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Arthur R. A. Scace

Douglas S. Ewens

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CANADIAN TAXATION OF FOREIGN AFFILIATES

By ARTHUR R. A. SCACE and DOUGLAS S. EWENS*

The 1972 amendments to the Income Tax Act have been subjected to the criticism that after almost a decade of in-depth study aimed at reforming Canada's tax system, surprisingly few changes of substance have survived the years of debate to form part of today's Income Tax Act. That comment, however, cannot be applied to the treatment of foreign-source income of Canadian residents under the new Act.

In the past, income earned by a foreign corporation controlled by Canadians was not subject to Canadian taxation until such income was received by way of dividends. Even then, if a Canadian corporation owned more than 25% of the shares of the foreign corporation, it was not required to pay any Canadian tax on dividends received from such shares by virtue of section 28(1) (d) of the former Act.¹ In cases where the 25% ownership criterion was not satisfied, Canadian tax was totally or partially offset² by a tax credit for any foreign withholding tax incurred.

*Members of the Ontario Bar, Toronto.

¹ Contrast this with the Canadian tax treatment accorded profits or losses of branch operations of a Canadian taxpayer. A Canadian corporation or individual carrying on its business operations in a foreign country through a branch computed Canadian income tax on the income earned by the branch by grossing it up to include direct taxes paid to the foreign country. The Canadian taxpayer was then entitled, under section 41(1) of the former Act, to claim a tax credit for those foreign taxes up to (but not exceeding) the amount of Canadian income tax which would have been paid had the same income been earned in Canada. The Canadian taxpayer was unable to defer Canadian tax on his branch profits.

If, however, a Canadian corporation owned shares of a foreign corporation which carried on business in the foreign country, its Canadian tax position varied depending on whether or not it owned more than 25% of the issued voting shares of the foreign corporation. If it owned more than 25% of such shares, it paid no Canadian income tax on either the income earned by the foreign corporation or the dividends received from it. Otherwise it would gross-up amounts received in respect of dividends by the amount of foreign withholding tax levied on dividends paid and claim a tax credit for the withholding taxes up to (but not exceeding) the amount of Canadian income tax on the same income. Unlike the Canadian taxpayer who had to pay tax when branch profits were earned, a corporation which held 25% or less of the shares of a foreign corporation paid Canadian tax only when dividends were actually received in Canada.

² Under section 41 of the former Act, the dividend received was "grossed up" by the amount of foreign withholding tax, whereupon a tax credit in the amount of withholding tax was deducted from Canadian tax otherwise payable. The amount of the credit could not, however, exceed the amount of tax which Canada would have imposed on the same income.

Section 28(1) (d) was introduced in 1949 by Mr. Abbot, the then Minister of Finance, who, in introducing the amendment in his budget speech, made the following comments:

There will be several amendments introduced affecting companies having business operations abroad. The more important of these will remove a complicated procedure by which corporations having controlled subsidiaries abroad are now allowed to claim a tax credit against their Canadian tax for taxes paid by the subsidiaries abroad, and in some cases by companies which are in turn subsidiaries of the foreign subsidiary. In view of the fact that most countries in which Canadian companies are now doing business abroad impose corporation taxes as heavy or heavier than the Canadian tax, the effect of the present tax credit provision is that no Canadian tax is imposed on this income. The procedure for attaining this result, however, is extremely complicated and it is proposed that the same result be achieved by an amendment which would allow dividends from such controlled foreign subsidiaries to be taken into Canadian income free of tax. This will greatly simplify one small but very complicated provision of the law at no appreciable cost in revenue.

The exemption introduced by section 28(1) (d) was soon to be utilized by Canadian corporations for tax avoidance purposes.

It was often possible for Canadian corporations to divert income through controlled foreign corporations situated in jurisdictions which imposed little or no tax and to repatriate such income to Canada at nominal tax cost. For example, a Canadian corporation could develop a valuable invention and have the patent held by a wholly-owned corporation located in a tax haven. The foreign corporation would receive royalty income from a licensee resident in, say, Canada on which it would pay, at most, 15% Canadian withholding tax. The corporation could pay dividends to its Canadian corporate shareholder which, because of section 28(1) (d), would incur no further tax. International sales subsidiaries were similarly utilized by Canadian multinational corporations to minimize tax.

The Canadian government now considers that the scope for abuse available under the former Act was entirely too broad. The measures invoked by the government to terminate such practices are formidable indeed.

Under the new Canadian income tax regime, Canadian residents will be compelled, after a three-year transitional period has elapsed, to pay tax on their proportionate share of all "passive income" (e.g. dividends, interest, rents, royalties, capital gains) in the year in which it is earned by non-resident corporations and trusts with which Canadian taxpayers are affiliated (called "foreign affiliates").³ The chief complaint is that this income will be taxable currently to Canadian residents notwithstanding that it may not have been received (and indeed may never be received) from their foreign affiliate: the Canadian residents may have little or no control over a foreign affiliate's dividend-payment policy.

Furthermore, dividends paid after 1975 to a Canadian corporation out of a foreign affiliate's active business income earned in a country with which Canada has not entered into a tax treaty will be subject to Canadian income tax to the extent necessary to ensure that such income has borne tax which

³ Section 91(1)(a). See discussion on page 345, *infra*.

at least equals the Canadian level of tax.⁴ These dividends will be included in the Canadian corporation's income when received by it, and a deduction from income (not a tax credit) will be allowed for the foreign tax levied upon the earnings which underlie the dividends and for twice the withholding tax. Any balance will be subjected to Canadian income tax.

The Canadian system of taxing foreign-source income of Canadians contemplates the enactment of extensive regulations to carry out the provisions of the Income Tax Act. At the time of writing, the regulations have not yet been promulgated. However on August 4, 1971 the Department of Finance issued a news release "outlining" the regulations which will apply to dividends received from foreign affiliates. That news release will hereinafter be referred to as the "proposed regulations." Other sources of official information in the area of international taxation consist of public statements made by the former Minister of Finance (The Honourable E. J. Benson) and his former Parliamentary Secretary (The Honourable P. M. Mahoney) before the House of Commons, statements contained in the June 18, 1971 budget, the text of the former Finance Minister's publication entitled "Summary of 1971 Tax Reform Legislation", and statements contained in the May 8, 1972 budget presented by the present Minister of Finance (The Honourable J. N. Turner).

The purpose of this paper is to explore the provisions of the Income Tax Act and proposed regulations relating to the detailed definition of "foreign affiliate", the taxation of passive income earned by foreign affiliates and the taxation of dividends received from foreign affiliates out of their active business income. Practical problems which may arise under the new tax regime will be posed and (in the relatively few situations in which the writers have been able to resolve them) solutions suggested. Wherever possible the experience of our American counterparts will be drawn upon, particularly in the area of the taxation of diverted investment income.

Definition of "Foreign Affiliate"

There are three independent tests to be used in determining whether a particular non-resident corporation qualifies for the dubious distinction of being a foreign affiliate. There is also a provision whereby a non-resident corporation which does not qualify under any of the three obligatory tests may elect to be regarded as a foreign affiliate.

Section 96 (1) (b) of the Act provides that a non-resident corporation will be defined as a foreign affiliate of a taxpayer resident in Canada if:

- (i) the Canadian resident taxpayer and all other Canadian residents with whom the taxpayer does not deal at arm's length hold sufficient voting shares in the non-resident corporation to give them a combined "voting percentage" of 25% or more. If the combined "voting percentage" is between 10% and 25%, the taxpayer may elect to have the non-resident corporation regarded as a foreign affiliate; or

⁴ Sections 90(1), 113 and 126, and the proposed regulations; see discussion at page 360, *infra*.

- (ii) the Canadian resident taxpayer and all other Canadian residents with whom the taxpayer does not deal at arm's length hold sufficient shares of any type or class in the non-resident corporation to give them a combined "equity percentage" of 50% or more; or
- (iii) the Canadian resident taxpayer, or the Canadian resident taxpayer and all other taxpayers (whether Canadian residents or not) with whom the Canadian-resident taxpayer does not deal at arm's length control, directly or indirectly in any manner whatever, the non-resident corporation.

Before the definition section is examined in detail, several preliminary observations should be made.

It is not only a Canadian *corporation* which may find itself saddled with a foreign affiliate. Any "taxpayer resident in Canada" may have a foreign affiliate. Section 248(1) indirectly defines "taxpayer" to include corporations, individuals and trusts.⁵

Section 96(1) requires that where a taxpayer is a member of a partnership, his income must be computed as if the partnership were a separate person resident in Canada. It will therefore be possible for a foreign corporation, some of the shares of which are partnership property, to be effectively rendered a foreign affiliate of the partners notwithstanding that if the shares did not constitute partnership property (but were held independently by the partners) none of the individual partners would hold sufficient shares to be considered affiliated with the foreign corporation.⁶

Furthermore section 95(3) states that several foreign affiliates of a common taxpayer will be deemed not to deal at arm's length either with each other or with the taxpayer. The result of this provision is that even though a Canadian taxpayer owns a 25% minority interest in the common shares of a non-resident corporation and in fact deals at arm's length with that corporation, the Canadian taxpayer will be deemed, for the purpose of casting the net of the foreign affiliate definition as broadly as possible, not to be dealing at arm's length with the non-resident corporation.

Although the definition section appears at first blush to designate only non-resident *corporations* as foreign affiliates, section 94 has the effect of exposing non-resident *inter vivos* trusts to the three tests of affiliation with a Canadian taxpayer. This is accomplished by deeming such a trust to be a non-resident corporation having 100 issued voting shares. Section 94(b) provides:

- (b) each beneficiary under the trust shall be deemed to own, at any time, a number of the (100 issued shares) that is equal to the greater of
 - (i) that proportion of 100 that

⁵ However a foreign corporation all of the shares of which are owned by a Canadian individual's private holding company will be a foreign affiliate only of the holding company.

⁶ This could arise, for example, where three arm's length taxpayers form a partnership the assets of which include 30% of the issued common shares of a particular foreign corporation.

- (A) the fair market value at that time of his capital interest in the trust
is of
- (B) the fair market value at that time of all capital interests in the trust,
and
- (ii) that proportion of 100 that
- (A) the fair market value at that time of his income interest in the trust
is of
- (B) the fair market value at that time of all income interests in the trust
(such fair market values being determined in each case as the amount that, having regard to all the circumstances including the terms and conditions of the trust arrangement, may reasonably be considered to be the fair market value of the interest or interests, as the case may be).

It is apparent that where the income beneficiaries are different from the capital beneficiaries the full amount of the passive income earned by the trust, and the dividends paid therefrom, will be *fully* attributed to *each* category of beneficiaries, resulting in the same income being taxed twice by Canada. It is expected that attempts to vary the terms of trusts exposed to this prospect will be widespread during the period leading up to the full application of the foreign affiliate rules.⁷

Voting Percentage Test

The "voting percentage" test is concerned with more than the Canadian taxpayer's direct voting power in a non-resident corporation. It recognizes that a Canadian taxpayer having substantial voting power in a non-resident corporation, which itself holds voting shares in a chain of non-resident subsidiaries, effectively enjoys some indirect voting power in the subsidiaries.

A Canadian taxpayer's "voting percentage" is therefore measured by adding his "direct voting percentage" in the non-resident corporation to his indirect voting power therein.

Section 95(4) (b) defines "voting percentage", and Section 95(5) (b) defines "direct voting percentage", as follows:

- 95(4)(b) the 'voting percentage' in any particular corporation, of a taxpayer resident in Canada is the aggregate of
- (i) the taxpayer's direct voting percentage in the particular corporation, and
 - (ii) all percentages each of which is a percentage in respect of any foreign affiliate of the taxpayer (other than the particular corporation), equal to the product obtained when the taxpayer's voting percentage in that affiliate is multiplied by that affiliate's direct voting percentage in the particular corporation."

95(5)(b) the 'direct voting percentage' of any person in a corporation is the number, expressed as a percentage, equal to that proportion of 100 that the number of issued shares (having full voting rights under all circumstances) of the capital stock of the corporation owned by that person is of the total number of issued shares (having full voting rights under all circumstances) of the capital stock of the corporation.

⁷The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the "Joint C.B.A.-C.I.C.A. Committee") submitted a brief to the Department of Finance in March, 1972 containing recommendations of those areas in which amendments to the new legislation appear to be warranted. One of its suggestions was that an income beneficiary of a foreign affiliate trust be required to include in his income only the share of the trust's passive income to which he may reasonably be regarded as having a present or future direct entitlement.

Accordingly, if Canadian taxpayer "C" owned 100 of the 320 issued voting shares of non-resident corporation "N", C's direct voting percentage in N would be ($\frac{100}{320} \times 100$) 31.3%. N would therefore be a foreign affiliate of C, since C's *direct* voting percentage alone satisfies the "voting percentage" test in section 95(1) (b) (ii).

However it is important to note that the voting percentage test does not scrutinize merely one particular Canadian taxpayer's voting percentage in a non-resident corporation; rather it takes into account a combination of that particular taxpayer's voting percentage and the voting percentages of all other taxpayers *resident in Canada* with whom the particular taxpayer does not deal at arm's length. If Canadian taxpayer "C" owned 10% of the issued voting shares of non-resident corporation "N", and C's Canadian-resident sister corporation "S" owned 20% of the issued voting shares of N, both C and S would be considered to have a 30% voting percentage in N. Accordingly, N would be a foreign affiliate of both C and S. If, on the other hand, S were a non-resident sister corporation of C, N would not be a foreign affiliate of C, since the voting percentage test combines only the voting percentages of taxpayers *resident in Canada* which do not deal at arm's length.

A Canadian taxpayer's indirect voting power⁸ in a particular non-resident corporation is irrelevant unless the corporation which intervenes between the particular non-resident corporation and the Canadian taxpayer is itself a foreign affiliate of the Canadian taxpayer. For example, assume that Canadian taxpayer "C" owns 50% of the issued voting shares of *foreign affiliate* "F", and that F owns 80% of the issued voting shares of a particular non-resident corporation "P". C's indirect voting power in P is ascertained by multiplying C's voting percentage in F (50%) by F's *direct* voting percentage in P (80%). Thus C has indirect voting power of 40% in P. Since C's voting percentage in P is also 40%, P is a foreign affiliate of C.

