm's-length person without affecting the computation of FAPI.

2) Canadian Goods

Property that is manufactured, produced, grown, extracted, or processed in Canada by the taxpayer or by a non-arm's-length person in the course of carrying on business in Canada, and is subsequently sold to the affiliate for sale to non-resident persons, is carved out of paragraph 95(2)(a.1). The amendments also exclude such property that is sold to non-resident persons other than the affiliate.

This exclusion is intended to allow Canadian producers to establish offshore marketing or sales corporations in respect of property destined for offshore markets. It should be emphasized, however, that it will apply only to property that is *manufactured*, *produced*, *grown*, *extracted*, or *processed* in Canada by the taxpayer or by a non-arm's-length person. If the activity in relation to the property falls short of this requirement, it will not be excluded.[87]

Under the 1994 draft legislation, the Canadian producer would have been required to sell the property to the affiliate. A revision in the 1995 amendments allows a direct sale to a non-resident person, permitting the affiliate to act as an agent in relation to the sale.

A concern with the 1994 draft legislation relating to offshore marketing companies was the breadth of the possible meaning of "investment property" and, in particular, "commodity," which could have caused an offshore marketing corporation to qualify as an investment business. Since (as discussed above) the inclusion of commodities in the definition of "investment property" has now been restricted, offshore marketing corporations should be accommodated. However, a problem may still arise with unrelated marketing corporations if the commodity is sold through an exchange.

For example, consider the circumstances where three unrelated Canadian commodity producers each own one-third of a foreign marketing

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[86] Supra footnote 51.

[87] Unless the de minimis rule applies, discussed below under "4) De Minimis Test."

corporation. Each producer sells its product to the marketing corporation. If the marketing corporation sells the product directly or indirectly on a commodities exchange, the product constitutes investment property, and the business carried on by the marketing corporation may be an investment business.

Query whether this problem with the definition of "investment business" may be circumvented by arranging for the marketing corporation to act as an agent in selling the producers' commodities, instead of purchasing the product and then reselling it. The activities of an agent will constitute an investment business only if the principal purpose is to derive profits from the disposition of investment property. Also query whether the phrase "profits from the disposition" contemplates only an actual sale of property by the affiliate.

In any event, such an alternative arrangement would likely fall within paragraph 95(2)(b), and the income from the services as agent would be deemed to be income from a business other than an active business.

3) Home Country Goods

The third potential exclusion from paragraph 95(2)(a.1) is included within the negatively phrased subparagraph 95(2)(a.1)(ii). If the income in the affiliate is derived from property manufactured, produced, grown, extracted, or processed in the country under whose laws the affiliate is governed, and the affiliate's business is principally carried on in that country, paragraph 95(2)(a.1) will not recharacterize the active business income as income from a business other than an active business.

The only change to this provision from the 1994 draft legislation is the description of the relevant country. The language has been tightened considerably to require that the affiliate be formed or continued under the laws of a particular country as well as existing and being governed under those laws.[88]

4) De Minimis Test

The final exclusion from paragraph 95(2)(a.1) is the de minimis test. In general terms, the recharacterization of active business income will not occur if in any particular year more than 90 percent of the affiliate's gross revenue from the sale of property is from the sale of property (other than the sale of property otherwise caught by subparagraphs 95(2)(a.1)(i) and (ii)) to persons dealing at arm's length with the affiliate. Bill C-70 has replaced the gross "income" test with a gross "revenue" test. This change clarifies that it is not gross margin that is contemplated. The 1995 amendments also provide that, for this purpose, the sale of property to persons dealing at arm's length with the affiliate will include a sale of property to a non-resident corporation with which the affiliate does not deal at arm's length, provided that the property is destined for sale to

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[88] See the earlier discussion in the text at footnote 69.

persons with whom the affiliate deals at arm's length. As a result, sales by the affiliate to non-arm's-length persons will be treated as arm's-length sales in calculating the de minimis threshold where the property is then sold to an arm's-length non-resident.

It should be noted that in computing the de minimis threshold, there is a question whether the property sales otherwise subject to paragraph 95(2)(a.1) should be deleted from both the numerator and the denominator (in calculating qualifying sales in proportion to all sales), or only from the denominator. If both the numerator and the denominator are reduced, it may be relatively simple to avoid paragraph 95(2)(a.1) in offshore marketing situations. For example, assume that the foreign affiliate purchases 99.9 percent of its property from the taxpayer (which property is not manufactured or produced by the taxpayer) and 0.1 percent of its property from arm's-length persons. Assume also that the affiliate sells all of its property to arm's-length non-resident persons. If 99.9 percent of sales are excluded from both the numerator and the denominator, the affiliate will satisfy the de minimis test. However, if only the numerator is reduced, it is clear the de minimis test will not be met. The better interpretation is that the reduction affects only the numerator.

Summary

The exclusions from the application of paragraph 95(2)(a.1) are aimed at currency arrangements, Canadian producers, and goods produced in a foreign country only if the affiliate is governed and principally carries on business in that country. These exclusions are narrow and, particularly with respect to the Canadian producer, will be subject to interpretation.

Insurance of Canadian Risks

Paragraph 95(2)(a.2) expands the current rules in paragraph 95(2)(b) and subsection 95(3) to prescribe that all insurance of Canadian risks, whether or not the insured is dealing at arm's length, is FAPI unless the de minimis test applies. The provision has not been altered from the 1994 draft legislation other than the substitution, in Bill C-70, of gross premium "revenue" for gross premium "income" in the de minimis test.

Income of a foreign affiliate derived from the insurance or reinsurance of risks[89] in respect of

- a person resident in Canada,
- a property situated in Canada, or
- a business carried on in Canada

will be deemed to be income from a business other than an active business and therefore will constitute FAPI unless the de minimis test applies.

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[89] Referred to in this article as "Canadian risks."

From a practical perspective, it may be difficult for offshore insurance corporations that insure arm's-length persons to determine whether they are dealing with Canadian risks.[90]

If paragraphs 95(2)(a.2) and (b) do not apply to deem the insurance business to be a business other than an active business, it must be determined whether the insurance business is an investment business. The affiliate must satisfy the "more than five full-time employees" test in order to avoid such characterization.

Canadian Debt and Lease Obligations

Paragraph 95(2)(a.3) deems certain income of an affiliate derived from indebtedness and lease obligations[91] of persons resident in Canada or in respect of businesses carried on in Canada by non-resident persons[92] to be income from a business other than an active business. This provision is the legislative response to *Canada Trustco Mortgage Company v. MNR*.[93]

Exclusions

The 1995 amendments exclude from paragraph 95(2)(a.3) income on indebtedness that is a specified deposit with a prescribed financial institution, income of certain regulated foreign financial institutions,[94] and certain indebtedness related to currency arrangements. These exclusions are in addition to the de minimis exclusion contained in the 1994 draft legislation.

1) Specified Deposits

Specified deposits are defined in new subsection 95(2.5) as certain deposits of a foreign affiliate with a prescribed financial institution resident in Canada. A prescribed financial institution is described in regulation 7900 as a Canadian deposit-taking financial institution.[95] In addition to being a deposit with a prescribed financial institution resident in Canada, a specified deposit must qualify under *one* of two further conditions.

The first condition is that the income from the deposit must be income of the affiliate for the year that would, but for paragraph 95(2)(a.3), be income from an active business carried on by it in a country other than Canada. For this purpose, however, the business cannot be one whose principal purpose is to derive income from property, including interest,

[90] See Jack, supra footnote 6.

[91] "Lease obligation" is defined in subsection 95(1).

[92] Referred to in this article as "Canadian obligations."

[93] 91 DTC 1312 (TCC). This decision is currently under appeal.

[94] Supra footnote 55 and the accompanying text.

[95] Regulation 7900 specifies the following as a prescribed financial institution:

(a) a corporation that is a member of the Canadian Payments Association; or

(b) a credit union that is a shareholder or member of a body corporate or organization that is a central for the purposes of the *Canadian Payments Association Act*.

dividends, rents, royalties, or similar returns or substitutes therefor or profits from the disposition of investment property. In other words, the foreign affiliate cannot rely upon the "more than five full-time employees" test in the definition of "investment business" to avoid the FAPI characterization of income from a Canadian obligation.

The second, alternative, condition is that the income from the deposit must be income of the affiliate that would, but for paragraph 95(2)(a.3), be income from an active business carried on by the affiliate principally with persons with whom the affiliate deals at arm's length in the country under whose laws the affiliate is governed[96] and in which the affiliate's business is principally carried on. Furthermore, the deposit must be held by the affiliate in the course of carrying on that part of the business conducted with non-resident persons with whom the affiliate deals at arm's length or that part of the business conducted with a person with whom the affiliate was related, where it can be demonstrated that the related person used or held the funds deposited in the course of a business carried on by the related person with non-resident persons with whom the related person and the affiliate deal at arm's length. In other words, the income must be derived from a deposit of funds in the course of carrying on business activities with arm's-length persons.

The meaning of "specified deposit" is intended to ensure that foreign affiliates of Canadian taxpayers do not remove their funds on deposit from foreign branches of Canadian deposit-taking financial institutions and place those funds with foreign financial institutions simply in order to avoid characterization of the interest on the deposit as FAPI pursuant to paragraph 95(2)(a.3).

