

# Canadian Taxation of Foreign Affiliate Distributions

Eric B. Switzer

Follow this and additional works at: <http://digitalcommons.osgoode.yorku.ca/ohlj>  
Article

## Citation Information

Switzer, Eric B. "Canadian Taxation of Foreign Affiliate Distributions." *Osgoode Hall Law Journal* 16.1 (1978) : 81-132.  
<http://digitalcommons.osgoode.yorku.ca/ohlj/vol16/iss1/4>

This Article is brought to you for free and open access by the Journals at Osgoode Digital Commons. It has been accepted for inclusion in Osgoode Hall Law Journal by an authorized editor of Osgoode Digital Commons.

# CANADIAN TAXATION OF FOREIGN AFFILIATE DISTRIBUTIONS

By ERIC B. SWITZER\*

The process of Canadian tax reform which began with the creation of the Royal Commission on Taxation<sup>1</sup> (the Carter Commission) produced major changes in the Canadian system of taxing income. One area of taxation that reflects the significant changes brought by the reform is the taxation of distributions received by a Canadian resident corporation from its foreign subsidiary. The rules under the pre-1971 *Income Tax Act* (the "former" Act) divided foreign subsidiaries into two groups based upon the direct share ownership of the Canadian parent. Once a subsidiary was properly classified, the method of taxing dividends was fixed. The existing *Income Tax Act* (the "Act") continues to divide foreign subsidiaries into two groups based upon the Canadian parent's equity interest in the subsidiary. However, unlike the system of the former Act, the taxation of dividends depends not only upon the categorization of the foreign subsidiary paying the dividend, but also upon the character of the income out of which the dividend is paid.<sup>2</sup> It is the purpose of this paper to review the complex set of rules which now govern the Canadian taxation of foreign subsidiary distributions.

## I. BACKGROUND—Paragraph 28(1)(d) of the Former Act

From the introduction of the first Canadian income tax act in 1917<sup>3</sup> until the tax reform amendments of 1972, Canada was content to grant foreign countries exclusive tax jurisdiction over the undistributed income earned by the foreign subsidiaries of a Canadian corporation. It was only when the foreign subsidiaries' income was distributed to the Canadian parent corporation that Canada asserted its tax jurisdiction.<sup>4</sup> For the first thirty-two years after the 1917 law, partial relief from double taxation was provided by the provision of the Act that allowed the resident corporation to claim a

---

© Copyright, 1977, Eric B. Switzer.

\*Member of the Ontario Bar. The author would like to thank Tom McDonnell of McMillan, Binch for his assistance during the preparation of earlier drafts of this paper.

<sup>1</sup> The Commission was formed by Order in Council P.C. 1962/1334, dated 25th September, 1962, and was under the chairmanship of Kenneth LeM. Carter. The Commission report was published in 6 volumes as *The Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1967).

<sup>2</sup> Brown, "Through the Darkest Jungles of the Foreign Affiliate Rules," in *Special Seminar on the New Tax Treaties and the FAPI Regulations*, June 1975. Sponsored by the International Fiscal Association. (Toronto: Richard De Boo, 1975) at 43.

<sup>3</sup> *The Income Tax Act, 1917*, S.C. 1917, c. 28.

<sup>4</sup> A. R. A. Scace, *The Income Tax Law of Canada* (2nd ed. Toronto: Law Society of Upper Canada, 1973) at 586.

foreign tax credit for the foreign withholding taxes (but not the underlying income taxes) paid when the foreign source income was distributed.<sup>5</sup>

This system of taxation continued until 1949 when a second method of preventing double taxation of international income was introduced. From 1949 to 1972, the foreign source dividend income of a corporation resident in Canada was taxable in one of two ways. If the Canadian Parent Corporation ("CPC") owned 25 percent or less of the voting shares of a foreign corporation, the dividends received were included in the corporation's income and were subject to Canadian tax. The CPC was allowed to claim a foreign tax credit for any foreign withholding taxes paid by it.<sup>6</sup> If the CPC receiving the dividend income owned more than 25 percent of the voting shares of a foreign subsidiary, the amount of the dividend was deductible in computing taxable income and was thereby exempted from Canadian income tax.<sup>7</sup>