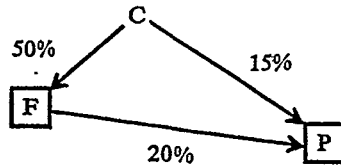
If, however, the foregoing example were varied to make C's voting percentage in F only 20%, it would be impossible for P to be a foreign affiliate of C (even if F owned all of the issued voting shares of P) since F would no longer be a foreign affiliate of C⁹ (which is a prerequisite of measuring indirect voting power under section 95(4) (b) (ii)).

The definition of "voting percentage" requires that a Canadian taxpayer's direct voting percentage be combined with that taxpayer's indirect voting power. Assume that Canadian taxpayer "C" owns 50% of the issued voting shares of foreign affiliate "F" and also owns 15% of the issued voting shares of a particular non-resident corporation "P". In addition F owns 20% of the issued voting shares of P. C's voting percentage in P is computed by combining C's direct voting percentage in P (15%) and indirect voting power in P (50% multiplied by 20%, or 10%), which produces (15% plus 10%)

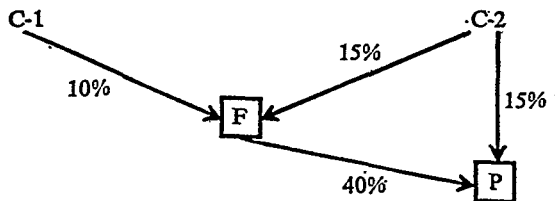
⁸ The phrase "indirect voting power" is not a defined term under the Act but a descriptive term adopted by the writers.

⁹ Unless C were to elect to have F so regarded.

25%. Accordingly C has a 25% voting percentage in P which is sufficient under section 95(1) (b) (ii) to render P a foreign affiliate of C.



Assume a further refinement as illustrated below. "C-1" and "C-2" are two related Canadian taxpayers. C-1 owns 10% of the issued voting shares of non-resident corporation "F" and C-2 owns 15% of the issued voting shares of a particular non-resident corporation, "P". F owns 40% of the issued voting shares of P.



The first question is whether F is a foreign affiliate of C-1 and C-2, since if F is not a foreign affiliate its direct voting percentage in P will be irrelevant in determining the status of P. However F is a foreign affiliate of both C-1 and C-2: they are resident Canadian taxpayers not dealing at arm's length, whose *combined* (direct) voting percentages in F total 25%.

The next question is whether P is a foreign affiliate of C-1 and C-2. Section 95(4) (b) requires that C-1's direct voting percentage (nil) and C-1's indirect voting power, (10% multiplied by 40%, or 4%) in P be combined. Thus the voting percentage of C-1 in P is only 4%, clearly insufficient by itself to satisfy the voting percentage test.

However the relationship between C-2 and P is closer. Computing the voting percentage of C-2 in P requires adding C-2's direct voting percentage (15%) and its indirect voting power (15% multiplied by 40%, or 6%) in P, which produces (15% plus 6%) 21%. The next step is to combine the voting percentages in P of the Canadian-resident, non-arm's-length taxpayers C-1 (4%) and C-2 (21%), which produces 25%. Hence P is a foreign affiliate of both C-1 and C-2.

Several principles which are essential to grasp when considering the voting percentage test are:

1. A particular Canadian taxpayer's shareholdings in a non-resident corporation cannot be viewed in isolation. The direct voting percentage and indirect voting power of *Canadian*-resident taxpayers with whom the particular taxpayer does not deal at arm's length are also essential considerations (section 95 (1) (b) (ii)).

2. Where a Canadian taxpayer owns voting shares in a particular non-resident corporation which, in turn, owns voting shares in a second non-resident corporation, the particular corporation's shareholdings are irrelevant in determining whether the second corporation is a foreign affiliate of the Canadian taxpayer, unless the particular corporation is itself first found to be a foreign affiliate.

3. A Canadian taxpayer will always have indirect voting power (and hence a voting percentage) where its foreign affiliate owns voting shares in a particular non-resident corporation; the overall voting percentage is measured by multiplying the Canadian taxpayer's voting percentage in the foreign affiliate by the foreign affiliate's *direct* voting percentage in the particular non-resident corporation. If the product is 25% or more, the particular non-resident corporation will be a foreign affiliate, and the voting shares owned by it will have to be considered. The process may repeat itself interminably down through sub-subsidiaries.

4. A Canadian taxpayer may have several different sources of indirect voting power in a particular foreign corporation. The Act requires all such sources to be combined. If, for example, several separate foreign affiliates of a Canadian taxpayer all own voting shares in a common particular non-resident corporation, the Canadian taxpayer must total the indirect voting power which is derived through each affiliate in order to determine its own voting percentage in the particular non-resident corporation.

10% Voting Percentage Election

As will be shown later, there are numerous situations in which Canadian taxpayers will wish to have non-resident corporations regarded as their foreign affiliates.¹⁰

Section 95(1) (b) (iv) of the Act enables a Canadian taxpayer with a voting percentage in a non-resident corporation ranging between 10% and 25% to elect, in prescribed manner and within a prescribed time, to have the non-resident corporation considered a foreign affiliate.

Equity Percentage Test

Like the voting percentage test, the "equity percentage" test is concerned with the indirect, as well as the direct, interest of a Canadian taxpayer in a non-resident corporation. In many respects the equity percentage test is parallel to the voting percentage test.

One principal difference between the two tests is that whereas a 25% voting percentage will suffice to render a non-resident corporation a foreign affiliate, a 50% equity percentage is needed to achieve the same result. It may often happen that a non-resident corporation will not meet the 25% voting percentage test but nevertheless will satisfy the 50% equity percentage criterion and therefore qualify as a foreign affiliate. For example, consider Cana-

¹⁰ Particularly where the affiliate is incorporated in a treaty country and carries on an active business in a treaty country, since dividends received from the affiliate will be exempt from Canadian income tax if received by a Canadian corporation.

dian taxpayer "C" who owns 5% of the common shares of non-resident corporation "N" and all of N's 6% cumulative, non-voting, redeemable preferred shares: N would be a foreign affiliate of C by virtue of the equity percentage test but not the voting percentage test.

Section 95(4) (a) defines a Canadian taxpayer's "equity percentage" in the following terms:

- 95(4) (a) the 'equity percentage', in any particular corporation, of a taxpayer resident in Canada is the aggregate of
- (i) the taxpayer's direct equity percentage in the particular corporation, and
 - (ii) all percentages each of which is a percentage in respect of any foreign affiliate of the taxpayer (other than the particular corporation), equal to the product obtained when the taxpayer's equity percentage is that affiliate is multiplied by that affiliate's direct equity percentage in the particular corporation.

The definition of "direct equity percentage" is rather more complex than the definition of "direct voting percentage":

- 95(5) (a) the 'direct equity percentage of any person in a corporation is the percentage determined by the following rules:
- (i) for each class of the issued shares of the capital stock of the corporation, determine the proportion of 100 that the number of shares of that class owned by that person is of the total number of issued shares of that class, and
 - (ii) select the proportion determined under subparagraph (i) for that person in respect of the corporation that is not less than any other proportion so determined for that person in respect of the corporation,
- and the proportion selected under subparagraph (ii), when expressed as a percentage, is that person's direct equity percentage in the corporation.

It is important to understand the meaning given to the term "class" of shares, in relation to the equity percentage test. Section 95(6) provides that shares will be considered to belong to the same class if they are identical in respect of all rights and obligations attaching thereto except the right to vote at shareholders' meetings. Thus voting and non-voting common shares will be considered as a single class: non-voting 8% cumulative preferred shares and voting 8% cumulative preferred shares will comprise a single class: but non-voting 5% cumulative preferred shares and non-voting 8% cumulative preferred shares will occupy separate classes.

Another provision of importance to both the equity percentage and voting percentage tests is found in section 95(7) (a), which confers the status of "share" upon an income bond issued by a foreign affiliate (unless interest paid by the affiliate in respect of the bond is deductible to it under the tax laws of its country of residence). In determining the direct equity percentage of a person who holds an income bond of a foreign affiliate, the aggregate of the principal amount of that person's bonds is expressed as a percentage of the total principal amounts of all income bonds issued by the affiliate.

Finally, section 95(7) (c) deems a person to own shares in a corporation if

- (a) that person has a contractual right either immediately or in the

future and either absolutely or contingently to *acquire* shares in the corporation, and

- (b) one of the main reasons for the existence of the right may reasonably be considered to be the reduction or postponement of Canadian income taxes.

This provision is also applicable to both the voting percentage and equity percentage tests.

One notable feature of the definition of "direct equity percentage" is that a Canadian taxpayer who holds 50% of a non-resident corporation's issued non-participating, non-voting, non-cumulative preferred shares will be considered to have the same direct equity percentage as a different Canadian taxpayer who holds 50% of the same non-resident corporation's issued common shares, notwithstanding that the former taxpayer has little or no "equity" in the normal sense of the word. It is quite apparent that numerous reorganizations of the capital structure of non-resident corporations in which Canadians are interested will be necessitated by the breadth of the definition of "direct equity percentage". For example, a Canadian taxpayer with a nominal number of common shares but a substantial number of preferred shares in a foreign holding company may find it beneficial to convert his preferred shares to debt or to a lesser number (and perhaps even a lesser percentage) of common shares.

Conversely, a Canadian corporation with less than a 10% voting percentage in a particular foreign corporation which desired to have the foreign corporation regarded as a foreign affiliate, could achieve that result if the non-resident corporation were willing to redeem the Canadian corporation's existing shares and to replace those shares with at least 50% of the shares of a separate class (perhaps created for the sole purpose of accommodating the Canadian taxpayer). The substituted shares could carry the same rights and obligations as the shares formerly held except in one minor respect (for example, they could carry a right to be converted to a different class of preferred shares).

Consider a taxpayer who owns 40% of the issued common shares of a non-resident corporation and 60% of its non-voting preferred shares. The non-resident corporation would be a foreign affiliate by virtue of both the voting percentage (at least 25%) and the equity percentage (the greater of 40% and 60% being in excess of 50%) tests having been met. If the same Canadian taxpayer owned only the 40% common share interest in the non-resident corporation such taxpayer's equity percentage and voting percentage would be the same. Even though the 50% equity percentage test would not be met, the 25% voting percentage test would be satisfied, and accordingly the non-resident corporation would be a foreign affiliate.

The equity percentage test requires a Canadian taxpayer's indirect equity interest¹¹ and direct equity percentage to be combined. Indirect equity interest

¹¹ The phrase "indirect equity interest" is not a defined term under the Act but a descriptive term adopted by the writers.

is computed in much the same manner as indirect voting power. For example, assume that Canadian taxpayer "C" owns 80% of the non-voting cumulative preferred shares of foreign affiliate "F". F in turn owns 70% of the common shares of a particular non-resident corporation "P". C's indirect equity interest in P is ascertained by multiplying C's equity percentage in F (80%) by F's *direct* equity percentage in P (70%). Thus C has an indirect equity interest in P of 56%. This, when combined with C's direct equity percentage in P of zero, produces an equity percentage of 56% (which suffices to render P a foreign affiliate of C).

As is the case when considering the extent of a Canadian taxpayer's indirect voting power, a Canadian taxpayer's indirect equity interest in a particular non-resident corporation is relevant only if the corporation which intervenes between the particular non-resident corporation and the Canadian taxpayer is itself a foreign affiliate of the Canadian taxpayer. If, in the above example, C had owned only 45% of the non-voting cumulative preferred shares of F, it would have been impossible for P to be a foreign affiliate of C, since F would not be a foreign affiliate. The extent of F's interest in P would therefore be irrelevant in determining C's indirect equity interest in P.

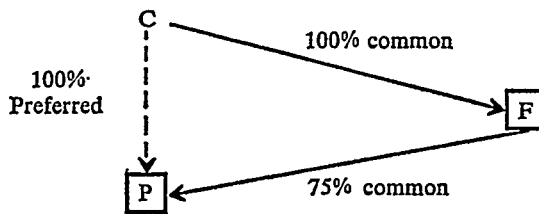
Section 95 (1) (b) requires that a particular Canadian taxpayer's equity percentage in a non-resident corporation be combined with the equity percentages of all other *Canadian-resident* taxpayers with whom the particular taxpayer does not deal at arm's length in order to determine whether the non-resident corporation is a foreign affiliate of the particular taxpayer. A similar requirement is inherent in the determination of voting percentage.

However, unlike the case of voting percentage, when the particular Canadian taxpayer's equity percentage in a non-resident corporation is combined with the equity percentages therein of all other Canadian-resident taxpayers who do not deal at arm's length with the particular taxpayer, the Canadian taxpayer's equity percentage may exceed 100%. In determining whether a non-resident corporation is a foreign affiliate of the Canadian taxpayer the equity percentage of the Canadian taxpayer and of all other taxpayers resident in Canada with whom the Canadian taxpayer does not deal at arm's length need attain only 50%: it is not significant *for that purpose* that the equity percentage could exceed 100%.

However, it is the equity percentage that is used to determine the *amount* of the "foreign accrual property income"¹² of a foreign affiliate which under section 91 a Canadian taxpayer must include in computing income. Accordingly, in certain cases, a Canadian taxpayer having an equity percentage in a foreign affiliate which amounts to, say 175%, will be required to include in income 175% of the affiliate's foreign accrual property income. Clearly the Canadian taxpayer would be taxed upon far more income than could conceivably be received from the affiliate, and the affiliate's foreign accrual property income would be subjected to a large measure of double taxation.

¹² See section 95(1) (a) and (c).