2) Subsection 95(2.4)

In addition to carving out a specified deposit from the application of paragraph 95(2)(a.3), new subsection 95(2.4) provides that paragraph 95(2)(a.3) will not apply in respect of income derived directly or indirectly from indebtedness if *two* conditions are satisfied.

First, the income must be derived by the affiliate in the course of a business conducted principally with persons with whom the affiliate deals at arm's length. The business must be carried on by the affiliate as a regulated foreign financial institution,[97] whose activities are regulated in the country under whose laws the affiliate is governed[98] and in which the business is principally carried on.[99]

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[96] Supra footnote 69 and the accompanying text.

[97] Supra footnote 55 and the accompanying text.

[98] Supra footnote 69 and the accompanying text.

[99] This language is comparable with that used in paragraph (a)(i) of the definition of "investment business" in subsection 95(1); however, subsection 95(2.4) also requires that the affiliate be governed in the country in which the business is principally carried on and regulated.

The second condition is that the income must be derived by the affiliate from trading or dealing in the indebtedness with persons (referred to as "regular customers") with whom the affiliate deals at arm's length that are resident in a country other than Canada in which the affiliate and any competitor compete and have a substantial market presence. The competitor must be resident in the country in which the affiliate is resident, regulated, and governed, and principally carries on its business. The competitor also must be regulated in the same manner, though not necessarily the same country, as the affiliate. For this purpose, income from trading or dealing in the indebtedness consists of income from the actual trading or dealing in the indebtedness and interest earned by the affiliate during a short-term holding period on indebtedness acquired for the purpose of trading or dealing. There is no statutory assistance as to the meaning of a "short-term holding period." If the indebtedness is acquired for the purpose of trading or dealing, presumably the debt will be sold within a relatively short time and the interest earned in the interim period will be included.

Again, from a practical perspective, it may be difficult for the foreign affiliate to determine where its regular customers and competitors are resident.[100]

For these purposes, an acquisition of indebtedness from the taxpayer (that is, the Canadian shareholder in respect of which the affiliate is a foreign affiliate) shall be deemed to be part of the trading or dealing in indebtedness where the indebtedness is acquired by the affiliate and sold to regular customers of the affiliate and the terms and conditions of the acquisition and the sale are substantially the same as the terms and conditions of similar acquisitions and sales made by the affiliate in transactions with persons with whom it deals at arm's length.

3) Subsection 95(2.5)

New subsection 95(2.5) provides that for the purposes of paragraph 95(2)(a.3), "indebtedness" does not include obligations of a person under agreements with non-resident corporations providing for the purchase, sale, or exchange of currency where conditions similar to those set out in subsections 95(2.1) and (2.3) are met. In particular,

• the agreement must be a currency agreement;[101]

• the person who issued the obligation must be a regulated Canadian financial institution;[102]

• the currency agreement must be entered into by the non-resident corporation in the course of a business carried on by it principally with persons with which it deals at arm's length in the country under whose

[100] See the earlier discussion in the text at footnote 74.

[101] Supra footnote 50 and the accompanying text.

[102] Supra footnote 48 and the accompanying text.

laws the non-resident corporation is governed and in which the business is principally carried on; and

• the terms and conditions of such currency agreement must be substantially the same as the terms and conditions of similar agreements made by persons dealing at arm's length.[103]

This provision should permit foreign affiliates to deal with the foreign branches of regulated Canadian financial institutions and avoid a FAPI characterization of income from such currency arrangements simply because the affiliate was dealing with a Canadian institution.

4) De Minimis Test

The de minimis test has not been altered from the 1994 draft legislation other than the substitution, in Bill C-70, of gross "revenue" for gross "income." If more than 90 percent of the gross revenue of the affiliate derived directly or indirectly from indebtedness (other than a specified deposit) and lease obligations was from such obligations of arm's-length non-residents, paragraph 95(2)(a.3) will not apply to the Canadian obligations held by that affiliate.

Summary

There are very narrow exclusions from the characterization of income from Canadian indebtedness and lease obligations as income from a business other than an active business. Other than the de minimis rule, the exclusions relate to regulated financial institutions.

Partnership Financing

A new provision in the 1995 amendments, paragraph 95(2)(a.4), will deem certain income of an affiliate from indebtedness and lease obligations[104] to be income from a business other than an active business. This provision will apply only to the extent that the income is not otherwise subject to paragraph 95(2)(a.3).

New paragraph 95(2)(a.4) deals with the situation where a partnership is used to carry on business and is financed by a foreign affiliate of the taxpayer. In this situation, a proportion of the financing income earned by the financing affiliate from the partnership is deemed to be income from a business other than an active business and thus constitutes FAPI.

The type of income that may be recharacterized is income of the foreign affiliate of a taxpayer derived directly or indirectly[105] from

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[103] Note that the January 1995 amendments required the currency agreements to be similar to agreements made by the *person* with arm's-length parties.

[104] Supra footnote 91.

[105] The use of the phrase "derived directly or indirectly" is intended to include arrangements where the affiliate may earn income from another entity that has financed the partnership. For example, the affiliate may put funds on deposit with a financial institution on condition that a loan is made to the partnership.

indebtedness and lease obligations (including the income of the affiliate from the purchase and sale of indebtedness and lease obligations on its own account) in respect of a business carried on outside Canada by a partnership. The portion of the income that is recharacterized is that proportion of the partnership's income or loss for the fiscal period of the partnership that ends in the affiliate's taxation year that is included or, if the partnership had income or a loss for that fiscal period, would be included directly or indirectly in computing the income or loss of the taxpayer (that is, the Canadian shareholder in respect of which the affiliate is a foreign affiliate) or a person resident in Canada with whom the taxpayer does not deal at arm's length. Where the income or loss of the partnership is nil, the Canadian partner's proportion is determined as if the partnership had income of $1 million for that fiscal period.

It is unclear how income or loss of a partnership is included *indirectly* in computing the income or loss of a Canadian resident. The situation contemplated may be that in which a Canadian is a member of a partnership that itself is a member of another partnership. In any event, such words should not allow a lookthrough of corporations.[106]

In summary, if the taxpayer (or a person resident in Canada with whom the taxpayer does not deal at arm's length) is a member of a partnership that reduces its income by an amount payable to the foreign affiliate of the taxpayer, the proportionate share to the taxpayer (or the non-arm's-length person) of the payment will be deemed to be FAPI of the foreign affiliate.

Paragraph 95(2)(a.4) will not apply if the de minimis rule is satisfied. If more than 90 percent of the gross revenue[107] of the affiliate derived directly or indirectly from indebtedness and lease obligations was derived directly or indirectly from indebtedness and lease obligations of non-resident persons with whom the affiliate deals at arm's length (other than indebtedness and lease obligations of a partnership otherwise described in paragraph 95(2)(a.4)), no recharacterization will occur.

As an example, consider the structure in figure 1. The taxpayer owns a 25 percent interest in a partnership, and a foreign affiliate (FA) of the taxpayer owns the remaining 75 percent interest. The particular foreign affiliate (PA) of the taxpayer has loaned funds to, and receives interest from, the partnership.

Paragraph 95(2)(a.4) will deem 25 percent of the interest received by the particular affiliate from the partnership to be income from a business other than an active business, and therefore FAPI, unless the particular affiliate satisfies the de minimis test. If paragraph 95(2)(a.4) applies to the income, it cannot be recharacterized as income from an active business under paragraph 95(2)(a). However, in these circumstances, the 75 percent of the interest paid to the particular affiliate could qualify under paragraph 95(2)(a).

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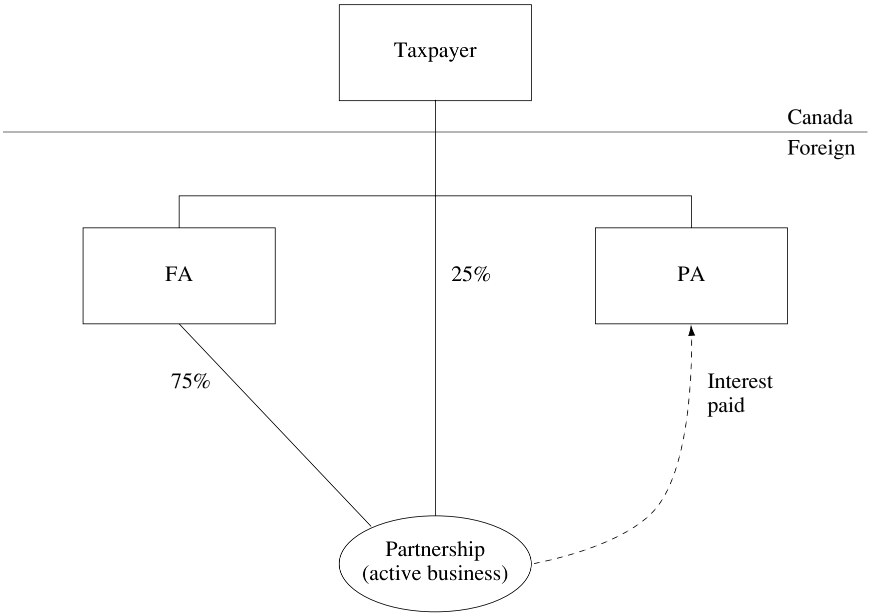
[106] See the earlier discussion under "Anti-Avoidance Rule."