The dividend income exemption rule, paragraph 28(1)(d) of the former Act, was created to achieve two objectives. The first was the stimulation of Canadian foreign direct investment.<sup>8</sup> The second and the more important of the two, was the simplification of administering the foreign tax credit provisions of the Act.<sup>9</sup> At the time paragraph 28(1)(d) was enacted, the majority of Canadian foreign direct investment was located in jurisdictions whose effective tax rates were as high, or higher than those in Canada.<sup>10</sup> As a result, the foreign tax credit available in Canada was usually sufficient to eliminate the Canadian tax otherwise payable on the foreign source dividend income. The exemption method was adopted because it prevented double taxation of the foreign income without the need for the detailed and complex calculations

---

<sup>5</sup> The first foreign tax credit provisions were introduced in 1919. All withholding taxes payable to Great Britain, its colonies and dependencies were deductible from Canadian tax otherwise payable subject to the general limitation that the foreign tax credit not exceed the Canadian taxes payable. Withholding taxes paid to a non-British country were creditable against Canadian taxes only if the foreign country allowed its taxpayers a foreign tax credit for Canadian taxes paid by them. Again the tax credit could not exceed the Canadian taxes payable: *An Act to Amend the Income War Tax Act, 1917*, S.C. 1919, c. 55, s. 3.

<sup>6</sup> Section 41 of the *Income Tax Act*, S.C. 1952, c. 148. For a discussion of Canada's foreign tax credit system prior to 1972, see J. S. Peterson, *Canada's Foreign Tax Credit System* (1971), 19 Can. Tax J. 89. The new foreign tax credit rules are compared with the old rules by Peterson in *Canada's Foreign Tax Credit* (1971), 23 Can. Tax Foundation Conf. Rep. 158.

<sup>7</sup> Paragraph 28(1)(d) of the former Act. A foreign tax credit was not allowed for any withholding taxes paid on dividends excluded by paragraph 28(1)(d) from income: Subsection 41(1) of the former Act.

As originally enacted, the Canadian resident was required to own more than 50% of the shares of the foreign corporation before the dividends were excluded from income. But on the advice of a special committee formed to review the rule the percentage shareholding was lowered to 25% in 1951: *An Act to Amend the Income Tax Act*, S.C. 1951, c. 51, s. 7(1).

<sup>8</sup> J. B. de la Giroday, *Canadian Taxation and Foreign Investment* (Toronto: Canadian Tax Foundation, 1955) at 31.

<sup>9</sup> (Can.) *Royal Commission on Taxation*, Vol. 4, *supra* note 1, at 511.

<sup>10</sup> *Id.* at 510.

inherent in the foreign tax credit rules of the former Act. As the Minister of Finance said when introducing the 1949 amendment:

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 corporations 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.<sup>11</sup>

There is little doubt that the exemption provision simplified the tax system, but it proved to be a "Pandora's Box." Once enacted, the amendment created innumerable opportunities for the use of international tax plans to minimize or avoid Canadian taxes.

An international tax plan was intended to accomplish a reduction in the aggregate of the foreign taxes and the Canadian taxes otherwise payable: (1) through the diversion of foreign trading and property income from the CPC to its foreign base corporation (a foreign base corporation is a corporation, usually in a tax haven<sup>11a</sup> used as a central point for handling paper work, for preparing and processing trade documents and as a location for the passage of title to goods); or (2) by the routing of Canadian source income through a foreign holding subsidiary of the CPC.<sup>12</sup>

#### A. *International Trading Subsidiary*

A CPC engaged in selling abroad has the choice of four methods of operation:

- (1) selling directly to foreign customers;
- (2) operating through branches in the foreign countries;
- (3) selling through subsidiaries in foreign countries; or
- (4) selling to the overseas customers through foreign base trading subsidiaries.<sup>13</sup>

---

<sup>11</sup> The Hon. Douglas C. Abbott, Minister of Finance, *Can.: H. of C., Debates*, March 22, 1949, at 1800.

<sup>11a</sup> Tax havens may be divided into four broad categories: (1) Countries which levy no form of income tax; (2) Countries which grant new industries tax holidays of a specified duration; (3) Countries which do not levy any form of income tax on income from sources outside their jurisdiction; and (4) Countries which do not levy any form of income tax on certain types of companies or operations: Barbeau, *An Introduction to International Tax Planning* (1963), 6 *Can. Bar J.* 214 at 218; B. Spitz, *International Tax Planning* (London: Butterworth's, 1972) at 82.