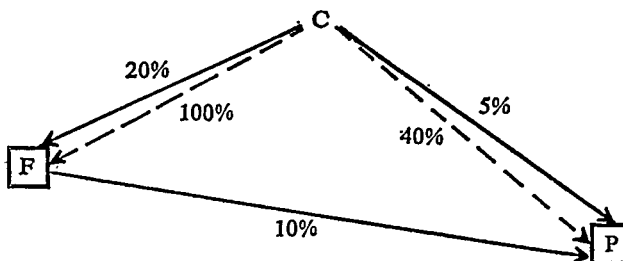
An example of how a Canadian taxpayer's equity percentage could exceed 100% is set forth below:



In this example Canadian taxpayer "C" owns all of the issued common shares of foreign affiliate "F" and 100% of the preferred shares of a particular foreign affiliate "P". F owns 75% of the common shares of P. C has a direct equity percentage in P of 100% and an indirect equity interest in P of (100% multiplied by 75%) 75%, which combine to produce an equity percentage of 175%. The amount of P's foreign accrual property income which C would be required to include in income would be 175% thereof. This aspect will be dealt with in more detail in the discussion of foreign accrual property income, *infra*.¹³

For present purposes we are concerned only with ascertaining whether a particular non-resident corporation is in fact a foreign affiliate of a Canadian taxpayer, not with the tax consequences of that fact to the Canadian taxpayer.

In the example illustrated below, Canadian taxpayer "C" owns all of the non-voting preferred shares and 20% of the common shares of non-resident corporation "F". C also owns 40% of the non-voting preferred shares and 5% of the common shares of a particular non-resident corporation "P"; and F owns 10% of the common shares of P. The dotted line represents preferred shares and the solid line common shares.



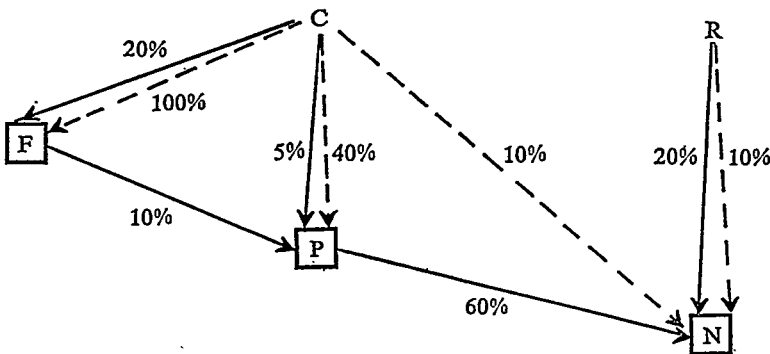
In considering whether, under the equity and voting percentage tests, P is a foreign affiliate of C, the following determinations must be made:

1. C's direct voting percentage in P (5%) is insufficient by itself to render P a foreign affiliate of C.

¹³ More particularly, under the heading "Participating Percentage" *infra* at page 352.

2. C's direct equity percentage in P (the greater of 40% and 5%, or 40%) is insufficient by itself to render P a foreign affiliate of C.
3. F's direct voting and direct equity percentages (both 10%) in P are relevant only if F is found to be a foreign affiliate of C.
4. C's voting percentage in F (20%) is insufficient by itself to render F a foreign affiliate of C, however if necessary and desirable C could elect under section 95(1) (b) (iv) to have F regarded as a foreign affiliate.
5. Such an election would be redundant here, since C's equity percentage in F (the greater of 100% and 20%, or 100%) is sufficient to render F a foreign affiliate of C.
6. C's voting percentage in P is calculated by combining C's direct voting percentage in P (5%) and indirect voting power in P (20% multiplied by 10%, or 2%), which produces 7%. Thus the voting percentage test is not met, and P is not thereby rendered a foreign affiliate of C.
7. C's equity percentage in P is calculated by combining C's direct equity percentage in P (40%) with C's indirect equity interest in P (100% multiplied by 10%, or 10%), which produces 50%. Since C's equity percentage in P is not less than the 50% required by section 95(1) (b) (iii), P is a foreign affiliate of C.

The next example, illustrated below, expands upon the foregoing example by introducing two additional corporations: one is a resident of Canada which is related to C (designated "R"); the other is a non-resident corporation (designated "N") in which R owns 10% of the non-voting preferred shares and 20% of the common shares and in which P owns 60% of the common shares. C also owns 10% of the non-voting preferred shares of N.



In ascertaining whether N is a foreign affiliate of C (and thereby necessarily a foreign affiliate of R as well),¹⁴ the following determinations are necessary:

¹⁴ Section 95(1) (b) (iii).

1. As concluded in the preceding example, C's voting percentage in P is 7% and C's equity percentage in P is 50%.
2. Subparagraphs 95(1) (b) (ii) and (iii) require C's voting and equity percentages in N to be combined with R's corresponding percentages in N because of the non-arm's-length relationship between C and R and the fact that both C and R are resident in Canada.
3. A combination of the voting percentages of C (7% multiplied by 60%, or 4.2%) and R (20%) in N is insufficient (24.2%) by itself to render N a foreign affiliate of C and R. If necessary and desirable either or both of C and R could elect to have N regarded as a foreign affiliate.¹⁵
4. A combination of the equity percentages of C (50% multiplied by 60%, or 30%) and R (the greater of 20% and 10%, or 20%) in N produces 50%, which suffices to render N a foreign affiliate of C and R.

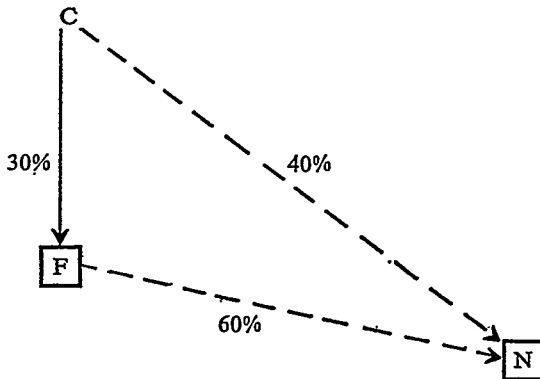
Some key factors to be considered when examining the equity percentage concept follow:

1. Where a Canadian taxpayer owns only one class of shares of a non-resident corporation, and where that class enjoys full voting rights under all circumstances, the taxpayer's direct voting and equity percentages in the non-resident corporation will be identical. In that event the non-resident corporation would qualify as a foreign affiliate if the taxpayer owned 25% of the shares of that class (i.e. the voting percentage criterion only need be satisfied).
2. In theory the number of Canadian taxpayers who could have a 100% equity percentage in a particular non-resident corporation is limited only by the countless number of combinations of rights and obligations which may attach to various different "classes"¹⁶ of shares. In other words, it is possible to envision five unrelated Canadian taxpayers each directly owning all of the shares of differing classes of a particular non-resident corporation and each thereby having a 100% equity percentage. The particular non-resident corporation would not only be a foreign affiliate of each of the five Canadian taxpayers, but (as will be discussed in the foreign accrual property income section of this paper) *all* of the foreign accrual property income of the affiliate would be included in computing the income of *each* of the five Canadian taxpayers.
3. Where a foreign affiliate of a Canadian taxpayer owns shares in a particular non-resident corporation, the Canadian taxpayer will necessarily have an indirect equity interest (and hence an equity percentage) in the particular non-resident corporation. It should be noted that the preliminary determination (i.e. as to whether the corporation in which the Canadian taxpayer directly owns shares is a

¹⁵ An election by C to that effect would not render N a foreign affiliate also of R.

¹⁶ As defined by section 95(b).

foreign affiliate) may utilize the voting percentage test *or* the equity percentage test *or* the "control test" (to be discussed *infra*). For example, assume that Canadian taxpayer "C" owns 30% of the common shares of a non-residence corporation "F" and 40% of the non-voting preferred shares of non-residence corporation "N". Assume further that F owns the remaining 60% of the non-voting preferred shares of N. The *voting* percentage test is used to conclude that F is a foreign affiliate of C. F's shareholding in N thereupon becomes significant. The *equity* percentage test is then used to conclude that N is also a foreign affiliate of C. C's direct equity percentage in N of 40% and indirect equity interest in N (ascertained by multiplying C's 30% equity percentage in F by F's 60% direct equity percentage in N) of 18% are combined. C's equity percentage in N is therefore (40% plus 18%) 58%.



Control Test

Section 95 (1) (b) provides the third alternative for determining whether a non-resident corporation constitutes a foreign affiliate of a Canadian taxpayer. It includes in the definition of "foreign affiliate" a non-resident corporation that is "controlled, directly or indirectly in any manner whatever", either by the Canadian taxpayer alone or by a combination of the Canadian taxpayer and other taxpayers (*wherever resident*) with whom the Canadian taxpayer was not dealing at arm's length.

Whereas the voting and equity percentage tests require a Canadian taxpayer's own voting and equity percentages in a non-resident corporation to be combined with the corresponding percentages of other taxpayers *resident in Canada* with whom the Canadian taxpayer does not deal at arm's length, the control test takes into account the influence able to be exerted on the non-resident corporation by the Canadian taxpayer and *all* other taxpayers with whom the Canadian taxpayer does not deal at arm's length, regardless of their country of residence.¹⁷

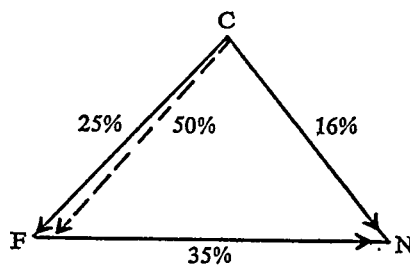
¹⁷The Joint C.B.A.-C.I.C.A. Committee recommended (at page 5-8 of its brief) against basing the attribution of FAPI on fixed rules. It favoured such attribution only in cases where the Canadian resident has sufficient control of a foreign corporation to cause events to occur which would be attributed to him for tax purposes.

For example, a multi-national foreign corporation "P" has a wholly-owned Canadian subsidiary "C" which owns 20% of the common shares of non-resident corporation "F". P owns 40% of the common shares of F. C's voting and equity percentages are only 20%, and but for the control test F would not be considered a foreign affiliate of C. The voting and equity strength of P is irrelevant for purposes of the voting and equity percentage tests, since P is not resident in Canada. However since F is controlled directly by the combination of C and its parent corporation P, F is a foreign affiliate of C by virtue of the control test.

It is clear from a study of the voting and equity percentage tests that the indirect voting power and indirect equity interest of a Canadian taxpayer are rapidly diluted by the multiplication formulae utilized by those tests. Consider, for example, a corporate chain in which a parent Canadian corporation "C" owns 51% of the common shares of its non-resident subsidiary "X", which in turn owns 51% of the common shares of its non-resident subsidiary "Y", and so on down the chain. While the voting percentage tests would render X and Y foreign affiliates of C, it would reach no further down the chain because of the dilution feature built into the indirect voting power concept. As long as the common or voting share ownership remained in excess of 50% from chain corporation to chain corporation, it is submitted that the *indirect* control test would render each non-resident chain corporation a foreign affiliate of C.

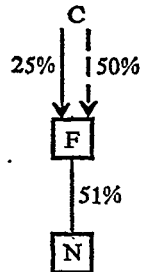
An extremely important provision to be examined when analyzing the control test is found in section 95(3), which states that a foreign affiliate of a taxpayer is deemed not to deal with the taxpayer or with any other foreign affiliate of the taxpayer at arm's length.

Consider, for example, the situation illustrated below in which Canadian taxpayer "C" owns 25% of the common shares and 50% of a class of non-voting preferred shares of foreign affiliate "F". F owns 35% and C owns 16% of the common shares of non-resident corporation "N".



C does not have either a sufficient voting or equity percentage in N to render it a foreign affiliate of C. Although F is clearly a foreign affiliate of C as a result of both the voting and equity percentage tests, C and F in fact deal with each other totally at arm's length. Nevertheless, the effect of section 95(3) is that C is deemed not to deal at arm's length with F. When that result is introduced into the control test, N becomes a foreign affiliate of C pursuant to clause (B) of section 95(1)(b)(i).

An interesting problem of statutory interpretation is illustrated in the next example. Canadian taxpayer "C" owns 25% of the common shares and 50% of the non-voting preferred shares of foreign affiliate "F". F in turn owns 51% of the common shares of non-resident corporation "N".



Neither C's voting percentage nor C's equity percentage in N is sufficient to render N a foreign affiliate. Although C and F may in fact deal at arm's length with each other, section 95(3) confers upon them a deemed non-arm's-length relationship. The problem arises in construing clause (B) of section 95(1) (b) (i)¹⁸ in this context. On the one hand, clause (B) may be considered to contemplate combining the voting power exerted upon N by each of C (nil) and F (51%) to see whether such combination results in *de jure* control in the hands of that deemed non-arm's length pair. On the other hand the argument which appeals to the writers is that clause (B) is not satisfied unless C also has some direct voting power to exert in N; in other words, some portion of the control of N must emanate from *both* C and F.

Support¹⁹ for this interpretation may be found in section 192 (4), which defines "control" in the designated surplus provisions of the Act in the following terms:

192 (4) For the purpose of this section, one corporation is controlled by another corporation if more than 50% of its issued share capital (having full voting rights under all circumstances) belongs to the other corporation, *to persons with whom the other corporation does not deal at arm's length*, or to the other corporation and persons with whom the other corporation does not deal at arm's length. (Italics added).

Parliament considered that it was necessary to include the italicized phrase in the above-quoted definition in order to extend the meaning of "control" beyond control by either "the other corporation" or "the other corporation and persons with whom the other corporation does not deal at arm's length"

¹⁸ Section 95(1) (b) (i) defines "foreign affiliate" to include a foreign corporation "(i) that was, at that time, controlled, directly or indirectly in any manner whatever, by (A) the taxpayer, or (B) the taxpayer and other taxpayers with whom the taxpayer was not dealing at arm's length."