[107] Bill C-70 replaced gross "income" with gross "revenue."

Figure 1 Partnership Financing: Paragraph 95(2)(a.4)



Consequences of Reclassification of Income Under Paragraphs 95(2)(a.1) Through (a.4)

One consequence of falling within paragraphs 95(2)(a.1) through (a.4) is that the income in the affiliate will constitute FAPI and therefore taxable surplus.[108] In addition, there is no opportunity to "requalify" the business by employing more than five employees.[109] Finally, the income may not be deemed active under paragraph 95(2)(a) since that provision requires the income otherwise to be income from property.

If paragraph 95(2)(a.1), (a.2), (a.3), or (a.4) applies,

- the sale of such property, the insurance of the Canadian risks, the activities carried out to earn income from the Canadian debt or lease obligations, or the activities carried out to earn income from financing a partnership, as the case may be, are deemed to be a separate business other than an active business carried on by the affiliate; and
- any income of the affiliate that pertains to or is incident to that business is deemed to be income from a business other than an active business.

These consequences, previously contained in the 1994 draft legislation, have not been altered.

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[108] Similar consequences arise under paragraph 95(2)(b).

[109] Under the "investment business" definition.

Fresh Start Rules: Paragraph 95(2)(k)

New paragraph 95(2)(k), introduced by the 1995 amendments, incorporates a "fresh start" rule in respect of an investment business or a business that is deemed to be other than an active business under paragraphs 95(2)(a.1) through (a.4). In addition, it provides rules for the computation of income of the affiliate from the investment business or the business deemed to be a business other than an active business for the "start-up" year and subsequent years. These rules assist in clarifying the quantum of deductions available in computing the income of the particular business. In effect, paragraph 95(2)(k) permits a fresh start to the business such that, inter alia, reserves and capital cost allowance are calculated in respect of the business as if it had just commenced.

Paragraph 95(2)(k) will apply where, in a particular taxation year, a foreign affiliate of the taxpayer either

• carries on an investment business outside Canada and, in the preceding taxation year, that business was not an investment business of the affiliate or the definition of "investment business" did not apply; or

• is deemed by any of paragraphs 95(2)(a.1) through (a.4) to carry on a separate business other than an active business, and in the preceding taxation year that paragraph did not apply.

In either of these two instances, the following rules are applicable for the purpose of computing the income of the affiliate from the investment business or the separate business (referred to as the "foreign business") for the particular year (that is, the start-up year) and each subsequent taxation year in which the foreign business is carried on:

1) Subparagraph 95(2)(k)(iii) deems the affiliate:

a) to have begun to carry on the foreign business in Canada at the later of the time the particular year began or the time it began to carry on the foreign business; and

b) to have carried on that business in Canada throughout that part of the particular year and each such subsequent taxation year in which the foreign business is carried on by it.

This is intended to cause the rules of the Act to apply in the computation of income from the foreign business, including applicable reserves.

2) Subparagraph 95(2)(k)(iv) deems the affiliate to have been required by law to report to and to have been subject to the supervision of a regulating authority, where the foreign business of the affiliate is a business in respect of which, if the foreign business were carried on in Canada, the affiliate would be required by law to report to a regulating authority in Canada such as the superintendent of financial institutions or a similar authority of a province. This rule is intended to allow the affiliate to claim certain insurance reserves under regulations 1400 and 1401.

Regulation 1402 has been revised by the January 1995 amendments to include new regulation 1402(2), which is intended to prevent a foreign affiliate that carries on a foreign business from claiming insurance reserves prescribed in regulations 1400 and 1401 that exceed a reasonable amount.

3) Subparagraph 95(2)(k)(v) provides that paragraphs 138(11.91)(c) to (f) apply to the affiliate for the particular year in respect of the foreign business as if

a) the affiliate was the insurer referred to in subsection 138(11.91);

b) the particular year of the affiliate was the particular year of the insurer referred to in subsection 138(11.91); and

c) the foreign business of the affiliate was the business of the insurer referred to in subsection 138(11.91).

Paragraph 138(11.91)(c) deems the affiliate to have had a taxation year immediately before the commencement of the particular year in which the foreign business commences. Paragraph 138(11.91)(d) deems the affiliate to have claimed, in the immediately preceding year, maximum amounts under

a) paragraphs 20(1)(l) and (l.1) in respect of reserves for doubtful accounts and credit risks under guarantees;

b) paragraph 20(7)(c), which denies a reserve under paragraph 20(1)(m) in respect of insurance reserves unless it represents a prescribed reserve of an insurance corporation; and

c) subparagraphs 138(3)(a)(i), (ii), and (iv) in respect of prescribed policy reserves for life insurance policies, prescribed reserves in respect of unpaid life insurance policy claims, and the stated reserve for policy dividends, respectively.

Where these maximum claim rules apply, the affiliate will bring opening reserves into income in the start-up year. As a result, the net amount of reserves claimed in the current year should be only the amount applicable to changes in circumstances for that year.

Paragraph 138(11.91)(e) deems the affiliate to dispose of, and to reacquire immediately before the commencement of the start-up year, property used in the foreign business for an amount equal to fair market value. This will establish a "fresh start" asset value for purposes of computing income from the foreign business. Where depreciable assets have a cost in excess of fair market value, paragraph 138(11.91)(f) deems the affiliate to reacquire the asset at that cost and to have previously claimed capital cost allowance down to the fair market value.

It is unclear what the consequences will be if the foreign business is terminated, since subparagraph 95(2)(k)(iii) applies to deem the business to be carried on in Canada only while the affiliate carries on such business. For example, there do not appear to be any deemed disposition rules.

Furthermore, if the foreign business is subsequently recommenced, the impact is uncertain. Paragraph 95(2)(k) applies where, in the preceding taxation year, the foreign business was not carried on. It does not refer to the "immediately" preceding taxation year. Therefore, upon recommencement, the rules may not result in another "fresh start."

Deemed Active Business Income

Once it has been determined that the income of the affiliate is income from property,[110] it may be possible to have the income recharacterized as income from an active business under paragraph 95(2)(a). The property income that may be so recharacterized must be from a source in a country other than Canada. As discussed above, income from property includes income from an investment business as well as income from an adventure or concern in the nature of trade. Income from property does not include income deemed to be income from a business other than an active business under paragraphs 95(2)(a.1) through (b).

Under the 1995 amendments, paragraph 95(2)(a) will include four general categories:

1) income derived from activities that are directly related to active business activities of a related non-resident corporation;[111]

2) payments between affiliates or related persons that are deductible in computing the active business income of the payer;[112]

3) interaffiliate interest payments in respect of debt used to acquire shares of a third affiliate;[113] and

4) income derived from the factoring of accounts receivable or the acquisition of loans or lending assets from a related non-resident corporation.[114]

However, paragraph 95(2)(a), as revised, will apply only to a foreign affiliate in which the taxpayer has a qualifying interest throughout the year.

Qualifying Interest

The preamble to paragraph 95(2)(a) has been altered from the 1994 draft legislation to provide that property income may be recharacterized as income from an active business for a taxation year of a particular foreign affiliate of a taxpayer only where that taxpayer has a qualifying interest in respect of the foreign affiliate throughout the year. A qualifying interest in a foreign affiliate of a taxpayer is described in new paragraph 95(2)(m). The taxpayer must own

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110 Income from property will include income deemed to be such under paragraph 95(2)(l).

111 Subparagraph 95(2)(a)(i).

112 Clauses 95(2)(a)(ii)(A), (B), (C), and (E).

113 Clause 95(2)(a)(ii)(D).

114 Subparagraphs 95(2)(a)(iii) and (iv).

- not less than 10 percent of the issued and outstanding shares (having full voting rights under all circumstances) of the affiliate; and

- shares of the affiliate having a fair market value of not less than 10 percent of the fair market value of all the issued and outstanding shares of the affiliate.

There is a series of rules in paragraph 95(2)(m) that must be examined to determine whether the taxpayer "owns" not less than 10 percent of the votes and value of the affiliate.

First, subparagraph 95(2)(m)(iii) provides a proportional lookthrough rule. In *Army and Navy Department Stores*,[115] the Supreme Court of Canada held that a shareholder of a corporation is not considered to own shares that are owned by the corporation. Therefore, without the proportional lookthrough rule, it seems that a taxpayer would have a qualifying interest in a foreign affiliate only if it actually owned shares in that foreign affiliate representing not less than 10 percent of votes and value of the affiliate. A qualifying interest in a lower-tier foreign affiliate would be excluded.

Subparagraph 95(2)(m)(iii) deems shares of a corporation that are owned by another corporation (referred to as the holding corporation) to be owned by each shareholder of the holding corporation in a proportion equal to the proportion of all such shares owned by the holding corporation that the fair market value of the shares of the holding corporation owned at that time by the shareholder is of the fair market value of all the issued shares of the holding corporation outstanding at that time.