For a discussion of the factors to be considered when choosing a tax haven as a place of incorporation, see Diamond and Diamond, *Tax Havens of the World*, (New York: Matthew Bender, 1975) at vi-xxiv; *Foreign Tax Havens* (2d ed. New York: Practising Law Institute, 1974) at 335-59.

<sup>12</sup> Diamond and Diamond, *Id.* at v.

<sup>13</sup> J. G. McDonald, "International Aspects of Corporate Distributions," in *Law Society of Upper Canada Special Lectures (Taxation)* (Toronto: Richard De Boo, 1964) at 19.

The first two methods of operation offered no tax advantage because the profits were subject to Canadian tax when earned even if not received by the CPC during the taxation year.<sup>14</sup> The third method of carrying on business did provide a means of deferring Canadian tax, but at the cost of increasing the foreign taxes payable on the income earned in the foreign jurisdiction. The fourth method was the only one that provided the possibility of minimizing or eliminating both foreign and Canadian taxes.<sup>15</sup>

The goal of a tax plan involving the use of a foreign tax haven trading company was to accumulate the largest possible percentage of the foreign trading profits in the foreign base corporation. In the case of sales to foreign customers, this was accomplished by the CPC first selling the commodities to the foreign base company at a price below the ultimate sale price to the third-party purchasers. The difference between the two prices, less the foreign corporation's expenses, represented the profit diverted from the CPC. The profits could be retained by the foreign corporation free of Canadian tax, or returned to Canada as a tax-free dividend.<sup>16</sup>

The advantages to a Canadian corporation of engaging in foreign trade through a foreign subsidiary were not limited to its export business. Where the Canadian parent corporation required products or materials obtainable abroad, a saving of Canadian tax was possible if the tax haven corporation first purchased the goods from the foreign supplier and then resold them to its CPC. This arrangement increased the parent's cost of supplies, thereby reducing its profit subject to Canadian tax. Simultaneously, the transaction would increase the tax-free accumulated profits of the foreign subsidiary.<sup>17</sup>

The incorporation of the foreign base corporation would be delayed if the Canadian parent anticipated that the foreign operations would produce start-up losses. The early losses would be used to off-set the parent's Canadian income and only when it became clear that such losses would be absorbed in this way would the foreign corporation be formed.<sup>18</sup>

Interposing a foreign trading subsidiary between the CPC and the foreign purchasers or sellers was not without its tax risk. The foreign subsidiary could be disregarded as a "sham," or its income re-allocated to the CPC under the non-arm's length rules of the former Act.<sup>19</sup> The principle of "sham transaction" is one that threatens all tax plans whose primary function is to

---

<sup>14</sup> *Id.* at 22.

<sup>15</sup> For a discussion of the non-tax reasons for incorporating a foreign trading corporation, see D. Ward, "International Operations—Trading Companies," *Corporate Management Tax Conference* (Toronto: Canadian Tax Foundation, 1965) at 29.

<sup>16</sup> O. A. Pyrcz, *Canadian Taxation of Corporate Foreign Source Income: An Overview*, (unpublished LL.M. thesis, University of Toronto, 1972) at 126-127.

<sup>17</sup> C. S. Bergh, *Effective Tax Avoidance* (Toronto: The Carswell Company Limited, 1965) at 114-15.

<sup>18</sup> McDonald, *supra* note 13, at 22.

<sup>19</sup> Section 17 of the former Act.

minimize tax.<sup>20</sup> The most comprehensive definition of what constitutes a sham was given by Diplock L.J. in the case of *Snook v. London & West Riding Investments*:

. . . it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.<sup>21</sup>

Invocation of the principle permitted the tax authorities to ignore the existence of the foreign subsidiary and to attribute its activities to the CPC.

A superb example of the use and consequences of the doctrine is the case of *Dominion Bridge Company Limited v. The Queen*.<sup>22</sup> Dominion Bridge incorporated a Bahamian company, Span International Ltd., to purchase all of Dominion's steel requirements from suppliers in countries other than Canada and the United States. Dominion in turn purchased the steel from its subsidiary at a price which exceeded the subsidiary's cost. The Department of National Revenue re-assessed Dominion Bridge, claiming the company had exaggerated its cost of sale. That is, the Department refused to allow the subsidiary to earn a profit on the resale to Dominion. At trial, Mr. Justice Decary found that the "evidence reveals that every single operation of any importance of Span was directed by the vice-president (who resided in Canada) of the appellant."<sup>23</sup> The Court decided that, for almost all purposes, Span did not have an existence separate from Dominion Bridge and therefore, "The contracts between the appellant and Span may be valid between themselves but they are not valid towards the Minister of Revenue because their nature and substance is not as it appears to be."<sup>24</sup>