¹⁹ Additional support for this position may be derived from the Supreme Court's judgment in *Settled Estates Limited v. M.N.R.*, 60 D.T.C. 1128 dealing with personal corporations, and also in *Dawson Investments Limited v. M.N.R.*, 63 D.T.C. 944 (T.A.B.)

in order to include control merely by "persons with whom the other corporation does not deal at arm's length".

Accordingly, if by clause (B) of section 95(1)(b)(i) it had been intended to include in the meaning of "foreign affiliate" a corporation controlled solely by a taxpayer with whom a Canadian taxpayer did not (or was deemed not to) deal at arm's length, it ought to have been expressly so provided. In this connection it should be noted that the term "taxpayer" is defined by section 248 (1) to include any "person" (which includes a corporation) whether or not liable to pay tax; hence a non-resident corporation is considered to be a "taxpayer". The effect of this construction on the example illustrated above is that N could not be considered a foreign affiliate of C.

Future jurisprudence may show that the phrase "controlled, directly or indirectly in any manner whatever" has expanded the meaning of "control" to encompass *de facto* control. Traditionally, courts which have had to pass upon the meaning of "control" of a corporation in taxing statutes have construed it strictly to refer to *de jure* control resulting from ownership, or direct influence over, sufficient voting shares to enable the holders to elect a majority of a corporation's board of directors.²⁰ Generally this has required that over 50% of the votes entitled to be cast at a shareholder's meeting for the purpose of electing directors be held by a "controlling" shareholder. The Supreme Court held in 1967 that a shareholder who owned an even 50% of the *only class* of voting shares of a corporation, but who was entitled to exercise the casting or deciding vote in the event of a tie, did not "control" the corporation, the casting vote being merely an adjunct of the office held by the shareholder and not his personal property.²¹ However, in a 1971 decision the Supreme Court held that a group of shareholders who owned 100% of a corporation's common shares but only 50% of its overall voting shares did have control, since the group enjoyed the power to cause the corporation to be dissolved, whereupon it would participate to an extent greater than 50%.²²

²⁰ See, for example, *B. W. Nobb Ltd. v. C.I.R.* (1917, 12 T.C. 926; *British American Tobacco Co. v. C.I.R.*, [1943] 1 All E.R. 13; *C.I.R. v. J. Bibby and Sons Limited*, [1945] 1 All E.R. 667; *Vancouver Towing Company Limited v. M.N.R.* 2 D.T.C. 706 (Ex. Ct.); *M.N.R. v. Wrights' Canadian Ropes Limited* 2 D.T.C. 927 (Ex. Ct.); *C.I.R. v. Silverts Limited* (1951) 1 All E.R. 703; *M.N.R. v. Sheldons Engineering Limited* 54 D.T.C. 1106 (Ex. Ct.), 55 D.T.C. 1110 (S.C.C.); *Buckerfield's Limited et al v. M.N.R.* 64 D.T.C. 5301 (Ex. Ct.); *Vineland Quarries and Crushed Stone Limited v. M.N.R.* 66 D.T.C. 5092 (Ex. Ct.) (taxpayer's appeal to Supreme Court dismissed without written reasons); *M.N.R. v. Dworkin Furs (Pembroke) Limited et al* 65 D.T.C. 5277 (Ex. Ct.), 67 D.T.C. 5035 (S.C.C.); *Vina-Rug (Canada) Limited v. M.N.R.* 68 D.T.C. 5021 (S.C.C.); *Donald Applicators Limited et al v. M.N.R.* 69 D.T.C. 5122 (Ex. Ct.) (taxpayer's appeal to Supreme Court dismissed without written reasons).

²¹ *M.N.R. v. Dworkin Furs (Pembroke) Limited et al* 67 D.T.C. 5035.

²² *Oakfield Developments (Toronto) Limited v. M.N.R.* 71 D.T.C. 5175. In this case the "controlling group" controlled 50% of the voting power through their ownership of common shares; they were entitled to all the surplus profits on a distribution by way of dividend after payment of a fixed cumulative dividend to preferred shareholders; on a winding-up they would receive all of the surplus remaining after the return of capital and after the payment of a 10% premium to preferred shareholders; and they had sufficient voting power to authorize a surrender of the company's charter. These circumstances were held to be sufficient to vest control in the group even though the preferred shareholders held the remaining 50% of the voting power.

In what may amount to a further break with tradition, the Supreme Court recently held that a shareholder owning a majority of a corporation's shares which carried the right to vote on a wide variety of matters, but not on the election of directors, nevertheless was the controlling shareholder.²³ However in that case the shareholder's voting power did extend to passing shareholders' resolutions, removing certain powers from the board of directors, dismissing directors and indirectly vesting itself with the ability to elect directors. The Supreme Court based its judgment upon the following excerpt from the reasons for judgment of Mr. Justice Thurlow in the Exchequer Court:

While the present is a converse case in that a particular shareholder has the voting power to pass a special resolution but no immediate right to elect directors, it seems to me that the same guiding principle can be applied. A shareholder who, though lacking immediate voting power to elect directors, has sufficient voting power to pass any ordinary resolution that may come before a meeting of shareholders and to pass as well a special resolution through which he can take away the powers of the directors and reserve decisions to his class of shareholders, dismiss directors from office and ultimately even secure the right to elect the directors is a person of whom I do not think it can correctly be said he has not *in the long run* the control of the company. Such a person in my view has the kind of *de jure* control contemplated by section 39 of the Act.²⁴

The cases decided by the courts to date have, in most instances,²⁵ dealt with the word "control" unmodified. The "control test" for foreign affiliate purposes, as well as for numerous other purposes in the newly-amended Income Tax Act,²⁶ must be construed in light of the entire phrase "controlled, directly or indirectly in any manner whatever". It remains to be seen whether the courts will attribute sufficient importance to the added words to construe control as meaning something beyond *de jure* control.²⁷

It is of interest to note that the application of the "saving provision",²⁸ whereby a person who acquired (by way of security only) a controlling block of the shares of a corporation to which he had extended a loan was not (under the former Act) considered to control the corporation pursuant to the "associated corporation" rules, has been extended. In the future that provision will not be restricted to the associated corporation rules, but will apply for all purposes of the Income Tax Act. Section 256(6) of the present Act provides:

256(6) Where, for the purposes of any provision of this Act, one corporation resident in Canada (in this subsection referred to as the 'controlled corporation')

²³ *Donald Applicators Limited v. M.N.R.* 69 D.T.C. 5122 (Ex. Ct.) 71 D.T.C. 5202 (S.C.C.).

²⁴ At page 5126 of 69 D.T.C.

²⁵ The phrase "controlled, whether through holding a majority of the shares of the corporation or in any other manner whatever" was used in the definition of a "personal corporation" in section 68(1) of the former Act. However the phrase "in any other manner whatsoever" appears to contemplate control (*eiusdem generis*) through voting control. Furthermore, the phrase as found in section 68(1) has not been judicially defined by Canadian courts. For an English decision giving little weight to a similar phrase see *Himley Estates Ltd. and Humble Investments Ltd. v. C.I.R.* 17 T.C. 367, at 375, 377 et seq.

²⁶ See, for example, sections 19(5) (b) (v)(c); 125(6) (a); and 189(4) (b) (iii).

²⁷ See David I. Matheson, *Corporate Control Concepts and Tax Reform* (1972), 20 Canada Tax Journal 45.

²⁸ Section 39(6) of the former Act.

would, but for this subsection, be regarded as having been controlled by another corporation resident in Canada (in this subsection referred to as the 'controller') at a particular time and it is established to the satisfaction of the Minister that

- (a) there was in effect at the particular time an agreement or arrangement enforceable according to the terms thereof, under which, upon the satisfaction of a condition or the happening of an event that it is reasonable to expect will be satisfied or happen, the controlled corporation will
 - (i) cease to be controlled by the controller, and
 - (ii) become controlled by a person or group of persons, with whom or with each of the members of which, as the case may be, the controller was at the particular time dealing at arm's length, and
- (b) the chief purpose for which the controlled corporation was at the particular time so controlled was the safeguarding of rights or interests of the controller in respect of
 - (i) any loan made by the controller the whole or any part of the principal amount of which was outstanding at the particular time, or
 - (ii) any shares of the capital stock of the controlled corporation that were owned by the controller at the particular time and that were, under the agreement or arrangement, to be redeemed by the controlled corporation or purchased by the person or group of persons referred to in subparagraph (a) (ii),

the controlled corporation shall be deemed, for the purposes of that provision, not to have been controlled by the controller at the particular time.

Because this provision applies only as between a Canadian lender and a *Canadian* corporate borrower, its relevance to the foreign affiliate voting and equity percentage tests and control test will be in determining the voting and equity percentages and control exerted by Canadian-resident taxpayers *with whom a particular Canadian taxpayer "does not deal at arm's length"*.²⁹ It will not be relevant in circumstances where a Canadian lender receives, as security for a loan made to a non-resident corporation, sufficient shares to carry control of the non-resident either alone or in concert with other taxpayers with whom the Canadian lender does not deal at arm's length.

Another important provision when discussing the control test is found in section 95(7)(c). It provides that a person who has a contractual right to acquire (either immediately or in the future and either absolutely or contingently) shares of a corporation may be deemed to be the owner of such shares if one of the main reasons for the existence of the right may reasonably be considered to be the reduction or postponement of tax. If the existence of such a right would confer upon a Canadian taxpayer a 25% voting percentage, a 50% equity percentage or control of the non-resident corporation which granted the right, such corporation would be a foreign affiliate; its foreign accrual property income would be included in computing the Canadian taxpayer's income notwithstanding that such taxpayer might never actually receive (or might never be legally able, in the case of a right which was merely contingent, to receive) dividends from those shares.

Options to acquire shares in non-resident corporations which earn passive income should therefore be reviewed carefully to ensure either that (a) none of the main reasons for their existence is the reduction or postponement of income tax or (b) that their existence will not render the corpo-

²⁹ See subparagraphs (i), (ii) and (iii) of section 95(1) (b).

ration, the shares of which are the subject of the option, a foreign affiliate of the holder of the option.

Foreign Accrual Property Income

After a brief transitional period, the "participating percentage" share of a Canadian taxpayer in a foreign affiliate's "foreign accrual property income" (and in certain types of dividends which the foreign affiliate receives from other foreign affiliates of the Canadian taxpayer) must be included in computing the taxpayer's income. The inclusion in income of foreign accrual property income will be required to be made in the year in which it is earned or received by the foreign affiliate, not in a subsequent year when it may be passed on to the Canadian taxpayer.

Several key sentences in the Department of Finance's publication entitled "Summary of 1971 Tax Reform Legislation" describe the government's aim in introducing the complex foreign accrual property income attribution rules as part of the tax reform package:

The purpose of these special rules is to remove the tax advantage that would otherwise be gained from the transfer of investments abroad, particularly to those jurisdictions which are popularly referred to as 'tax havens'. These rules will *not* apply to *active business income*.

A Canadian shareholder of a foreign affiliate will be required to include in his income his proportionate share of the affiliate's *diverted* income (generally investment income and capital gains) whether or not that income is actually distributed to him.³⁰ (*Italics added*).

It is evident that the Canadian government is attempting to remove any advantage which could be derived from "diverting" passive income that would otherwise be taxed in Canada through a corporation or trust located in a tax haven: it is not attempting to affect "active business income." However the critical question is whether that intention has been achieved by the language used in the Act.

In 1962 the United States enacted provisions designed to neutralize the tax treatment as between investment at home and investment abroad by eliminating the deferral of income tax available in respect of the latter. Those provisions, known as "subpart F"³¹ of the Internal Revenue Code, require a U.S. taxpayer owning more than 50% of the voting shares of a foreign corporation ("controlled foreign corporation", or "C.F.C.") to include in income the appropriate share of specified categories of the foreign corporation's income. Subpart F reaches a variety of different sources of income.

1. The most common operation affected by subpart F is that of a foreign sales company, whereby a C.F.C. purchases goods from or sells goods to a related party and both the purchase and sale occur outside the country in which the C.F.C. was incorporated.
2. If a C.F.C. carries on services for a related party outside the country in which the C.F.C. was incorporated, such service income is ren-

³⁰ Page 57.

³¹ International Revenue Code, 1954, sections 951-964 as amended by the Revenue Act of 1962.

dered taxable by subpart F. From items 1 and 2, it is apparent that subpart F taxes even "active business" income which a U.S. taxpayer attempts to divert to a foreign country, other than the country of destination.

3. The type of income which most closely approximates the Canadian concept of "foreign accrual property income" is designated "foreign personal holding company income".³² It includes dividends, rents and royalties.

Contrary to the threatening overtones contained in the "White Paper Proposals for Tax Reform" issued by the Canadian Government on November 7, 1969 to the effect that a system similar to subpart F would be instituted in Canada, the foreign accrual property income rules purport to ignore sales and services income of the type described in the first two items in the preceding list (provided the affiliate carries on an *active* business).

Definition of "Foreign Accrual Property Income"

Certain dividends received by one foreign affiliate from another foreign affiliate are required to be included in the income of a Canadian taxpayer in much the same manner as passive income. Such dividends are, however, expressly excluded from the definition of "foreign accrual property income": they are dealt with later in this paper.

Section 95(1) (a) defines "foreign accrual property income" (or "FAPI", as it has been affectionately dubbed by tax practitioners) of a foreign affiliate of a Canadian taxpayer to mean the aggregate of

- (i) the affiliate's incomes for the year (net of losses) from property (other than dividends received from other foreign affiliates of the Canadian taxpayer) and from businesses other than active businesses, and
- (ii) the affiliate's taxable capital gains for the year (net of allowable capital losses) from dispositions of property (other than tangible property used exclusively for the purpose of gaining or producing income from an active business carried on by it).

The report of the Standing Senate Committee on Banking, Trade and Commerce,³³ questioned whether the FAPI provisions do indeed effectively tax only diverted passive income:

Most certainly, the objective of attempting to thwart tax avoidance is a valid one. However, the anti-avoidance rules related to diverted income are extended in such an indiscriminate manner as to encompass not only diverted income but also all passive income of foreign affiliates even though the affiliates are established for bona fide business purposes and are not established or used for the purpose of diverting passive income abroad in order to avoid or unduly defer Canadian income tax.