Subparagraph 95(2)(m)(iv) provides a similar proportional lookthrough rule where shares are owned by a partnership. Shares owned by a partnership are deemed to be owned by each member of the partnership in a proportion equal to the proportion of all such shares owned by the partnership that the member's share of the income or loss of the partnership for its fiscal period that includes the time at which the qualifying interest is being determined is of the income or loss of a partnership for its fiscal period that includes that time. For the purpose of this lookthrough rule, where the income or loss of a partnership is nil, the proportion shall be computed as if the partnership had income in the amount of $1 million.

Finally, subparagraph 95(2)(m)(v) incorporates a transitional rule with respect to convertible property that was issued by the affiliate before June 23, 1994. Where a person is a holder of convertible property issued by the affiliate before June 23, 1994, which confers on the holder the right to exchange the convertible property for shares of the affiliate, if the taxpayer elects in its return of income for its taxation year that ends after 1994 to have this rule apply, each holder of the convertible property shall be deemed, immediately before the time at which the qualifying interest is being determined, to have exchanged the convertible property for shares

[115] Supra footnote 18.

of the affiliate and to have acquired shares of the affiliate in accordance with the terms and conditions of the convertible property. If this election is made, it will apply to all the convertible property issued by the affiliate and outstanding at that time. As a result, the taxpayer cannot make an election that would deem only convertible property held by it as having been converted into shares.

Subparagraph 95(2)(m)(v) uses the term "person" to refer to the holder of convertible property. Since subparagraph 95(2)(m)(iv) deals specifically with partnerships, it is unclear whether subparagraph 95(2)(m)(v) contemplates a circumstance where a partnership is the holder of convertible property. Subparagraph 95(2)(m)(v) apparently does not contemplate the situation where a person holds convertible property issued by a partnership, which confers on the holder the right to exchange the convertible property for a partnership interest.

New paragraph 95(2.2)(a) is a relieving provision that deems a taxpayer to have a qualifying interest in respect of a foreign affiliate *throughout the year* where

• a person has, in that year, acquired or disposed[116] of shares of that non-resident corporation or any other corporation and, because of the acquisition or disposition, the non-resident corporation became or ceased to be a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest; and

• at the beginning or end of that year, the non-resident corporation was a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest.

It is not clear whether paragraph 95(2.2)(a) contemplates an acquisition or disposition by a partnership. The reference is to an acquisition or disposition by a person, and a partnership is often considered not to be a person for purposes of the Act.

The Categories of Income

Directly Related Income

Subparagraph 95(2)(a)(i) has been altered from the 1994 draft legislation in two ways. First, it accommodates income derived by the particular foreign affiliate of the taxpayer which is directly related to the active business activities carried on in a country other than Canada by another non-resident corporation that is related to the particular affiliate. However, that other non-resident corporation must also be related to the

[116] Whereas new paragraph 95(6)(b) considered an acquisition or disposition of shares occurring directly or indirectly, subsection 95(2.2) is not as generous because it omits the phrase "directly or indirectly." This raises the question whether these provisions are meant to be interpreted differently. For the reasons given earlier, it is suggested that the phrase "directly or indirectly" in paragraph 95(6)(b) is superfluous, and therefore the same interpretation should apply to paragraph 95(6)(b) and subsection 95(2.2).

taxpayer (that is, the Canadian shareholder in respect of which the affiliate is a foreign affiliate). In addition, the non-resident corporation must be related to the particular affiliate and the taxpayer throughout the year.

New paragraph 95(2.2)(b), added in Bill C-70, will deem a non-resident corporation to be related to the particular affiliate and the taxpayer *throughout the year* where

- a person has, in that year, acquired or disposed[117] of shares of that non-resident corporation or any other corporation and, because of the acquisition or disposition, the non-resident corporation became or ceased to be related to the particular affiliate and the taxpayer; and
- at the beginning or end of that year, the non-resident corporation was related to the particular affiliate and the taxpayer.

As a result, subparagraph 95(2)(a)(i) should be capable of applying in the year in which the non-resident corporation becomes or ceases to be related to the particular affiliate and the taxpayer. However, paragraph 95(2.2)(b) does not refer to an acquisition or disposition by a partnership. As a result, it is unclear whether such acquisitions or dispositions will be accommodated.

The second amendment to subparagraph 95(2)(a)(i) from the 1994 draft legislation is that the income derived by the particular foreign affiliate of the taxpayer may be directly related to the active business activities carried on in a country other than Canada by the taxpayer, where the taxpayer is a life insurance corporation resident in Canada throughout the year. Since life insurance corporations are taxable in Canada only on their Canadian source income, this provision will ensure that their offshore activities are treated in a manner that is consistent with the taxation of an incorporated foreign subsidiary that carries on the foreign business of a life insurance corporation.

The income will be recharacterized as income from an active business only to the extent that the amounts would be included in computing the earnings or loss from an active business carried on outside Canada of the non-resident corporation, or the taxpayer where it is a life insurance corporation resident in Canada, if the corporation were a foreign affiliate of the taxpayer and the income were earned by it.

Earnings of a foreign affiliate of a taxpayer for a taxation year of the affiliate from an active business are described in regulation 5907(1)(a). Where the affiliate carries on an active business, the income must be computed in accordance with the income tax law of the country in which the affiliate is resident, where the resident is required by such law to compute that income.[118] Alternatively, the income is to be computed in accordance with the income tax law of the country in which the business

[117] Supra footnote 116.

[118] Regulation 5907(1)(a)(i)(A).

is carried on, where the affiliate is required by such law to compute that income.[119] Finally, if the affiliate is not required by foreign law to compute income from an active business, the income is to be computed in accordance with part I of the Act on the assumption that the business was carried on in Canada and the affiliate was resident in Canada.[120]

As a result, in determining whether the income will be recharacterized, in most cases, the foreign tax law must be examined.

As an example of the circumstances in which subparagraph 95(2)(a)(i) could apply, consider figure 2. The particular affiliate (PA) in which the taxpayer has a qualifying interest (QI) throughout the year earns income that is directly related to the active business carried on by a non-resident corporation. Provided that the non-resident corporation is related to both the taxpayer and the particular affiliate throughout the particular affiliate's taxation year, subparagraph 95(2)(a)(i) could apply.

Figure 3 illustrates a situation in which subparagraph 95(2)(a)(i) will not apply. The taxpayer and an unrelated person each own 50 percent of two non-resident corporations. Even though the particular affiliate and the non-resident corporation are related, subparagraph 95(2)(a)(i) will not apply because the non-resident corporation is not related to the taxpayer. The non-resident corporation must be related to both the particular affiliate *and* the taxpayer throughout the year in order for subparagraph 95(2)(a)(i) to apply.

The explanatory notes accompanying Bill C-70 include a detailed description of the circumstances in which subparagraph 95(1)(a)(i) will apply and provide revised examples. These examples fall more clearly within the statutory language than do the examples provided with the 1994 draft legislation.

The explanatory notes state:

> Subparagraph 95(2)(a)(i) is directed at cases where the business activities of a single foreign active business are conducted in more than one related corporation. It also deals with the situation where income of one foreign corporation is derived from assets that are at risk in a foreign active business carried on by a related foreign corporation. Assets will be considered to be at risk in a business where the permanent removal of such assets would have a destabilizing effect on the business.
>
> There must be a link between the foreign active business activities conducted by the related foreign corporation and the activities conducted by the other foreign corporation that produces income from property. The activities resulting in the income from property must be dependent upon and would not have taken place but for the active business activities taking place. The fact that activities are similar is not enough to demonstrate a link.[121]

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[119] Regulation 5907(1)(a)(i)(B).

[120] Regulation 5907(1)(a)(i)(C).

[121] Explanatory notes, supra footnote 5, at 106.