The second type of challenge that could have been launched against the foreign base corporation's operations did not dispute the separate existence of the parent and the subsidiary. The object of its attention was the prices the parties charged each other in their dealings. As shown above, the transfer of

---

<sup>20</sup> Lanigan, *Trends in the Interpretation of the Taxation Laws*, [1974] Taxation in Australia 736; D. Ward, *The Judicial Approach to Tax Avoidance* (1973), 25 Conf. Rep. 408 at 410.

<sup>21</sup> [1967] 1 All E.R. 518 at 528.

<sup>22</sup> 75 D.T.C. 5150 (F.C.T.D.) appeal to the Federal Court of Appeal filed. A comment on the case by G. McGregor appears in (1973), 21 Can. Tax J. 333. A more complete examination of the effect on *Dominion* on tax haven subsidiary operations is made by Pilling, *The Tax Haven Subsidiary* (1975), 23 Can. Tax J. 467.

<sup>23</sup> 75 D.T.C. 5150 at 5153. The evidence suggests that Span was resident in Canada because its central management and control resided in Canada. The Minister did not argue this point, probably because of the enforcement difficulties involved in collecting taxes from corporations not incorporated in Canada.

<sup>24</sup> 75 D.T.C. 5150 at 5160. See *Richardson Terminals Limited v. M.N.R.*, 71 D.T.C. 5028 (Ex. Ct.) *aff'd without reasons* 72 D.T.C. 6431 (S.C.C.) and *West Hill Redevelopment Company Limited v. M.N.R.* 69 D.T.C. 5385 (Ex. Ct.).

profits between the corporations by the method of inter-company pricing is one of the advantages of the international trading company.<sup>25</sup> If this method is denied, the tax advantages of the international tax plan would be substantially impaired. When the parties to the transaction were not at arm's length, section 17 of the former Act allowed the authorities to ignore the agreed prices and adjust the accounts of the parties to reflect those that would have existed had the parties charged each other the fair-market value of the commodities.<sup>26</sup> Fair-market value was not defined by the Act, giving the Revenue authorities wide discretion in evaluating the legitimacy of the pricing. The uncertainty of meaning also made it difficult for companies to know whether they violated the terms of the Act.<sup>27</sup>

### B. *International Holding Corporations*

Two separate factors often compelled a resident corporation to incorporate a foreign international holding corporation, which was not to engage in an active business, but which was to hold property and receive the income from that property prior to its being forwarded to Canada.<sup>28</sup> The first factor was the limited number of comprehensive tax treaties entered into by Canada. A resident corporation wanting to form an operating subsidiary closer to its foreign markets could discover that the most favourable nation of location did not have an international tax agreement with Canada. The absence of a tax treaty could mean repatriated income was subject to a withholding tax (a tax which could be adjusted unilaterally) far higher than the standard 15 percent tax provided for in most tax treaties. This excessive rate could jeopardize the profitability of the venture. To limit the level of withholding tax, the subsidiary could be incorporated in a less commercially advantageous country having a tax treaty with Canada. A second alternative was to incorporate an international holding corporation in a country having a treaty with both Canada and the foreign active business country and to have the shares of the active subsidiary transferred to the holding corporation. This solution was clearly the best because it allowed commercial objectives to dictate the location of the active business subsidiary. The potential for reducing the level of

---

<sup>25</sup> The economic consequences to nations which do not regulate international inter-affiliate transactions can be severe. For a discussion of these costs see Surrey and Tillinghast, *General Report* in 56b Cahiers de Droit Fiscal International I/1 at I/2-I/3, (1971).

<sup>26</sup> Section 69 of the amended Act performs the same function as section 17 of the former Act. For a review of section 17 of the former Act, see Brown, 56b Cahiers de Droit Fiscal International, II/97. An examination of section 69 of the amended Act is given by G. T. Tamaki and R. W. Pound, *Intercompany Pricing: In Search of Guidelines* (1974), 22 Can. Tax J. 460.

<sup>27</sup> W. A. Macdonald, "Taxation of Non-Residents," *supra* note 13, at 95-97.