This is particularly unfortunate in the light of the fact that the proposed legislation does not define what income is to be excluded from the diverted income.

³² Section 954(a) (1) and (c).

³³ Appendix to Debates of the Senate, Hansard, November 4, 1971, at 5.

rules as being "active business income". Because of this, there is a serious danger that income such as interest received by a foreign affiliate on short term deposits or on trade receivables and royalties received by such an affiliate in respect of patents or know-how developed by it abroad in the course of its active business operations (to name but a few) may be taxed currently in the hands of the Canadian shareholder as diverted income even though such income is in fact directly attributable to the foreign affiliate's active business. Such income is not diverted income.³⁴

Dealing with this and similar criticisms, The Honourable E. J. Benson, then Minister of Finance, made the following statement in the House of Commons:

Second, many taxpayers have expressed concern that rental income, interest income and capital gains on property used in connection with an active business will be subject to the foreign accrual property income rules. The bill is not quite clear on this point, namely, that such income will not be treated as foreign accrual property income if it is earned in connection with the carrying on of an active business. I want to reassure the House on this point. Frankly, people are misreading the bill in this connection and those who urge that the term 'active business income' be precisely defined are arguing against their own best interests. If the term is defined, it is bound to be defined narrowly. As it now stands, there is room for the taxpayer to argue about specific factual situations.³⁵

The whole problem appears to stem from the fact that "foreign accrual property income" is defined to include "income from property", without any modification of that phrase to restrict its application to income from property resulting from, or used primarily for the purpose of gaining or producing income from, an active business. Traditionally income from property and income from business have been accorded somewhat disparate tax treatment.³⁶ Income from property is generally regarded as the return on invested funds where relatively little time and activity is expended to produce the income,³⁷ whereas income from a business usually results from the sale of goods or services.

It is submitted that in order to achieve the results intended by the Department of Finance, a qualification to the phrase "income from property" in the definition of "FAPI" is needed.

In his budget address of May 8, 1972, The Honourable J. N. Turner, Minister of Finance, admitted that FAPI is "a difficult area", that the passive income rules "may produce unintended results in particular cases" and that he was not satisfied that the Government had "yet found appropriate solutions which will eliminate the difficulties, while preserving the basic thrust of the reform."³⁸

³⁴ Interested readers should also refer to the comments of the Joint C.B.A.-C.I.C.A. Committee on this subject, at page 5-5 and the following of this brief.

³⁵ House of Commons Debates, Hansard, December 10, 1971, Vol. 115, No. 229, at 10360.

³⁶ For example, only losses from a business could be used to reduce profits therefrom in the preceding taxation year and the following five taxation years. No carry-over was granted for losses from a property.

³⁷ The comparison is, of course, complicated by such fine distinctions as "adventure or concern in the nature of trade" and active vs. non-active business.

³⁸ Budget Speech, May 8, 1972, page 19.

Section 95(2) provides that for the purposes of the definition of "FAPI", each taxable capital gain and each allowable capital loss of an affiliate shall be computed according to the Income Tax Act as if the affiliate were a resident of Canada.

There is no comparable provision relating to the computation of an affiliate's income from property or income from non-active businesses. However section 4(1) (a) states that for the purposes of the Act a taxpayer's income or loss from, inter alia, a business, property or other source is his income or loss computed in accordance with the Income Tax Act. Section 9(1) provides that a taxpayer's income from a business or property is his profit therefrom for the year. Finally, section 3 prescribes a series of rules for computing a taxpayer's income for a taxation year. Hence it is reasonable to construe section 95(1)(a) as requiring foreign accrual property income of a foreign affiliate to be computed pursuant to the provisions of the Canadian Income Tax Act for the purpose of determining the amount of such income that will be attributed to the Canadian taxpayer.³⁹ It is therefore expected that the deductions allowed by subdivisions b and e of Division B of the Income Tax Act will be available for use by a Canadian taxpayer attempting to determine the amount of an affiliate's FAPI which must be included in computing the taxpayer's income.⁴⁰

If a foreign affiliate is subject to the provisions of the Canadian Income Tax Act for the purpose of computing its foreign accrual property income, presumably any dispositions by an affiliate which are not made at arm's length would be considered to have been made at fair market value pursuant to section 69(1)(b). As will be discussed further below, it seems that few "rollovers" will be applicable to transfers of capital property by or to foreign affiliates, even if permitted by the tax law of the jurisdiction in which the affiliate is incorporated or resident.

One of the more significant deductions in computing income permitted by subdivision b of Division B is, of course, capital cost allowance.⁴¹ In 1970 the Supreme Court of Canada held that an otherwise depreciable asset did not constitute "depreciable property" in the hands of a non-resident.⁴² The appellant, a Canadian-resident corporation, had attempted to claim a "terminal loss"⁴³ resulting from the sale of a capital asset (an airplane) to its U.S.

³⁹ This conclusion is in marked contrast to the computation of a foreign affiliate's "active business income" earned in a foreign country, which, as the proposed regulations provide (at page 13 of the Appendix) is to be governed wherever possible by the tax laws of the country in which the affiliate is incorporated.

⁴⁰ See also section 4(1) (a), which defines "income" from a particular source to be income computed in accordance with the Act on the assumption that the taxpayer had during the taxation year no income except from that source and was allowed no deductions in computing his income for the taxation year except such deductions as may reasonably be regarded as wholly applicable to that source and except such part of any other deductions as may reasonably be regarded as applicable thereto.

⁴¹ Section 20(1) (a).

⁴² *Lea-Don Canada Limited v. M.N.R.*, [1969] C.T.C. 85 (Ex. Ct.), [1970] C.T.C. 346 (S.C.C.).

⁴³ Regulation 1100(2).

parent company. The Minister of National Revenue not only disallowed the terminal loss deduction, but, contending that the fair market value of the airplane exceeded the transfer price, attempted to "recapture" an amount of capital cost allowance which the appellant had claimed on the airplane in previous years. The appellant argued that its U.S. parent company was a non-arm's-length "taxpayer" and that section 20(4)⁴⁴ should apply to preclude the appellant from incurring recapture. In rejecting the appellant's contention, Mr. Justice Hall agreed with the conclusion reached by the trial judge, Mr. Justice Cattanach:

The learned trial judge based his conclusion on a finding that the parent company being a non-resident, a computation of its Canadian income is neither necessary nor relevant and further that in its hands the aircraft was not 'depreciable property' because, under the Regulations, a capital cost allowance can be claimed by non-residents only if carrying on business in Canada or if receiving income from property within Section 110 of the Act.⁴⁵

It is submitted that the terms of this decision of the Supreme Court ought not to govern the computation of the FAPI of a foreign affiliate of a Canadian taxpayer. It is submitted that the Supreme Court's conclusion rested upon the fact that the rules prescribed by the Income Tax Act relating to the computation of income of the particular U.S. parent company were wholly irrelevant for Canadian tax purposes in 1970; that such a premise no longer exists with respect to FAPI earned by a foreign affiliate; that the Income Tax Act requires a Canadian taxpayer to pay tax on a foreign affiliate's FAPI pursuant to Canadian income tax law; and that therefore, in computing FAPI an affiliate is entitled to claim the deductions allowed by the Income Tax Act.

In any event a more substantial problem in this area appears to arise from the fact that the present section 1102(3) of the Income Tax Regulations provides that where a non-resident taxpayer is concerned, the classes of property described in Part XI of the Regulations (ie. the capital cost allowance provisions) and in Schedule B shall be deemed not to include property situated outside Canada. The existing Income Tax Regulations are bound to undergo substantial revision during the course of the current year, and it is hoped that the amendment necessary to remedy this deficiency will be forthcoming prior to the coming into force of the FAPI provisions.

Several other significant conclusions may be drawn from the definition of "FAPI":

1. FAPI can never be a negative amount. It is defined in such a way that only positive income and positive taxable capital gains, if any, will be attributed to the Canadian taxpayer. Property, business and capital losses incurred by a foreign affiliate will reduce its income from property and businesses and its capital gains respectively to zero but no further. Hence the Canadian taxpayer will not be able to

⁴⁴ The present Income Tax Act contains no provision similar to section 20(4) of the former Act, and accordingly all non-arm's-length transfers of depreciable (and other) property will be considered as having been effected at fair market value, except in the limited "rollover" situations.

⁴⁵ At page 348.

apply actual foreign accrual property losses for a taxation year to reduce any income from other sources for the year pursuant to section 3(d), nor will the Canadian taxpayer be permitted to apply actual capital losses sustained by an affiliate for the year in reduction of either taxable capital gains from other sources under section 3(b) or (in the case of an individual Canadian taxpayer) up to \$1,000 of other income under section 3(e). Furthermore, no business, property⁴⁶ or capital loss⁴⁷ carry-back or carry-forward will be available to the Canadian taxpayer in computing taxable income, where such losses actually arise in the foreign affiliate.

2. FAPI is to be computed separately for each foreign affiliate of a taxpayer rather than on a consolidated basis. Thus if one foreign affiliate of a taxpayer had \$20,000 of FAPI in a particular year and another foreign affiliate of the same taxpayer had foreign accrual property losses of \$20,000 in the same year, the taxpayer would be required to include in income the first affiliate's FAPI of \$20,000 with no recognition of the foreign accrual property losses of \$20,000 sustained by the second affiliate. This would indicate that wherever possible FAPI of a particular affiliate should be timed to arise in a year in which it could be offset by foreign accrual property losses of that same affiliate.
3. FAPI includes not only foreign-source income of an affiliate, but also any income earned by the affiliate from Canadian sources.
4. It is submitted that "eligible capital amounts"⁴⁸ received by a foreign affiliate in respect of a disposition by it of "eligible capital property"⁴⁹ (for example, goodwill) which it had developed in the course of carrying on an active business will not be included in computing the affiliate's FAPI. Although eligible capital amounts are required by section 14(1) of the Act to be included in computing the vendor's "income", they are specifically designated to be included as income from a business, rather than from property. They are not considered to be capital gains.⁵⁰ Hence, eligible capital amounts received by a foreign affiliate will, in most circumstances,⁵¹ constitute income from an active business, and accordingly will be excluded from FAPI.
5. In order to guard against retroactive taxation of a foreign affiliate's capital gains, section 95(2) of the Act and rule 35(2) of the Income Tax Application Rules ("I.T.A.R.") combine to provide that in computing each taxable capital gain (and allowable capital loss) of a foreign affiliate there shall not be included such portion of the gain

⁴⁶ Technically termed "non-capital losses" by sections 111(1) (a) and 111(8) (b).

⁴⁷ Technically termed "net capital losses" by sections 111(1) (b) and 111(8) (a).

⁴⁸ Section 14(1).

⁴⁹ Section 54(d).

⁵⁰ See section 39(1) (a).

⁵¹ The only possible exception would appear to be where goodwill developed in (or purchased by) a non-active business is sold, however such occurrences will be exceedingly rare.

(or loss) as may reasonably be considered to have accrued before January 1, 1972. The "tax-free zone rules", established by I.T.A.R. 26(3), which govern the computation of capital gains and losses of taxpayers in respect of property owned by them on December 31, 1971, (and which also ensure that gains accrued before January 1, 1972 will not be taxed) are not applicable to foreign affiliates.

Furthermore, if a non-resident corporation becomes a foreign affiliate of a Canadian taxpayer at a particular time after 1971, such portion of the affiliate's taxable capital gains (or allowable capital losses) as may reasonably be considered to have accrued before that particular time are not included in computing the amount of its taxable capital gains (or allowable capital losses).

6. Although section 95(2) requires the capital gains provisions of the Income Tax Act to be applied by a Canadian taxpayer in computing the amount of a foreign affiliate's capital gains or losses, there is no provision to permit affiliates any capital gains tax deferral in respect of corporate reorganizations or transfers of property resulting in no net economic benefit being realized by the Canadian taxpayer. Canadian-resident taxpayers are, on the other hand, permitted limited deferrals of their capital gains tax on such transactions as transfers of capital property or eligible capital property to an 80%-controlled Canadian corporation⁵² or to a Canadian partnership⁵³ transfers of property to a Canadian parent company from a wholly-owned Canadian subsidiary,⁵⁴ and amalgamations of Canadian corporations,⁵⁵ to cite just a few. Since by definition a foreign affiliate is a non-resident corporation, transfers of capital property to an affiliate, or by one affiliate to another, will not be eligible for such deferrals.⁵⁶
7. The manner in which section 95(1) (a) is drafted would indicate that a foreign affiliate's allowable capital losses will be able to reduce any of the affiliate's other FAPI. Canadian corporate taxpayers may deduct allowable capital losses from taxable capital gains only. Foreign affiliates are not subject to such a limitation, presumably in order to compensate for their not being able to apply net capital losses against taxable capital gains in any future years. Section 95(2) merely requires a foreign affiliate to apply the rules of subdivision c in computing the amount of each taxable capital gain and each allowable capital loss.
8. Section 91(2) requires that a Canadian taxpayer include FAPI in income only if the FAPI from all foreign affiliates attributable to such

⁵² Section 85(1).

⁵³ Section 97(2).

⁵⁴ Section 88.

⁵⁵ Section 87.