Figure 2 Circumstances in Which Subparagraph 95(2)(a)(i) Could Apply

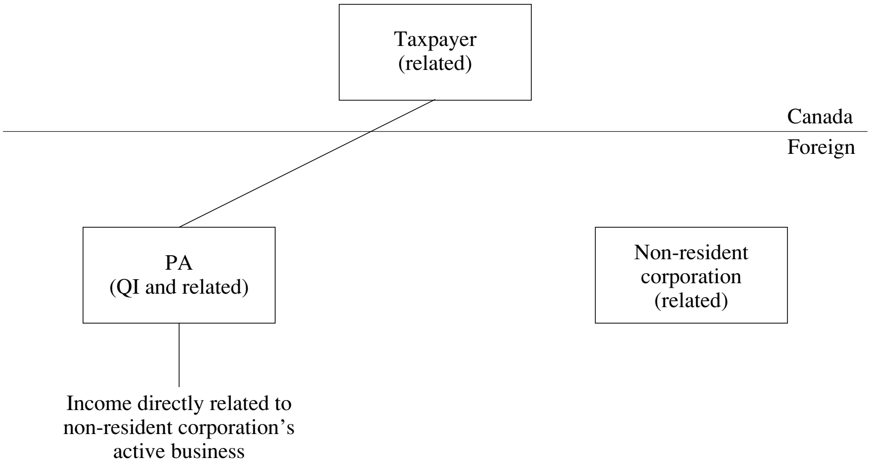
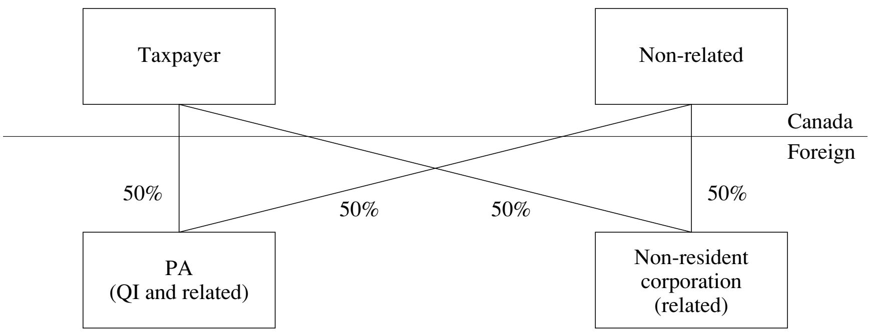


Figure 3 Circumstances in Which Subparagraph 95(2)(a)(i) Does Not Apply



The new examples in the explanatory notes more clearly illustrate the link between the active business activities of the related non-resident corporation and the particular foreign affiliate. Examples 5 and 6[122] restrict the activities of the particular affiliate to high-risk aspects of the related non-resident corporation's business of leasing and real estate development, respectively. These high-risk ventures are easily seen as being directly related to the ordinary business of the non-resident corporation. Example 7[123] likely applies to many organizations. Related non-resident

122 Ibid., at 106-7.

123 Ibid., at 107-9.

corporations advance funds (which are temporarily surplus to their active business) to the particular affiliate, which performs treasury functions for the related group. The income earned by the particular affiliate, assumed otherwise to be income from an investment business, is recharacterized as income from an active business on the basis that such income is directly related to the active business of the related non-resident corporations.

In determining whether activities are directly related, some guidance may be obtained from the jurisprudence dealing with whether income pertains to or is incident to an active business.[124] The Department of Finance appears to contemplate such a link in the explanatory notes.[125]

Interaffiliate/Related-Party Payments

The second category of property income that could be deemed to be active business income is income from certain affiliates and other entities described in subparagraph 95(2)(a)(ii). This provision has been revised substantially from the version in the 1994 draft legislation. The entity making the payment is now described in considerable detail. In addition, a payer that qualifies specifically includes certain partnerships.

Subparagraph 95(2)(a)(ii) will recharacterize certain property income that is derived from amounts paid or payable, directly or indirectly, to the affiliate or a partnership of which the affiliate was a member. Clauses 95(2)(a)(ii)(A) through (C) contemplate payments by certain non-resident corporations and partnerships. Clause 95(2)(a)(ii)(E) contemplates payments by a Canadian resident life insurance corporation. Clause 95(2)(a)(ii)(D), discussed below, contemplates interaffiliate interest payments in respect of a share acquisition.

Subsection 20(3), amended pursuant to the 1994 draft legislation, specifically refers to subparagraph 95(2)(a)(ii) in respect of borrowed money used to replace other borrowed money.

In each case in clauses 95(2)(a)(ii)(A), (B), and (C), the amount will be recharacterized as income from an active business only to the extent that the amounts that were paid or payable were for expenditures that would, if the non-resident corporation or the partnership were a foreign affiliate of the taxpayer, be deductible by it in the year or in a subsequent year in computing the amount prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada.[126] The expenditures will include capital amounts that are deductible over time as an allowance, such as depreciation.[127]

The qualifying payers include the following:

[124] See Jack, supra footnote 6.

[125] See the earlier discussion under "Pertains to or Is Incident to."

[126] See the earlier discussion in the text at footnote 118 and following.

[127] Explanatory notes, supra footnote 5, at 108.

• a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year;[128]

• another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year;[129] and

• a partnership in respect of which the non-resident corporation[130] or other foreign affiliate,[131] as described above, or the particular affiliate[132] is a member, provided that it is not a specified member at any time in a fiscal period of the partnership ending in the year of the particular affiliate.

Clause 95(2)(a)(ii)(E) specifies that the payments to the particular affiliate may be made by the taxpayer, where the taxpayer is a life insurance corporation resident in Canada, to the extent that the amounts paid were for expenditures that are deductible in the year or in a subsequent taxation year by the taxpayer in computing its income or loss from carrying on its life insurance business outside Canada and are not deductible in the year or in a subsequent taxation year in computing its income or loss from carrying on its life insurance business in Canada.

Where the payer is a partnership, the relevant non-resident corporation or foreign affiliate cannot be a specified member[133] at any time in the fiscal period of the partnership. The status of partners is irrelevant with respect to a partnership that receives such payments.

An example of circumstances in which subparagraph 95(2)(a)(ii) could apply is presented in figure 4.

Where a partnership makes the payments, the quantum of the partnership interest owned by the particular affiliate, the non-resident corporation, or the other foreign affiliate is irrelevant. If a joint business arrangement were to be undertaken such that a Canadian taxpayer would not otherwise have a qualifying interest in a foreign corporation, the arrangement could be established by way of a partnership in which a foreign affiliate of the taxpayer could have an interest in the partnership of less than 10 percent. Payments from the partnership to the foreign affiliate could qualify under subparagraph 95(2)(a)(ii).

Figure 5 illustrates a situation in which subparagraph 95(2)(a)(ii) will not apply. Since the payer non-resident corporation neither is related to the particular affiliate or the taxpayer, nor is a foreign affiliate of the taxpayer in which the taxpayer has a qualifying interest, subparagraph 95(2)(a)(ii) is not applicable.

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[128] Subclause 95(2)(a)(ii)(A)(I).

[129] Subclause 95(2)(a)(ii)(B)(I).

[130] Subclause 95(2)(a)(ii)(A)(II).

[131] Subclause 95(2)(a)(ii)(B)(II).

[132] Clause 95(2)(a)(ii)(C).

[133] Supra footnote 66.

Figure 4 Circumstances in Which Subparagraph 95(2)(a)(ii) Could Apply

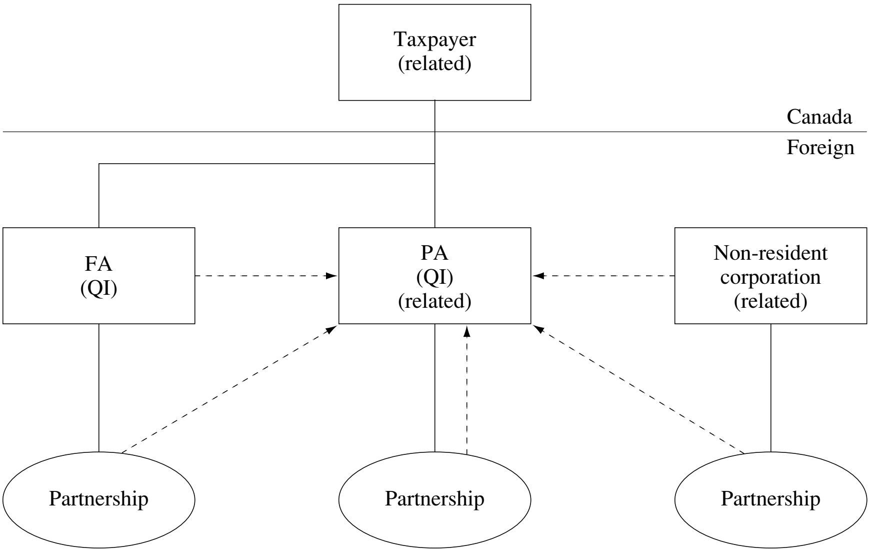
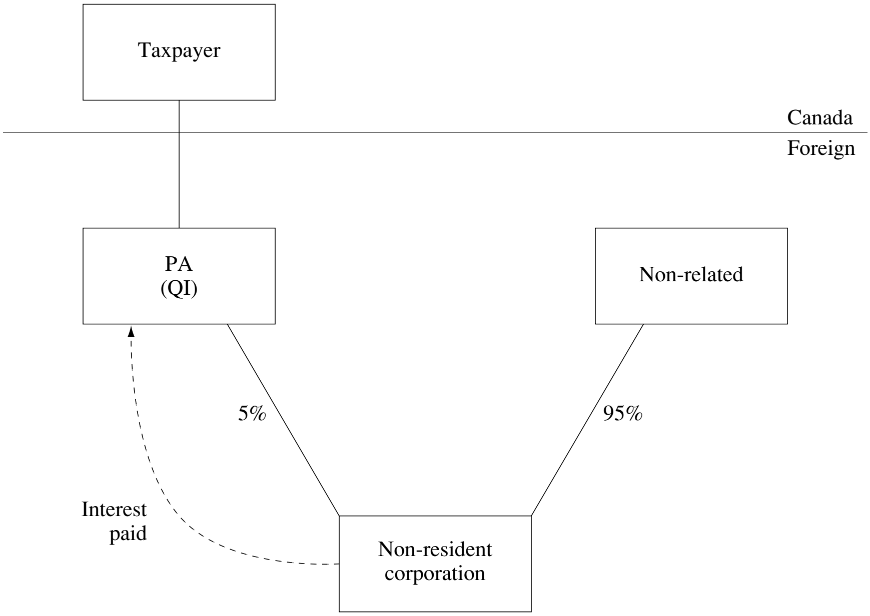


Figure 5 Circumstances in Which Subparagraph 95(2)(a)(ii) Does Not Apply



If, however, the particular affiliate and the unrelated person formed a partnership, rather than a jointly owned corporation, interest payments from the partnership to the particular affiliate could qualify under subparagraph 95(2)(a)(ii) (see figure 6). Presumably, the rationale is that if the particular affiliate is exposed to the commercial risks as a general partner, the benefits of subparagraph 95(2)(a)(ii) may be enjoyed.