One might add that it was equally difficult for the Minister to establish a violation of section 17. See *J. Hofert Ltd. v. M.N.R.*, 28 Tax A.B.C. 270 (1962).

<sup>28</sup> J. E. Ford, "International Operations—Holding Companies" in *Corporate Management Tax Conference* (Toronto: Canadian Tax Foundation, 1965) at 41.

foreign taxes through the use of this type of corporation can be illustrated by considering the situation in which a Canadian manufacturer decided to handle its European sales and services through a Swiss-based corporation. Switzerland would be chosen because of its central geographic position, its well developed transportation, financial and communication systems, and its stable currency. Moreover, Switzerland's suitability was enhanced because it had concluded a fairly extensive network of international tax treaties and because its level of taxes were generally well below those imposed by other Western countries. However, one problem was associated with use of Switzerland; it had not concluded a tax treaty with Canada. Consequently, direct remittance of the subsidiary's profits to the Canadian parent would have attracted the full 30 percent Swiss withholding tax for which no credit was available in Canada.<sup>29</sup> One method of minimizing the Swiss tax was to incorporate a Dutch holding corporation to hold the shares of the Swiss subsidiary. By virtue of the Swiss-Netherlands tax treaty,<sup>30</sup> no withholding tax would be levied against dividends paid by the Swiss company to the Dutch company. Furthermore, under Dutch domestic law, dividends received by a resident corporation from a company in which it has a "substantial holding" were exempted from Dutch income tax.<sup>31</sup> This privilege is extended to dividends from Dutch or foreign corporations as long as the Dutch holding corporation owned at least 5 percent of the capital stock (including non-voting shares) of the distributing corporation. Finally, under the auspices of Article VII(3) of the Canada-Netherlands Tax Convention,<sup>32</sup> no Dutch withholding tax would be paid on the payment of a dividend by the holding company to the CPC, provided the Canadian parent owned all the shares of the Dutch company and during the last three years before the dividend was paid or credited, at least 95 percent of the Dutch company's gross income was dividend or interest income from non-Dutch sources. The Dutch holding corporation paying the dividend also could not hold the stock of any other Dutch company if it desired to take advantage of this provision. Thus, this tri-lateral arrangement permitted the CPC to lower its potential foreign withholding tax burden from 30 percent to zero.

---

<sup>29</sup> See "The taxation . . ." in *1 Guides to European Taxation*, "The Taxation of Patent Royalties, Dividends, Interest in Europe," (The Netherlands: International Bureau of Fiscal Documentation, updated at irregular intervals), for a discussion of Switzerland as the taxing country and a Canadian corporation as the non-resident taxpayer.

<sup>30</sup> Switzerland-Netherlands Tax Treaty, Art. 9(2)(a). Reproduced in Diamond and Diamond, *International Tax Treaties of all Nations*, Vol. 3, (Dobbs Ferry, N.Y.: Oceana Publications, 1975) 114 at 117.

<sup>31</sup> Under Dutch law, a Dutch corporation owning 5% (25% prior to 1969) of the shares of a foreign subsidiary is allowed to receive dividends from that subsidiary without Dutch corporate tax being payable on the dividends. This right of exemption from tax is known as the "Deelneming" or substantial holding privilege. M. J. Rooyen, *The Substantial Holding Privilege in Netherlands Corporate Income Tax* (1969), Bulletin for International Fiscal Documentation 337.

<sup>32</sup> *Canada-Netherlands Income Tax Agreement, 1957*, S.C. 1956-57, c. 16, proclaimed in force 15th January, 1958.



Ideally, the international holding corporation would be incorporated in a country that maintained a tax treaty with both Canada and the nation of commercial activity. But in the event it was not possible to find or use such a country, a chain of holding companies were used to ensure effective use of the world tax treaty system. Regardless of the complexity of the completed system of corporate holdings, the objective was always to lower the total foreign withholding tax burden below the level that would have existed had there been direct Canadian ownership of the foreign business subsidiary.

The second factor that motivated a resident corporation to use an international holding corporation was the limited nature of the paragraph 28(1)(d) exemption; it applied only to dividend income. Direct receipt of foreign source non-dividend income would have ensured that the total tax burden on the income was not less than the Canadian corporate rate.<sup>33</sup> Routing of the income through an international holding corporation could eliminate the Canadian element of tax.<sup>34</sup> The conversion of the passive income into dividend income was accomplished by transferring ownership or the rights of exclusive exploitation of the income generating property to the foreign base holding corporation. The non-dividend property income would be received by the holding corporation and added to its accumulating profits. Extraction of the profits by the CPC would be accomplished by having the subsidiary pay a dividend. The aggregate foreign withholding tax burden could be kept to an acceptable level if the tax-havens of the holding companies had signed a substantial number of tax treaties.