⁵⁶ In this connection the Joint C.B.A.-C.I.C.A. Committee at pages 5-7 and 5-8 of its brief, recommended a capital gains tax deferral on the sale of one controlled foreign affiliate to another foreign affiliate, the liquidation of one or more foreign affiliates into another and the transfer of residency or places of incorporation of a foreign affiliate, where such transactions are part of any bona fide reorganization from which the Canadian taxpayer obtains no Canadian tax advantage.

taxpayer for the year exceeds \$500. The \$500 is a *de minimis* exclusion, not a deduction: accordingly if the Canadian taxpayer's FAPI amounted to \$501, the full amount thereof would have to be included in income for the year. In computing the \$500 exclusion, a deduction is allowed in respect of the taxpayer's portion of any income tax (called "foreign accrual tax applicable")⁵⁷ paid by the foreign affiliate to its home country.⁵⁸

9. A Canadian taxpayer will be permitted to deduct a reserve in computing the amount of FAPI of an affiliate to the extent that the effect of any monetary or exchange restrictions imposed by the law of a country other than Canada would impose "undue hardship" on the Canadian taxpayer.⁵⁹ The restrictions apparently need not have been imposed by the country in which the foreign affiliate is resident; relief will be available where the restrictions of any country would have an unduly harsh effect on a Canadian taxpayer. However before the taxpayer may claim the deduction in computing his FAPI, the consent of the Minister of National Revenue must be obtained. In addition, the amount of any reserve so deducted must be included in computing the taxpayer's income for the following taxation year.⁶⁰
10. In addition to a foreign exchange reserve a Canadian taxpayer will be able to defer the recognition of any income that would arise out of receiving compensation for the expropriation by a foreign government of an interest of the taxpayer in a foreign affiliate that carried on business in such foreign country. The taxpayer may also elect to have all or a portion of interest on unpaid compensation treated as a return of capital. All receipts of the taxpayer in excess of the total amount of compensation would be regarded as interest.⁶¹

"Participating Percentage"

The inclusion of FAPI in the income of a Canadian taxpayer, required by section 91(1)(a), is "in respect of each share owned by the taxpayer of the capital stock of a foreign affiliate of the taxpayer". While at first glance this would appear to include in the Canadian taxpayer's income only FAPI of a foreign affiliate the shares of which are held directly by such taxpayer, that is not the case. Rather, each share directly held by a Canadian taxpayer in a foreign affiliate is said to have a "participating percentage" in respect of every other foreign affiliate of the taxpayer in which the first-mentioned affiliate has a direct or indirect interest. The participating percentage of each directly held share is applied to the FAPI of each foreign affiliate in which such share represents an interest, and the resulting sum is the amount which is attributable to the Canadian taxpayer's income for the year.

⁵⁷ Sections 113(3) and 113(7).

⁵⁸ If the Canadian taxpayer is a corporation the deduction is doubled.

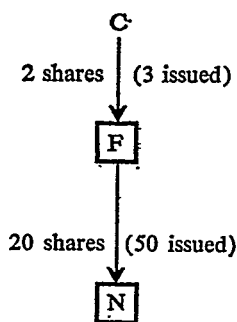
⁵⁹ Section 91(3).

⁶⁰ Section 91(4).

⁶¹ Budget Resolution Number 24, May 8, 1972.

The "participating percentage" of a particular share owned by a Canadian taxpayer of the capital stock of a corporation in respect of any particular foreign affiliate of the taxpayer is defined in section 95(1)(c). In general terms the participating percentage of a single share of the taxpayer is equivalent to the equity percentage computed as if the taxpayer owned no shares other than that single share. Each single share of a Canadian taxpayer may have a different participating percentage in respect of each different foreign affiliate of that taxpayer.

Thus where Canadian taxpayer "C" owns 2 common shares of an aggregate of 3 issued common shares of foreign affiliate "F", and where F in turn owns 20 of the 50 issued common shares of non-resident corporation "N", the participating percentage of each of C's shares in F is calculated as follows:



1. As mentioned above, F is a foreign affiliate of C since C has a 66.6% voting (and equity) percentage in F.
2. Each one of C's shares of F has a participating percentage of (66.7% multiplied by $\frac{1}{2}$) 33.3% in respect of F.
3. N is a foreign affiliate of C since C has a voting percentage in N of (66.7% multiplied by 40%) 26.7%. C's equity percentage in N (which must be determined in order to compute C's participating in N) is also 26.7%.
4. Each of C's shares of F has a participating percentage of (26.7% multiplied by $\frac{1}{2}$) 13.3% in respect of N. If instead F had owned 30 of 50 issued shares of N, each of C's shares of F would have had a participating percentage of (40% multiplied by $\frac{1}{2}$) 20% in respect of N.
5. Accordingly C must include in computing income in each year
 - (a) 66.7% of the FAPI of F, plus
 - (b) 26.7% of the FAPI of N.

Section 95(1)(c) provides relief to a Canadian taxpayer where the aggregate of participating percentages of all shares owned by the taxpayer in a foreign affiliate in respect of any particular foreign affiliate exceeds the taxpayer's equity percentage in the particular affiliate. In such a situation each share's participating percentage in respect of the particular affiliate is

reduced so that the aggregate of those participating percentages will not exceed the taxpayer's equity percentage in the particular affiliate. For example, assume that Canadian taxpayer "C" owns all of the issued 8% preferred shares of his foreign affiliate "F" and 60% of the common shares of F. C's equity percentage in F is 100% (the *greater* of 100% and 60%). C's participating percentage (as computed in the first instance) of all of his shares in F would total 160%; however, section 95(1) (c) (ii) reduces C's participating percentage to $(\frac{100}{160} \times 160) 100\%$.

As illustrated under the heading "Equity Percentage", *supra*, it may nevertheless happen that Canadian taxpayer "C" could have both an equity percentage and a participating percentage in a foreign affiliate far in excess of 100%. Consider a situation wherein C owns all of the issued preferred shares of a particular non-resident corporation "N" plus all of the issued common shares of foreign affiliate "F". F in turn owns 60% of the common shares of N. C's equity percentage in N is (100% direct plus 60% indirect) 160%. The aggregate of C's participating percentages in N is similarly 160%. C would therefore have to include in income 160% of the FAPI of N plus 100% of the FAPI of F in these circumstances.

Similarly, as was mentioned earlier, it is quite possible for each of several Canadian taxpayers to have a 100% participating percentage in a common foreign affiliate. This would arise where, for example, unrelated Canadian taxpayers "X", "Y" and "Z" owned respectively all of the issued common shares, all of the issued Class "A" preferred shares and all of the issued Class "B" preferred shares of a single foreign affiliate "F". In that event X, Y and Z would all include, in computing their income for a particular taxation year, 100% of the FAPI of F.

Section 91(1) (a) requires the FAPI earned by a particular foreign affiliate to be attributed to the Canadian taxpayer in that taxpayer's taxation year in which the particular foreign affiliate's taxation year ends. FAPI is therefore attributed to the Canadian taxpayer as it is earned by his foreign affiliate.

I.T.A.R. 35(3) as varied by the May 8, 1972 budget, will provide that no FAPI of a particular foreign affiliate shall be attributed to a Canadian taxpayer until the first taxation year of the particular affiliate which commences after December 31, 1974. That means that the first taxation year of many Canadian taxpayers in which FAPI will be taxed will be their 1976 taxation year.⁶²

There are two distinct but closely related Canadian tax consequences of a foreign affiliate's earning FAPI. The first involves the extent of the inclusion of FAPI in a Canadian taxpayer's income and the extent of the deduction by him of any "foreign accrual tax applicable"⁶³ thereto. The second centres

⁶² If the foreign affiliate's taxation year ended on December 31, its FAPI will be attributed in the Canadian taxpayer's 1975 taxation year. In most other cases the first taxation year in which FAPI would be attributed will be the Canadian taxpayer's 1976 taxation year.

⁶³ Section 90(2).

around the additions to (and subtractions from) the adjusted cost base of the Canadian taxpayer's shares in a foreign affiliate in respect of FAPI attributed to such shares (and dividends paid on them).

Deductions From FAPI

The Canadian tax treatment of FAPI varies according to whether the Canadian taxpayer is an individual or a corporation. Section 113(3) (a) provides that where an individual taxpayer resident in Canada has been required to include FAPI of a foreign affiliate in his income in a year, he may deduct in computing his taxable income for the same year the lesser of the amount of FAPI so included and the "foreign accrual tax applicable" to that amount.

Section 113(7) defines "foreign accrual tax applicable" to a particular amount of FAPI which has been attributed to a Canadian taxpayer as the portion of any income or profits tax paid by the foreign affiliate that may reasonably be regarded as applicable to that particular FAPI. There is no limitation upon the number of countries to which the affiliate may have paid tax on its FAPI. If, for example, a Canadian taxpayer's foreign affiliate resident in the United States earned rental income from property held in Brazil, the foreign accrual tax applicable to the Canadian taxpayer's portion of such rental income would be the equivalent portion of the aggregate of income taxes paid by the affiliate to both Brazil and the United States. If, in the year in which such affiliate earned the rental income it were also to pay a dividend therefrom to its shareholders, the Canadian taxpayer could not increase the foreign accrual tax applicable to the FAPI by the amount of U.S. withholding tax eligible upon the dividend, since that would be a tax which was paid by the Canadian taxpayer, not by the affiliate. Further, if the U.S. affiliate had formed a Brazilian company to receive the rental income, the Canadian taxpayer would not be able to include in the deductible amount of foreign accrual tax applicable to such income the U.S. income tax paid by the U.S. affiliate on dividends received from the Brazilian subsidiary. As will be discussed later in this paper, the Canadian taxpayer would not get a deduction by way of foreign accrual tax in respect of the U.S. income tax levied upon the dividend from the Brazilian company because that dividend would be neither attributed nor taxable to the Canadian taxpayer.⁶⁴ As will also be discussed later, a Canadian taxpayer will frequently not be able to use foreign withholding tax levied upon dividends paid by an affiliate to the Canadian taxpayer to offset his Canadian income tax, since dividends paid out of an affiliate's previously-taxed FAPI will not be taxable.⁶⁵ In such circumstances the Canadian taxpayer might benefit far more by receiving the passive income directly, rather than through a foreign affiliate, so that a tax credit could be claimed against all foreign income taxes paid by the taxpayer.⁶⁶

⁶⁴ Since it would be paid out of the Brazilian company's "exempt surplus".

⁶⁵ Section 90(2).

⁶⁶ Section 126(1).

As the following example demonstrates, an individual Canadian taxpayer will often be placed under a more onerous tax burden by earning passive income in a foreign affiliate (Column I) than by earning the same income directly (Column II).

	I	II
Rental Income Received in Bahamas by Foreign Affiliate from U.S. Tenant	\$600	- - -
Rental Income Received in Canada Directly from U.S. Tenant	- -	\$600
U.S. Withholding Tax — 30%	180	- - -
— 15%	- -	90
Gross Amount of Passive Income	600	600
Deduct Foreign Accrual Tax Applicable Income	180	- - -
	420	600
Canadian Tax (50%)	210	300
Canadian Foreign Tax Credit	- -	90
Total Canadian Tax	210	210
Total U.S. Tax	180	90
Total Combined Tax	\$390	\$300

Column I shows that where a Canadian individual attempts to divert income through a tax haven, he will in future be placed under a heavier tax burden. His tax burden will be heavier than it was under the former Act since he will be unable to either defer income tax on the affiliate's FAPI or sell its shares for a tax-free capital gain. His burden under the present Act will be heavier than if he received the same income directly, since the United States (and most other countries with which Canada has a tax treaty) levies a higher rate of withholding tax on income earned in the U.S. and paid to taxpayers in countries with which the United States has not entered into a tax treaty. The higher amount of U.S. withholding tax paid by the foreign affiliate qualifies for deduction from the affiliate's FAPI only, and not for deduction from Canadian income tax paid by the individual Canadian taxpayer. It is anticipated that many Canadian individual shareholders will be reorganizing their affairs in order to avoid the situation illustrated by column I above.

Canadian *corporate* taxpayers to which FAPI is attributed are entitled, under section 113 (3) (b), to deduct from the gross amount of FAPI two times the foreign accrual tax applicable thereto. This is apparently in recognition of a degree of double taxation of corporate income after it has been distributed to shareholders.

The deduction permitted corporate taxpayers of twice the foreign accrual tax applicable to their FAPI approximates a full tax credit for the tax paid by the foreign affiliate. However, as the federal rate of corporate tax gradually declines from 50% to 46% in 1976,⁶⁷ the corporate taxpayer earning FAPI through an affiliate will (because of the higher level of foreign withholding tax thereon) have less FAPI available to be taxed at the reduced

⁶⁷ Section 123.

Canadian rate. Canadian corporate taxpayers (like Canadian individual taxpayers) will therefore not generally be inclined to earn (or divert) passive income through a foreign affiliate.

In the example which follows, the tax position of a Canadian corporation which earns passive income through a foreign affiliate (Column I) is compared with the tax position of the same corporation earning the same income directly (Column II). Note particularly the effect of the decrease in the corporate tax rate to 46%.

	I	II
Rental Income Received in Bahamas by Foreign Affiliate from U.S. Tenant	\$600	- - -
Rental Income Received in Canada Directly from U.S. Tenant	- -	\$600
U.S. Withholding Tax — 30%	180	- - -
— 15%	- -	90
Gross Amount of Passive Income	600	600
Deduct 2 x Foreign Accrual Tax Applicable	360	- - -
Income	240	600
Canadian Tax: Case A 50%	120	300
(Case B 46%)	(110.40)	(276)
Canadian Foreign Tax Credit	- -	90
Total Canadian Tax: Case A	120	210
(Case B)	(110.40)	(186)
Total Combined Tax: Case A	\$300	\$300
(Case B)	(\$290.40)	(\$276)

Section 113(5) contemplates an exceptional situation in which a Canadian taxpayer may be both required to include in income FAPI (less foreign accrual tax applicable) and entitled under a treaty (or any law of Canada *other* than the Income Tax Act) to a credit in computing Canadian income tax for foreign taxes paid by a foreign affiliate. In order to preclude the Canadian taxpayer from enjoying double relief in respect of the foreign tax paid by the affiliate, section 113(5) reduces proportionately the amount of the deduction for foreign accrual tax applicable under section 113(3). Hence the Canadian taxpayer will claim the tax credit and forego the deduction under section 113(3) in computing the FAPI of the foreign affiliate.