Interaffiliate Interest Payments on Share Acquisitions

Clause 95(2)(a)(ii)(D) is a revised version of proposed clause 95(2)(a)(ii)(B) in the 1994 draft legislation. It deals with the recharacterization of certain payments received by a particular foreign affiliate from another related foreign affiliate in respect of interest charges on debt used to acquire shares of a third foreign affiliate.

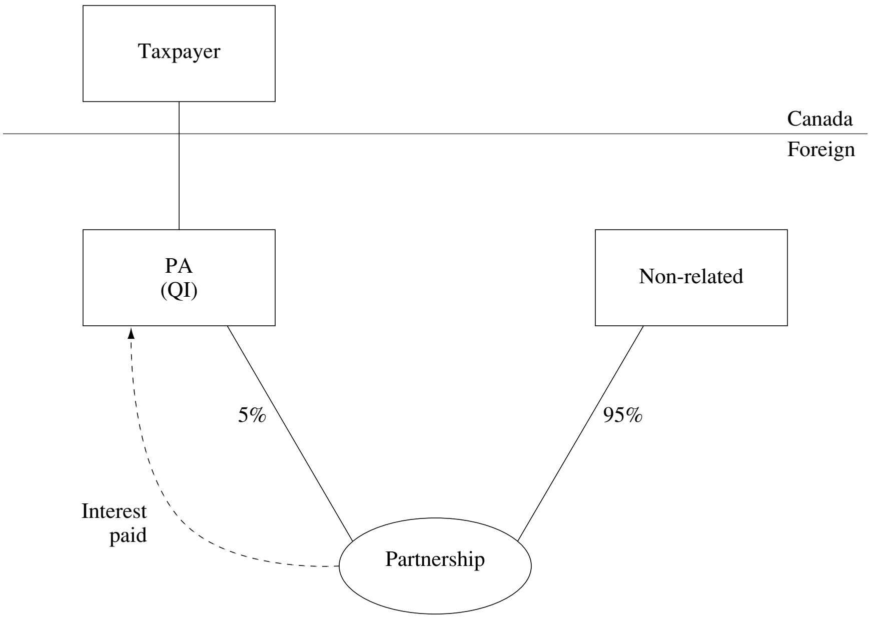
The conditions necessary for clause 95(2)(a)(ii)(D) to apply have been altered from those contained in the 1994 draft legislation. The interest income must be paid or payable, directly or indirectly, to the particular affiliate by another foreign affiliate ("the second affiliate"), which is related to both the particular affiliate and the taxpayer throughout the year. The interest paid or payable must be pursuant to a legal obligation to pay interest on borrowed money used to acquire (or on a debt for the acquisition of) shares of another foreign affiliate ("the third affiliate") in respect of which the taxpayer has a qualifying interest throughout the year. The third affiliate cannot be the particular affiliate. In addition, the shares of the third affiliate must be excluded property to the second affiliate, and the interest paid by the second affiliate must be relevant in computing the liability for taxes of a corporate group of which the second affiliate and other foreign affiliates of the taxpayer, in respect of which the taxpayer has a qualifying interest throughout the year, are members in a country in which they are resident and subject to tax.

A summary of the requirements is as follows:

- the taxpayer must have a qualifying interest throughout the taxation year of the particular affiliate and each foreign affiliate contemplated by the provision;
- the second affiliate (that is, the acquiring affiliate) must be related to both the taxpayer and the particular affiliate;
- the third affiliate (that is, the acquired affiliate) need not be related to the particular affiliate, but it cannot itself be the particular affiliate;
- the second and third affiliates must be resident and subject to tax in the same country; and
- the second affiliate and the other affiliates (which could include the third affiliate) in respect of each of which the taxpayer has a qualifying interest must be resident and subject to group taxation (including an imputation system[134]) in the same country.

[134] *Release*, no. 95-005, supra footnote 1.

Figure 6 Circumstances in Which Subparagraph 95(2)(a)(ii) Could Apply



Although clause 95(2)(a)(ii)(D) provides a beneficial result (since such recharacterization would not occur under the current rules), it remains unclear why the requirements are so strict (even though the 1995 amendments are less restrictive than the provisions proposed in the 1994 draft). In particular, if the original rationale was to ensure that the interest expense was "consolidated" with the active business income in the third affiliate (that is, the acquired affiliate), it is not clear why the consolidation requirement was relaxed, at least with respect to the acquired affiliate.

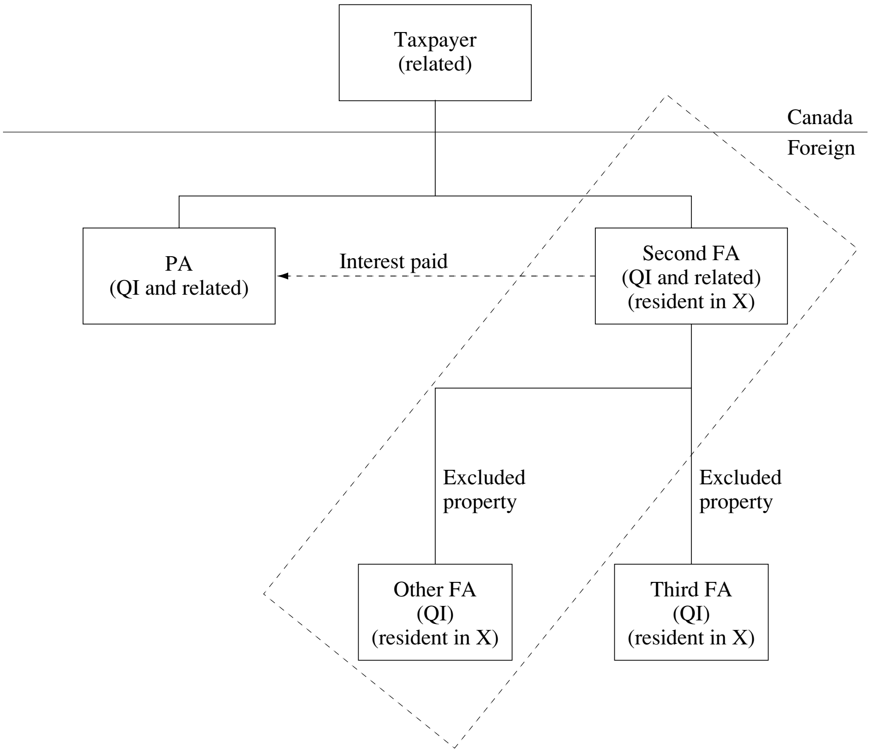
Figure 7 is an example of the operation of clause 95(2)(a)(ii)(D). The second foreign affiliate and other foreign affiliates (which could include the third foreign affiliate) must be subject to group taxation.

Factoring of Accounts Receivable or Loans or Lending Assets

Subparagraphs 95(2)(a)(iii) and (iv) have been added by the 1995 amendments. As a result of these provisions, income from an active business includes income derived by the particular affiliate from the factoring of accounts receivable[135] or loans or lending assets acquired by the particular affiliate, or a partnership of which the particular affiliate was a member, from a non-resident corporation to which the particular affiliate and the

[135] See the earlier discussion in the text at footnote 78.

Figure 7 Operation of Clause 95(2)(a)(ii)(D)



taxpayer are related throughout the year.[136] The accounts receivable or loans or lending assets must arise in the course of an active business carried on outside Canada by the non-resident corporation.

Subparagraph 95(2)(a)(iii), dealing with the factoring of accounts receivable that arise in the course of an active business carried on outside Canada by a related non-resident corporation, should remove the income from such factoring from the application of paragraph 95(2)(l). However, if paragraph 95(2)(a.3) applies with respect to Canadian obligations, subparagraph 95(2)(a)(iii) will not apply.

Subparagraph 95(2)(a)(iv) could possibly recharacterize the income derived by the particular affiliate from loans or lending assets that constitute part of an investment business. The loans or lending assets must have arisen in the course of an active business carried on outside Canada by the related non-resident corporation. However, if the loans or lending

[136] Paragraph 95(2.2)(b) will apply in certain circumstances to deem the parties to be related throughout the year.

assets constitute Canadian obligations and paragraph 95(2)(a.3) applies, subparagraph 95(2)(a)(iv) will not be relevant.