An international holding corporation could also be employed to reduce or avoid Canadian tax on income from Canadian sources. The CPC of the offshore corporation would have the tax-haven holding corporation acquire Canadian securities or rental property. The income would attract Canadian withholding tax on payments to the foreign enterprise, but no further Canadian tax would be levied against the income as its repatriation from the foreign subsidiary would be by dividend. Thus, the total tax burden on the income was lowered from the existing Canadian corporate tax to the Canadian withholding tax. Total elimination of all Canadian taxes was possible if the international holding corporation invested in property, such as government bonds, the income from which was exempt from Canadian withholding tax.<sup>35</sup>

The income of international holding corporations, as in the case of international trading corporations, could become subject to full taxation under the Canadian *Income Tax Act*. A corporation, at common law, was held to be

---

<sup>33</sup> The Canadian foreign tax credit system ensured that the income was subject to the higher of the Canadian tax rate or the foreign tax rate.

<sup>34</sup> A. B. McKie, *Tax Havens—Use and Abuse* (1968), 21 Can. Tax Foundation Conf. Rep. 407 at 412; McDonald, *supra* note 13, at 23; Ford, *supra* note 28, at 48-49.

<sup>35</sup> J. R. Brown, *An Overview of the White Paper* (1970), 22 Can. Tax Foundation Conf. Rep. 5 at 6-7. The exemption from withholding tax on interest on government bonds was provided by section 106(a) of the former Act. This exemption has been preserved by paragraph 212(1)(b) of the amended Act.

resident in the jurisdiction in which "the central management and control" of the company was exercised.<sup>36</sup> Judicial extension of this principle produced one important ruling: a corporation could have dual residency.<sup>37</sup> The breadth of the common law rules made it difficult to insulate the international holding corporation from their reach. Because of the passive nature and limited function of the international holding corporation, the functions of management were less onerous and it was often uneconomic to maintain management personnel at the holding subsidiary's head office. The holding subsidiary, therefore, was very susceptible to the charge that its most important decisions were made by persons residing in Canada.<sup>38</sup>

## II. THE RULES UNDER THE *INCOME TAX ACT*

One of the features of the former Act carried over into the present *Income Tax Act* is the classification of a foreign subsidiary as one of two types based upon the equity participation of the CPC in the subsidiary. If the CPC's equity interest in a foreign corporation is less than 10 percent, the subsidiary is classified as an "ordinary" subsidiary. Dividends from such a subsidiary are included in the CPC's income and they are subject to Canadian tax.<sup>39</sup> Foreign withholding taxes paid by the CPC on the dividend are creditable against Canadian taxes payable on the dividend.<sup>40</sup> The taxation of dividends from an "ordinary" subsidiary is very similar to the taxation of a foreign source dividend under the former Act when paragraph 28(1)(d) did not apply.

The complex and technical rules for the taxation of dividends for a foreign subsidiary introduced in the present Act are operative only if the foreign subsidiary qualifies as a foreign affiliate of the CPC. A foreign corporation achieves this status when the CPC's equity participation in the foreign subsidiary is 10 percent or more.<sup>41</sup> As will be established below, this ownership test differs in three significant ways from the ownership test in former section 28(1)(d). First, the level of ownership has been reduced from 25 percent to 10 percent. Second, the new ownership percentage is not restricted to the level of direct ownership but includes indirect participation

---

<sup>36</sup> *De Beers Consolidated Mines Ltd. v. Howe*, [1906] A.C. 455 (H.L.); *M.N.R. v. Crossley Carpets (Canada) Ltd.*, 69 D.T.C. 5015 (Ex. Ct.).

<sup>37</sup> *Swedish Central Railway Co. v. Thompson* [1925] A.C. 495; see O. A. Pycz, *The Basis of Canadian Corporate Taxation: Residence* (1973), 21 Can. Tax J. 374 at 381.

<sup>38</sup> Ford, *supra* note 28, at 19; D. A. Ward, "Corporate Residence as a Tax Factor," in *Corporate Management Tax Conference* (Toronto: Canadian Tax Foundation, 1961) at 3.