Heretofore no directly comparable tax credit has been known to Canadian tax law. The foreign tax credit allowed under the Income Tax Act to offset taxes paid directly by Canadian taxpayers has provided the major source of relief. Perhaps a more beneficial alternative to the foreign accrual tax deduction may be on the horizon for some Canadian taxpayers with foreign affiliates located in countries with which Canada enters into treaties upon the terms contemplated by section 113 (5). A possible application of section 113 (5) would be where Canada desired to encourage Canadian capital investment in a specific underdeveloped country, and was therefore prepared to increase the allowance to Canadian taxpayers for taxes paid by foreign affiliates located in that country.

Fluctuation in Adjusted Cost Base of Shares of a Foreign Affiliate

The second consequence of a foreign affiliate's earning FAPI has to do with the adjustments which must be made to the cost base of the Canadian taxpayer's shares of the affiliate.⁶⁸ The "adjusted cost base"⁶⁹ of capital property owned by a Canadian taxpayer is its actual cost adjusted in accordance with section 53 of the Act. Sections 53(1) (d) and 92 (1) (a) specify amounts to be added to the adjusted cost base of the shares of a foreign affiliate, and sections 53(2), 92 and 93 (1) prescribe amounts to be deducted therefrom.

The adjusted cost base to a Canadian taxpayer of a share owned by him of a foreign affiliate will be increased by each amount of FAPI (after deducting any foreign monetary or exchange reserve, any foreign expropriation reserve and the appropriate multiple of the foreign accrual tax applicable) which the Canadian taxpayer has been required to include in computing income.⁷⁰ The cost base increase will be proportionately greater in respect of a share of a foreign affiliate owned by a corporate taxpayer than where the same share owned by an individual, because a corporate taxpayer is entitled to deduct twice as much foreign accrual tax as an individual.⁷¹

The adjusted cost base of the shares of a foreign affiliate is reduced to the extent that the Canadian taxpayer receives dividends paid by the affiliate out of its previously taxed FAPI. The reduction will be in proportion to both the amount of the previous addition to the adjusted cost base and the amount of the dividend paid. In other words, the adjusted cost base will be reduced by the lesser of the amount of the dividend and the net amount of *prior* increases in the adjusted cost base.

The adjusted cost base of a share of a foreign affiliate that was owned by a taxpayer on December 31, 1971 will be computed in accordance with I.T.A.R. 26(3).⁷² Thus a capital gain on the disposition of shares of a foreign affiliate will be measured from the greater of the actual cost of such shares to the Canadian taxpayer and the fair market value thereof on valuation day (December 31, 1971); a capital loss thereon will be measured from the lesser of the actual cost of the shares to the Canadian taxpayer and their fair market value on valuation day. Although I.T.A.R. 35(2) provides that a corporation that was, on January 1, 1972, a foreign affiliate of a taxpayer shall be deemed to have become a foreign affiliate on that day, that deeming

⁶⁸ Whereas the foregoing portion of this paper has dealt with provisions applicable to foreign affiliate trusts as well as to foreign affiliate corporations, the balance pertains only to foreign affiliate corporations (see section 94).

⁶⁹ Section 54(a). The significance of the "adjusted cost base" of capital property is that it is, generally, the amount which is subtracted from a taxpayer's proceeds of disposition in computing a "capital gain". Accordingly additions to the cost base reduce a taxpayer's potential capital gains tax liability, while deductions therefrom increase the potential capital gains tax liability.

⁷⁰ Section 92(1) (a).

⁷¹ Section 113(3).

⁷² Except where an individual taxpayer has made an election under I.T.A.R. 26(7).

position arises only for the purposes of computing the amount of a capital gain or loss realized by the affiliate itself.

It may happen that a Canadian taxpayer, having been taxed on the appropriate share of the FAPI of a foreign affiliate, disposes of a sufficient number of the shares to deprive the foreign corporation of its status as a foreign affiliate. If that should occur before the taxpayer has received the previously taxed FAPI by way of an exempt dividend while the corporation was a foreign affiliate, the following results would occur once the taxpayer had been paid a taxable dividend by the foreign affiliate:

1. the taxpayer would not be required by section 92(1)(b) to reduce the adjusted cost base of the remaining shares in the former affiliate; and
2. the taxpayer would not be able to offset the amount of the dividend required to be included in income under section 90(1) by the amount of previously taxed FAPI.⁷³

The onus is placed on the Canadian shareholder to avoid the second of these consequences.

If, conversely, a Canadian taxpayer acquires sufficient shares of a non-resident corporation to render it a foreign affiliate at a time when substantial underlying FAPI has been previously taxed in the hands of the Canadian vendor of the shares (before the vendor has received the underlying FAPI as a tax-free dividend) the following results occur when dividends therefrom are received by the purchaser:

1. no reduction in the adjusted cost base is required to be made;⁷⁴ and,
2. the amount of the dividend received would be taxable, unless the purchaser happened to be a corporation, in which case a deduction would be available to the extent that the dividend is considered to have been paid out of the "pre-acquisition surplus" of the affiliate.⁷⁵

Wherever possible, therefore, a Canadian taxpayer who has had to include in income an amount of the FAPI of a foreign affiliate should not dispose of such number of the shares of the foreign affiliate as would deprive the corporation of its foreign affiliate status: rather the taxpayer should first extract all tax-free dividends from the affiliate out of the previously taxed FAPI.

Apart from the problem of changes of ownership of shares of foreign affiliates, several timing difficulties exist which will create substantial practical dilemmas for Canadian taxpayers in their relations with foreign affiliates. Sections 90(2) and 92(1) (b) permit a Canadian taxpayer to deduct a dividend received out of an affiliate's previously taxed FAPI. Because of the sequence of events contemplated by sections 92(1) (a), 91(1), 92(1) (b) (i)

⁷³ The reason for both of these consequences is that at the time the dividend was paid the payor corporation was not a foreign affiliate of the Canadian taxpayer.

⁷⁴ Section 92(1) (b) contemplates a reduction in the adjusted cost base of the shares of a foreign affiliate only where FAPI has previously been included in the income of the recipient of a dividend from the affiliate.

⁷⁵ Section 90(3) and the proposed regulations.

and 90(2), it appears that in order for an individual to obtain a deduction under section 90(2) the dividend must not be received until *after* the taxation year of the foreign affiliate in which the FAPI (out of which the said dividend was paid) was earned.⁷⁶ In order to obtain the full deduction the Canadian individual taxpayer must endeavour to ensure that his affiliate will not pay dividends in excess of FAPI which has been attributed to him in prior taxation years of the affiliate.

Unfortunately, the very act of solving the preceding problem creates a new problem. When the Canadian individual taxpayer's affiliate pays a dividend out of its previously taxed FAPI, very often withholding tax will be levied upon the recipient Canadian individual taxpayer by the country in which the payer affiliate is resident. Under the foreign tax credit formula set forth in section 126(1) the amount of such withholding tax will not be creditable against the Canadian individual taxpayer's tax otherwise payable, unless he happens to have other sources of passive income from the same country in the same taxation year. This results because the dividend received is not "income" of the Canadian individual taxpayer: furthermore the foreign tax credit must be computed separately in respect of total taxes paid to each different foreign country in a year. Where, however, the amount of any such foreign withholding tax paid by a Canadian individual taxpayer (after 1975) exceeds 15%, section 20(11) will enable him to deduct the excess in computing his income.

In any event, section 126(1) expressly prohibits Canadian corporate taxpayers from obtaining a foreign tax credit in respect of withholding tax levied on dividends from a foreign affiliate; and no deduction is available to corporations under section 20(11).

Inter-Affiliate FAPI Dividends

Section 95(1)(a) expressly excludes from the definition of FAPI dividends received by one foreign affiliate from another foreign affiliate of a Canadian taxpayer. However the amount of such dividends is required, by section 91(1)(b), to be included in the income of the Canadian taxpayer "except to the extent that that amount is prescribed to be excluded". In order to eliminate the possibility of taxing the same FAPI as it is passed up a chain of foreign affiliates, the proposed regulations provide that dividends

⁷⁶ The sequence of events is as follows: 1) the deduction granted by sections 90(2) depends upon the amount of the reduction in the adjusted cost base of the shares of the affiliate required by paragraph 92(1) (b); 2) the deduction in the adjusted cost base required by subparagraph 92(1) (b) (i) pertains to such amount of a dividend from an affiliate *received* by the taxpayer as was required by paragraph 92(1) (a) to be added to the adjusted cost base *before* such dividend was received; 3) the addition to the adjusted cost base under paragraph 92(1) (a) is made only in respect of FAPI which has been required to be included in computing the Canadian taxpayer's income for the year or for any preceding year; 4) no FAPI becomes attributable to a Canadian taxpayer until the *end* of the taxation year of the foreign affiliate. The problem is remedied in the case of Canadian *corporate* taxpayers (other than private corporations that do not control the affiliate) by their ability to deduct dividends out of an affiliate's "exempt surplus", which will include previously taxed FAPI.

paid from an affiliate's FAPI (after deduction of any foreign tax paid thereon) will be excluded from the scope of section 91(1)(b).⁷⁷ It would appear that the only dividends that will be attributed to a Canadian taxpayer under section 91(1)(b) will be dividends out of the active business earnings of an affiliate which either was incorporated in a non-treaty country or earned such income in a non-treaty country.⁷⁸

Dividends Received by a Canadian Corporation from a Foreign Affiliate

The preceding portion of this paper has been devoted largely to the treatment of passive income earned by foreign affiliates and the treatment of dividends paid therefrom; the next portion will consider the treatment given dividends received by a Canadian corporation (and by its foreign affiliates) from the active business earnings of its foreign affiliates.

As a preliminary matter, it should be emphasized that this portion of the paper will discuss the complex rules pertaining only to dividends received by Canadian corporations from the active business income of their foreign affiliates. By way of contrast the treatment of similar income passed on as dividends to Canadian individual taxpayers should be briefly re-stated. They will be entitled to apply the foreign tax credit provisions of section 126(1) to obtain a tax credit on up to 15% of a foreign country's withholding tax and a deduction from income to the extent that the withholding tax imposed by such country exceeds 15%.⁷⁹

The proposed regulations undoubtedly treat dividends received by a Canadian corporation from a foreign affiliate much more generously than the foreign tax credit provisions of the Act treat similar dividends received by a Canadian individual. To begin with, dividends received by a Canadian corporation will be exempt from tax if the dividends are paid out of profits earned by an affiliate prior to 1976. Dividends paid out of post-1975 profits will also be exempt if the profits are earned by an affiliate in a country with which Canada has entered into a comprehensive tax treaty (a "treaty country").⁸⁰

Dividends paid out of post-1975 profits earned in a non-treaty country will be taxable, but a deduction will be permitted depending upon the amount

⁷⁷ Proposed regulations, page 11.

⁷⁸ Such dividends are termed dividends from "taxable surplus" which is defined at page 2 of the proposed regulations. These dividends are discussed in greater detail *infra*.

⁷⁹ See sections 126(7) (c) and 20 (11).

⁸⁰ So far as a Canadian *private* corporation is concerned, dividends received from a controlled foreign affiliate will be totally non-taxable under the Income Tax Act in these two instances. However, such dividends received by a private corporation which does not own or "control" more than 50% of the issued voting shares of a foreign affiliate are subject to a partially refundable tax under Part IV of the Act equal to one-third of the dividends received. This part IV tax is only "partially" refundable (rather than fully refundable, as in the case of Canadian portfolio dividend income) because of the limitation contained in the definition of "refundable dividend tax on hand" in section 129(3) (b) (ii).

of income tax paid by the foreign affiliate on its earnings in non-treaty countries and the withholding tax imposed on the dividend.

The Department of Finance described the intended effect of these provisions as follows:

The general effect of the provisions in this area is to place dividends from foreign affiliates in non-treaty circumstances on the same basis as foreign branch earnings of corporations. The Canadian tax imposed on dividends from foreign affiliates and overseas branch earnings is restricted to the amount necessary to bring the total burden of tax, both foreign and domestic, up to the level of Canadian tax.⁸¹

The proposed regulations and the Act contemplate segregating the surplus of foreign affiliates into three distinct categories:

- (1) pre-acquisition surplus;⁸²
- (2) exempt surplus;⁸³ and
- (3) taxable surplus,⁸⁴

Exempt surplus at any particular time of a foreign affiliate of a Canadian corporation is described by the proposed regulations⁸⁵ as including

- (a) the affiliate's FAPI for taxation years ended before that particular time (net of foreign tax paid by the affiliate on such FAPI);
- (2) "control-period" business earnings of the affiliate for the affiliate's 1972 to 1975 taxation years (net of foreign income tax paid thereon). The control period refers to the period during which the non-resident corporation has qualified as a foreign affiliate of the Canadian corporation. Technically, the control period commences at the beginning of the affiliate's first taxation year in which it qualified as a foreign affiliate. The control period must be a continuous period during which the non-resident corporation constantly maintains its foreign affiliate status. Non-resident corporations which both qualify under the definition of "foreign affiliate" and were in existence prior to 1972 are deemed to have been acquired by the Canadian corporation on January 1, 1972.⁸⁶ Their control-period business earnings will be calculated on that footing;
- (3) post-1975 "control-period" business earnings for taxation years ended before that particular time (net of foreign income tax paid thereon) from carrying on business in a treaty country *if* the affiliate was incorporated in a treaty country; and
- (4) dividends received out of the exempt surplus and pre-acquisition surplus of another foreign affiliate of the same Canadian corpora-

⁸¹ Summary of 1971 Tax Reform Legislation, page 57.

⁸² Section 90 (3).

⁸³ Section 113 (1) (a).

⁸⁴ Section 113 (1) (b).

⁸⁵ At page 2.

⁸⁶ I.T.A.R. 35(2).

tion (and also dividends received out of the other affiliate's taxable surplus where the other affiliate is not incorporated in the same country as the recipient affiliate).