EXEMPT EARNINGS

Various definitions contained in regulation 5907 are to be amended from the versions proposed in the 1994 draft legislation. The most significant amendment is with respect to the definition of "exempt earnings" in regulation 5907(1)(b). The revisions set out in the January 1995 amendments ensure that the provisions in paragraph 95(2)(a), which treat certain property income as income from an active business, are carried through in the calculation of the affiliate's exempt earnings.

The January 1995 amendments include new regulation 5907(1.01), which provides that, whether or not a corporation has a "qualifying interest" in respect of a foreign affiliate throughout a taxation year or is related to another corporation throughout a taxation year, the determination shall be made as it would be for purposes of paragraph 95(2)(a). As a result, the meaning of "qualifying interest" in paragraph 95(2)(m) will be relevant. In addition, subsection 95(2.2) will apply. This subsection deems a person to have a qualifying interest in respect of a foreign affiliate throughout a taxation year, and a person to be related to a non-resident corporation throughout a taxation year.

Regulations 5907(2.7) and (2.8) have been somewhat revised from the version in the 1994 draft legislation. The intent of these provisions, however, has not been altered. Regulation 5907(2.7) is intended to ensure that there are no timing differences between the affiliate's recognition of active business income under paragraph 95(2)(a) and the non-resident corporation's deduction from active business income of the payment made or to be made. Regulation 5907(2.8) provides that interest paid or payable in respect of interest relating to the acquisition of shares in circumstances where clause 95(2)(a)(ii)(D) applies to the recipient of the interest shall be deducted by the payer in computing its income from an active business at the earlier of the time when the interest was paid and the time it became payable.

These amendments are applicable to taxation years of a foreign affiliate that begin after 1994, except where there has been a change in a taxation year in 1994 and after February 22, 1994, in which case it will apply to taxation years of the affiliate that end after 1994.[137]

No changes have been made from the 1994 draft legislation in respect of the definitions of "exempt earnings," "exempt loss," "net earnings," "net loss," "taxable earnings," and "taxable loss." All of these definitions have been amended to refer to a "designated treaty country" rather than a country listed in regulation 5907. These changes will come into effect in a manner that is consistent with the implementation of the designated treaty country provisions.

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[137] Supra footnote 28.

DESIGNATED TREATY COUNTRY STATUS

Where a foreign affiliate earns income that is characterized as "exempt earnings," the repatriation of such amounts by a corporation resident in Canada will generally not be taxable in Canada.[138] Exempt earnings include active business income earned by the foreign affiliate, but only if the foreign affiliate is resident in a country listed in regulation 5907(11) and carries on the active business in Canada or a listed country. Regulation 5907(11) is intended to include countries with which Canada has a treaty. However, this list is very much out of date, and it also includes certain countries with which Canada has a treaty but which are considered to be tax havens.

The 1994 draft legislation introduced a revised regulation 5907(11), as well as new regulations 5907(11.1) and (11.2), to replace the "listed country" concept with that of a "designated treaty country." Instead of conforming to a list of particular countries, a country will be a designated treaty country only when Canada and that country have entered into a tax treaty that has entered into force and has effect for the particular taxation year, subject to the "lookback" and "lookforward" rules in regulation 5907(11.1).[139]

The only revision of significance in the January 1995 amendments occurs in regulation 5907(11.2)(c). Regulation 5907(11.2) provides that a foreign affiliate is deemed not to be a resident in a country with which Canada has entered into a treaty unless the affiliate is a resident of that country for the purposes of the treaty, or the affiliate would be resident for purposes of the treaty if the affiliate were treated, for the purposes of income taxation in that country, as a body corporate. In addition, if the affiliate would be a resident of that country for the purposes of the treaty but for a provision in the treaty that provides that the treaty does not apply to the affiliate,[140] it may qualify as a resident of a designated treaty country. The January 1995 amendments revised this latter provision. It will now be required that the treaty entered into force before 1995, and the provision that provides that the treaty does not apply to the affiliate has not been amended after 1994. As a result, it appears that Barbados international business corporations and Cyprus offshore companies, to

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138 Paragraph 113(1)(a) provides for a deduction in computing a corporation's taxable income for the year in respect of dividends that have been prescribed to have been paid out of exempt surplus.

139 See the discussion in Jack, supra footnote 6.

140 For example, see article 29(3) of the Convention Between Canada and the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed in Nicosia on May 2, 1984, pertaining to offshore companies; and article XXX(3) of the 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 in Bridgetown on January 22, 1980 (herein referred to as "the Barbados agreement"), pertaining to international business corporations.

name only two, will be "grandfathered" until a new treaty is entered into or the exempting provision within the particular treaty is amended.[141]

The regulations dealing with designated treaty country status will apply to taxation years of a foreign affiliate of a corporation[142] that begin after 1995. However, the corporation may elect to have regulations 5907(11), (11.1), and (11.2) apply to earlier taxation years. The election must be made in the corporation's first taxation year that begins after 1994 or be applicable to a taxation year in which a dividend was paid by the foreign affiliate. In these circumstances, regulations 5907(11), (11.1), and (11.2) will apply to the taxation year that begins before 1996 and each subsequent taxation year of the foreign affiliate of the corporation.

CONCLUSION

The complexity of the foreign affiliate rules continues to increase. This area is full of traps for the unwary; however, there may also be benefits to certain taxpayers if the rules are considered carefully.

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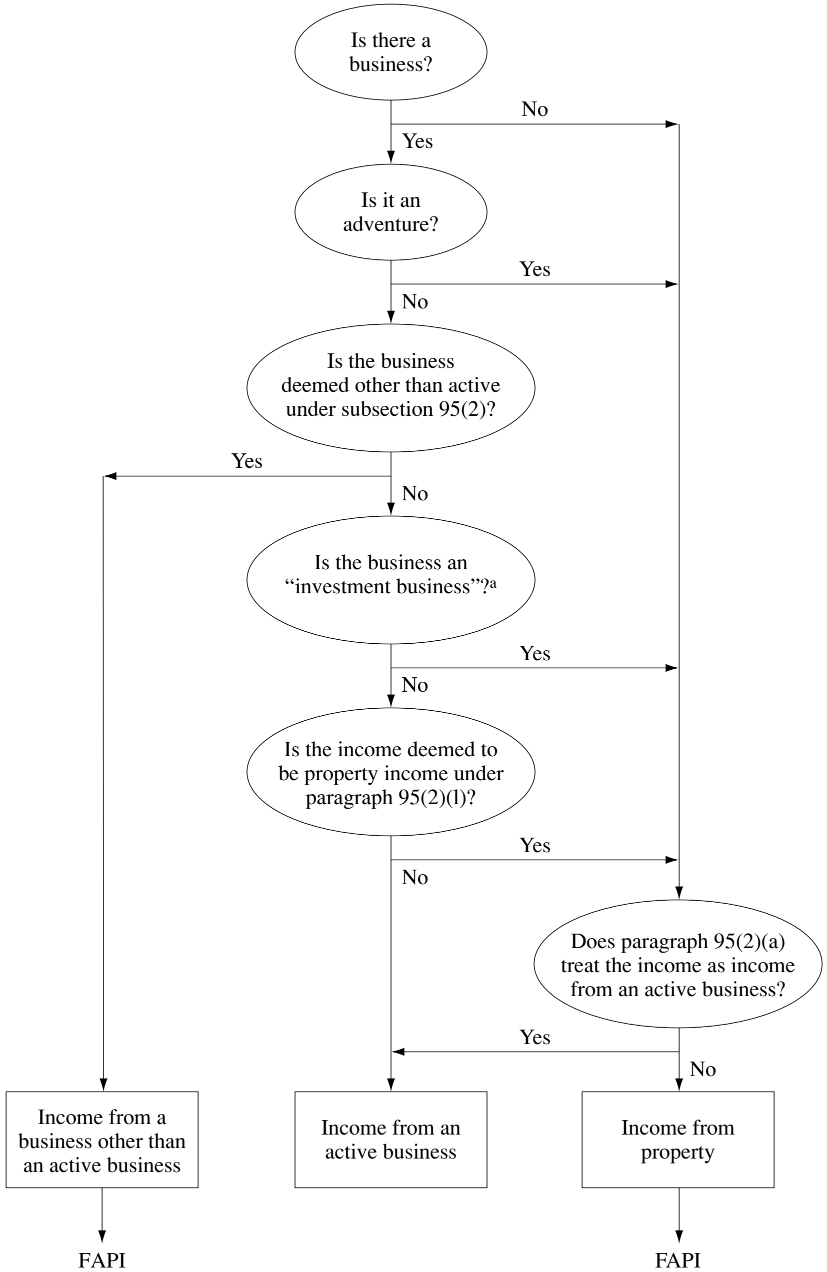
[141] While Barbados international business corporations should continue to be eligible for exempt surplus treatment, it is unclear whether, for example, a Barbados exempt insurance company licensed under the Exempt Insurance Act 1983 (Barbados) will qualify (see O'Neill and Borgmann, supra footnote 6, at 1360). Very briefly, to be eligible the foreign affiliate must be a resident of Barbados for purposes of the Barbados agreement. Article IV(1) defines resident for purposes of the agreement as a person "liable to taxation" by reason of domicile, residence, etc. Since an exempt insurance company is generally not subject to any tax in Barbados, it is unclear whether income earned by such a company may qualify as exempt earnings. Arguments exist, based on section 29 of the Exempt Insurance Act and *The Queen v. Crown Forest Industries Limited*, 94 DTC 6107 (FCA) (appeal to the Supreme Court of Canada heard on March 2, 1995, judgment not yet rendered), that such a company may be entitled to generate exempt surplus.