In view of the variety of items included in the definition of exempt surplus", and of the fact that Canadian corporations will not be taxed on dividends received out of the exempt surplus of a foreign affiliate,⁸⁷ it is evident that it will very often be desirable for a non-resident corporation to be considered a foreign affiliate; hence the relevance of the right to elect to be so regarded.⁸⁸ A crucial consideration will be whether the operations carried on by the non-resident corporation are of an active business nature or of a passive business or investment nature; and, if the former, whether the corporation is both carrying on business and incorporated in a treaty country.

As dividends are paid out of the exempt surplus of a foreign affiliate, the amount of its exempt surplus account will be reduced accordingly.

The taxable surplus at any particular time of a foreign affiliate of a Canadian corporation will include

- (1) post-1975 control-period business earnings of the affiliate for taxation years ended before that time; and
- (2) dividends received out of the taxable surplus of another foreign affiliate of the same Canadian corporation, where such other affiliate is incorporated in the same country as the recipient affiliate,

provided that either

- (a) the affiliate's earnings are derived from a business carried on in a non-treaty country, or
- (b) the affiliate is incorporated in a non-treaty country.

To the extent that a Canadian corporation receives a dividend out of an affiliate's taxable surplus it will be entitled to a deduction under section 113(1)(b), the amount of which will depend upon the level of the affiliate's "foreign tax prescribed to be applicable" to the dividend and the portion of any income or profits tax paid by the Canadian corporation⁸⁹ to the government of a country other than Canada which may reasonably be said to have been paid in respect of the amount of the dividend paid out of taxable surplus.⁹⁰

The pre-acquisition surplus of a foreign affiliate does not represent an amount of surplus for which records must be maintained. It is merely the source from which all dividends other than "exempt" and "taxable" dividends are paid. Since exempt and taxable surpluses are defined by reference to the "control-period" business earnings of a foreign affiliate, it is apparent that pre-acquisition surplus constitutes, in effect, the retained business earnings of a non-resident corporation prior to its becoming acquired by a Cana-

⁸⁷ The deduction of such dividend is provided by section 113 (1) (a).

⁸⁸ Section 95 (1) (b) (iv).

⁸⁹ i.e. withholding tax on the dividend.

⁹⁰ The latter deduction is *two times* the portion of such income or profits.

dian corporation and achieving the status of a foreign affiliate.⁹¹ Dividends which are considered to have been received by a Canadian corporation out of the pre-acquisition surplus of its foreign affiliate will be deductible under section 90(3); however they will effect a reduction in the adjusted cost base of the shares of foreign affiliate, pursuant to section 92(2).⁹²

It should be noted that post-1975 control-period business earnings of a foreign affiliate will comprise exempt surplus only if two separate requirements are met. Not only must such earnings be derived from a business carried on in a treaty country, but the affiliate must also have been incorporated in a treaty country.

Where a foreign affiliate carrying on business in a non-treaty country pays a dividend to another foreign affiliate, the dividend will be included in the Canadian corporation's income, pursuant to section 91(1)(b), only if the recipient foreign affiliate was not incorporated in the same jurisdiction as the affiliate which paid the dividend. In that event the amount of the dividend becomes exempt surplus of the recipient affiliate. If, however, the recipient affiliate was incorporated in the same jurisdiction as the affiliate which paid the dividend, the Canadian corporation will not be taxed upon the dividend until such time as the recipient affiliate passes it on as a dividend to the Canadian corporation.⁹³ This creates an opportunity for a Canadian taxpayer with a minority interest in a foreign affiliate carrying on business in a non-treaty country to defer Canadian tax by incorporating a holding company in the same jurisdiction as that in which its present affiliate is incorporated, without interruption of the present affiliate's dividend-payment policy. However to the extent that the holding company earns income by investing dividends which it receives, such income will be subjected annually to Canadian tax as FAPI.

The order in which a foreign affiliate will be considered to distribute its surplus, for Canadian tax purposes, is prescribed by the proposed regulations to be as follows:

- (1) first, out of its exempt surplus, if any;
- (2) second, out of its taxable surplus;
- (3) third, to the extent that a dividend paid *in* the first 3 months of a foreign affiliate's taxation year exceeds the total of its exempt surplus and taxable surplus at the date of the dividend, the dividend will be deemed to have been paid out of the affiliate's pre-acquisition surplus;
- (4) fourth, to the extent that a dividend paid after the third month of an affiliate's taxation year exceeds the total of its exempt surplus and taxable surplus at the date of the dividend, the dividend will be regarded first as a distribution of the exempt surplus as at the

⁹¹ It will also comprise an affiliate's pre-1972 surplus.

⁹² The adjusted cost base will be reduced by the amount of the dividend out of pre-acquisition surplus net of foreign withholding tax levied thereon.

⁹³ The recipient affiliate credits its taxable surplus with the amount of the dividend received from the subsidiary affiliate.

end of the taxation year *in which* the dividend was paid, second as a distribution of the affiliate's taxable surplus as at the end of that year, and third as a distribution of the affiliate's pre-acquisition surplus.⁹⁴

One unhappy consequence of this prescribed order of distribution is that it will not be possible to distribute the pre-1972 surplus of an existing foreign affiliate at a particular time after 1975 until its taxable surplus has been fully distributed; this will involve a tax cost. The dividend payment policies of existing affiliates should therefore be re-examined during the interim with a view to avoiding that consequence.

Reference was made earlier to the fact that when a Canadian corporation receives a dividend out of the taxable surplus of a foreign affiliate, it will be entitled to a deduction under section 113(1)(b) of the lesser of the amount of the dividend and the aggregate of the amount of "foreign tax prescribed to be applicable" to the dividend and 2 times the foreign withholding tax paid by the Canadian corporation. The amount of foreign tax prescribed to be applicable is determined by apportioning the foreign tax paid by the affiliate to the dividend out of taxable surplus, according to the portion of the affiliate's total taxable surplus which was distributed by virtue of the dividend. For example, if foreign affiliate "F" accumulated control-period business earnings of \$1500 after deduction of \$600 of foreign tax and then paid a dividend of \$1000 on its common shares (all of which were owned by Canadian corporation "C") subject to 10% foreign withholding tax, the "foreign tax prescribed to be applicable" to the \$1000 dividend would be ($\frac{1000}{1500} \times 600$) \$400. C's deduction under section 113 (1)(b) would be the lesser of the amount of the dividend out of taxable surplus (\$1,000) and the aggregate of the foreign tax prescribed to be applicable (\$400) and 2 times the withholding tax ($2 \times (10\% \text{ of } \$1,000)$), or \$200, for a total deduction of \$600. The net amount of the dividend which would be included in C's income under section 90(1) would be (\$1,000 - 600) \$400.

The proposed regulations⁹⁵ point out that the Canadian tax payable on a dividend out of a foreign affiliate's taxable surplus would approximate the amount that would be payable under an indirect foreign tax credit system (i.e. a system in which the Canadian corporation is entitled, not only to a credit for the foreign dividend withholding tax, but also to a credit for the foreign corporation tax imposed on the underlying profits from which the dividends are paid).

It is worth noting that in the case of a dividend paid out of the taxable surplus of foreign affiliate "A" to foreign affiliate "B" (where A and B were

⁹⁴ The stated purpose of this ordering of distribution is "to enable the resident corporation in most circumstances to foresee the full Canadian tax implications of receiving a dividend from a foreign affiliate" — page 5 of the proposed regulations.

⁹⁵ At page 3.

not incorporated in the same jurisdiction) which is subject to withholding tax, section 113(1)(b) is not applicable. Instead, the Canadian corporation will include the amount of the dividend in its income under section 91(1)(b) and will claim a deduction under section 113(3)(b) of the aggregate of the foreign tax prescribed to be applicable and 2 times the withholding tax paid by B.

Section 93(1) of the Act permits a Canadian corporation which disposes of shares of a foreign affiliate to elect to treat a portion of its proceeds of disposition of such shares as a dividend (rather than a taxable capital gain) to the extent that the gain represents a realization of the affiliate's underlying exempt and taxable surpluses.⁹⁶ This type of election will enable Canadian corporations to use exempt surplus of a foreign affiliate to reduce the amount of tax otherwise payable by it on a disposition of the shares of the affiliate. This will benefit most those Canadian corporations which have insufficient influence over the dividend-paying policy of an affiliate to cause it to distribute its exempt surplus prior to a sale by the Canadian corporation of shares of the foreign affiliate.

Section 113(2) is an extremely significant section. After the end of a Canadian corporation's 1975 taxation year, any net amount required to be included in computing its income by reason of its having received a dividend out of the taxable surplus of a foreign affiliate may be deducted by the Canadian corporation. However, if such a deduction is claimed, the adjusted cost base of the shares of the affiliate will be reduced by the amount of the deduction.⁹⁷ No deductions may be made under section 113(2) after the adjusted cost base has been reduced to nil. Not only is this election a deferral of tax which would otherwise have been payable in the year in which the dividend was received, but it replaces a full inclusion of an amount of taxable surplus in income with a potential inclusion in income of only one-half thereof (the taxable half of a capital gain realized by the Canadian corporation).

The purpose of this concession is to avoid uncertainty and to avoid impeding Canadian corporate investment abroad during a period in which Canada will be attempting to expand the list of countries with which a treaty has been concluded.⁹⁸ Once a treaty has been finalized, all dividends out of business income subsequently earned by the affiliate⁹⁹ will be from exempt surplus.

The proposed regulations¹⁰⁰ provide a Canadian corporation with a further election in respect of dividends received out of the taxable surplus of a foreign affiliate. Instead of being restricted by section 113(1)(b)(ii) to a deduction for such amount of the foreign tax paid by the affiliate as bears a direct proportion to the fraction of the affiliate's total taxable surplus received by way of dividend, a Canadian corporation may elect to deduct an additional

⁹⁶ Proposed regulations page 6 and 7.

⁹⁷ Section 92(3).

⁹⁸ Summary of 1971 Tax Reform Legislation, page 57.

⁹⁹ Provided it was incorporated in a treaty country.

¹⁰⁰ At pages 8 and 9.

amount of the affiliate's underlying foreign tax in computing its taxable income. Such an election would, of course, reduce the amount of such tax available to offset future dividends received out of taxable surplus, but it would be very useful, for example, to Canadian corporations which were preparing to dispose of shares of an affiliate. It would also assist Canadian corporations which were able to defer receipt of dividends to a time when their being inclusion in income would be less detrimental. This election will be restricted to those circumstances in which the foreign affiliate has only one class of shares outstanding or, if the affiliate has more than one class of shares outstanding, the Canadian corporation owns the same percentage of the issued shares of each class.

The proposed regulations¹⁰¹ also provide for "tax-sparing relief". Where a developing country has granted tax incentives to a foreign affiliate in respect of projects undertaken by the affiliate before the end of 1975, an adjustment will be made to the affiliate's underlying foreign tax account to reflect the taxes "spared" by virtue of the incentives. The underlying foreign tax account will be increased by twice the amount by which the tax spared by the foreign country exceeds the amount of withholding tax that would be payable to that country if an amount equal to the tax spared were distributed by way of a dividend to the Canadian corporation. Such an increase to an affiliate's underlying foreign tax account will place an ultimate distribution of the affiliate's earnings on the same tax footing in Canada as a distribution of its earnings had the affiliate not qualified for the tax-sparing incentive. To qualify for tax-sparing relief the foreign affiliate must carry on an active business in a developing country, and the foreign tax imposed on the earnings of that business must be reduced under a qualifying tax concession in that country.

Problems of Compliance

Where a Canadian corporation does not provide the prescribed information concerning a foreign affiliate, the proposed regulations¹⁰² will deem a dividend paid by that affiliate to have been paid out of taxable surplus to which no underlying foreign tax is applicable. The effect of such a sanction is to limit the deduction under section 113(1) to twice the foreign withholding tax imposed on the dividend.

It will therefore be necessary for a Canadian corporation to maintain for each of its foreign affiliates carrying on an active business a separate computation of exempt surplus, taxable surplus and underlying foreign tax imposed on all earnings included in the affiliate's taxable surplus. In respect of each foreign affiliate earning passive income, a separate computation of the amount of its FAPI (which involves keeping careful cost records for capital gains calculations) and foreign accrual tax will be required.

While problems of compliance with the information retrieval requirements of the Act will be minimal in the case of wholly-owned foreign affiliates, they will be onerous, and often insurmountable, in the case of affiliates which

¹⁰¹ At pages 9 to 11.

¹⁰² At page 5.

are not controlled by a Canadian taxpayer. Indeed it will not be surprising if the cost and difficulty of obtaining sufficient data to permit calculation of the Canadian tax payable in respect of the operations of a foreign affiliate causes many Canadians to abandon either Canada or foreign investment altogether.

In this connection the Joint C.B.A.-C.I.C.A. Committee recommended¹⁰³ that the scope of the FAPI rules be limited to situations in which one or more Canadian residents (whether or not dealing at arm's length) are in a position to exercise effective control over a foreign corporation. For example, the FAPI provisions could apply

- (a) where a Canadian taxpayer and the foreign affiliate (and persons with whom the Canadian taxpayer did not deal at arm's length) had provided, directly or indirectly, more than 50% of the combined capital and loan funds of the foreign corporation or more than 50% of its paid-up capital. (For this purpose, the guaranteeing of loans would be regarded as the provision of funds).
- (b) where one or more Canadian residents (and persons with whom they did not deal at arm's length) owned, directly or indirectly, more than 50% of the outstanding shares of any class which carried with it either voting rights or rights to participate (either currently or on liquidation in the earnings or surplus of the foreign corporation). For this purpose due account would be taken of outstanding options and the convertibility features of debt or stock, and
- (c) where one or more Canadian residents (and persons with whom they did not deal at arm's length) control by any means whatsoever (including management contracts) the foreign corporation.

Conclusion

The taxation of foreign affiliates of Canadian taxpayers is indeed a novel concept and requires thorough research prior to implementation. It is hoped that over the course of the next few years amendments will be introduced which will clarify, and render more equitable, the rules to which Canadian taxpayers with investments in foreign affiliates will be subject.

¹⁰³ At page 5-3 of its brief.