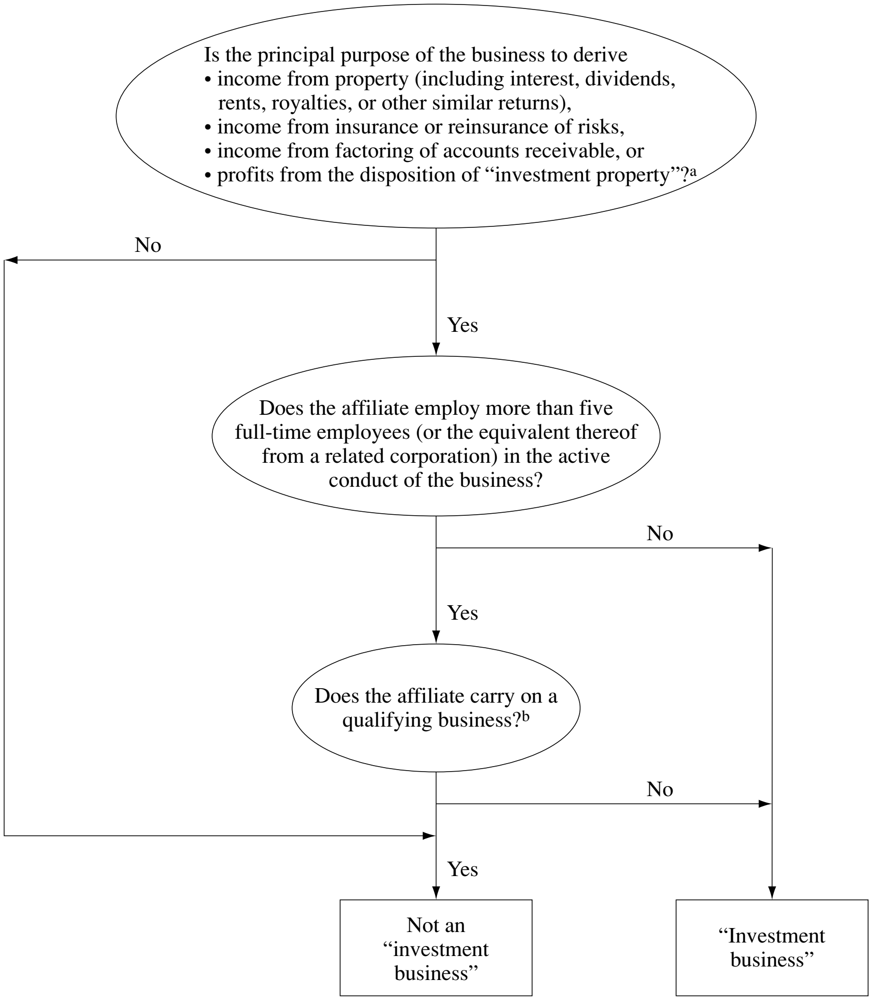
[142] Note that the coming-into-force provision applies only to a foreign affiliate of a corporation. If an individual owns the foreign affiliate and that individual subsequently transfers the foreign affiliate to a related corporation, there is no exempt surplus that may be inherited by the corporation. See *Trans World Oil & Gas Ltd. v. The Queen*, [1995] 1 CTC 2087 (TCC).

APPENDIX 1: CHARACTERIZATION OF INCOME



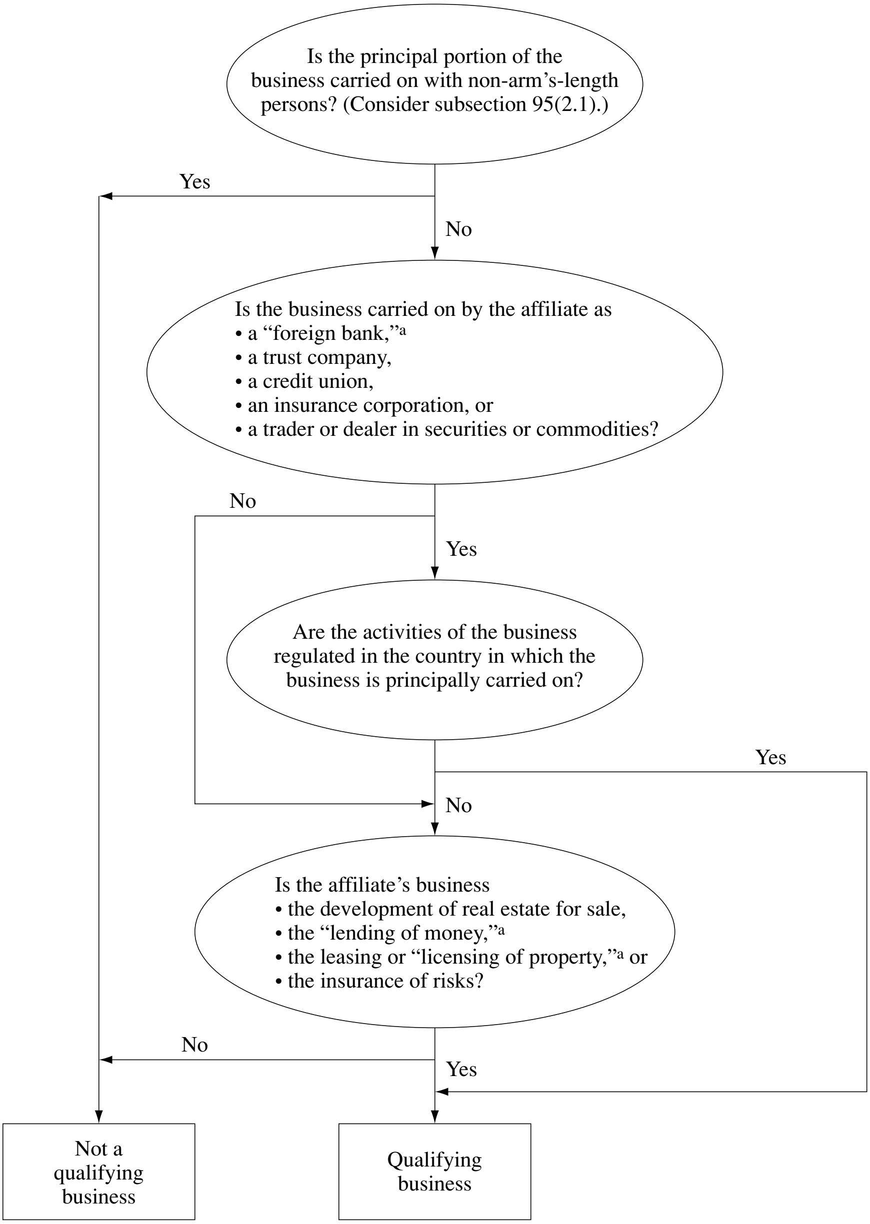
[a] See appendix 2.

APPENDIX 2: "INVESTMENT BUSINESS"



[a] See the definition in subsection 95(1). [b] See appendix 3.

APPENDIX 3: QUALIFYING BUSINESS



[a] See the definition in subsection 95(1).

APPENDIX 4

Concept	*Relevant provisions*
Investment business	• subsection 95(1) definition of “investment business” “foreign bank” “investment property” “lending of money” “licensing of property” • paragraph 95(2)(k): fresh start rules • subsection 95(2.1): arm’s-length dealings with respect to certain currency arrangements
Income from property	• subsection 95(1) definition of “investment business” • paragraph 95(2)(l): trading or dealing in indebtedness
Deemed active business income: paragraph 95(2)(a)	• paragraph 95(2)(m) definition of “qualifying interest” • subsection 95(2.2): meaning of “throughout the year” • subsection 20(3): borrowing to replace previously borrowed money
Property sales in affiliate: paragraph 95(2)(a.1)	• subsection 95(2.3): certain currency arrangements • subsection 95(1) definition of “investment business”: sales of commodities on an exchange • paragraph 95(2)(b): agents • paragraph 95(2)(k): fresh start rules
Insurance of Canadian risks: paragraph 95(2)(a.2)	• paragraph 95(2)(b) and subsection 95(3) • paragraph 95(2)(k): fresh start rules • subsection 95(1) definition of “investment business” may be applicable
Canadian debt and lease obligations: paragraph 95(2)(a.3)	• subsection 95(1) definition of “lease obligation” • paragraph 95(2)(k): fresh start rules

	• subsection 95(2.4): foreign regulated financial institution
	• subsection 95(2.5): restricting the meaning of "indebtedness" with respect to certain currency arrangements
	• subsection 95(2.5) definition of "specified deposit"
Partnership financing: paragraph 95(2)(a.4)	• subsection 95(1) definition of "lease obligation"
	• paragraph 95(2)(k): fresh start rules