<sup>39</sup> Paragraph 12(1)(k) and Section 90 of the Act.

<sup>40</sup> Subsection 126(1) of the Act. The foreign tax credit provisions of the Act are discussed by Peterson, *Canada's Foreign Tax Credit* (1971), 23 Can. Tax Foundation Conf. Rep. 158.

<sup>41</sup> Paragraph 95(1)(d) of the Act. A foreign corporation is also a foreign affiliate of the CPC if under the former rules of subparagraph 95(1)(b)(iv) the CPC elected to have the subsidiary deemed a foreign affiliate: ITAR 35(4).

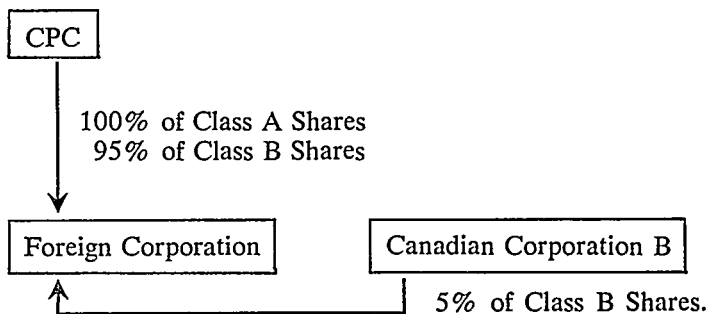
figures as well. Third, the shares which may be considered in the ownership calculation are not restricted to voting shares but include all shares whether or not the shares carry the right to vote.

Because the complex tax rules apply only when the foreign subsidiary is a foreign affiliate, the remainder of this article will be restricted to a discussion of the taxation of dividends from a foreign affiliate. It is assumed that the affiliate is a corporation and not a foreign trust.

#### A. Definition of Foreign Affiliate

The Act defines a foreign affiliate of a CPC to be a non-resident corporation<sup>42</sup> in which the CPC's equity percentage is at least 10 percent.<sup>43</sup> A CPC's equity percentage in a foreign corporation is the aggregate of two amounts: the CPC's direct equity percentage in the subsidiary and the CPC's indirect equity percentage in the subsidiary.<sup>44</sup> As its name implies, the CPC's direct equity percentage<sup>45</sup> in a foreign corporation is a calculation of the CPC's ownership of each class of shares issued by the subsidiary.<sup>46</sup> The highest percentage so calculated is the CPC's direct equity percentage in the affiliate.<sup>47</sup> The direct equity calculation is illustrated by the following example:

##### Example: Direct Equity Percentage



<sup>42</sup> Corporation is defined in subsection 248(1) of the Act as including an incorporated company. It appears that a foreign entity which has a separate juridic personality, evidenced by ownership of its assets and income, and which gives its members limited liability will be considered a corporation for tax purposes: *C. L. Dreyfus v. C.I.R.* (1929), 14 T.C. 560 (K.B.)—the court ruled that a French *société en nom collectif* was a corporation; *Ryall v. The DuBois Company Ltd.* (1933), 18 T.C. 431 (C.A.)—the court ruled that a German GmbH was a corporation. Interpretation Bulletin IT-343R, September 26, 1977 contains a list of foreign entities which Revenue Canada treats as corporations.

<sup>43</sup> Paragraph 95(1)(d) of the Act.

<sup>44</sup> Paragraph 95(4)(b) of the Act.

<sup>45</sup> "Class of shares" is not defined by the Act, which suggests that corporate law is to be used to determine whether or not shares are of a class. A. R. A. Scace, *The Income Tax Law of Canada* (3d ed. Toronto: Law Society of Upper Canada, 1976) at 683.

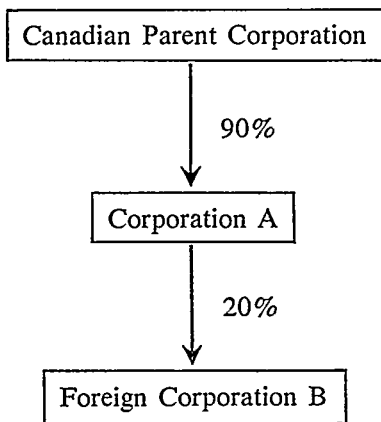
<sup>46</sup> Subparagraph 95(4)(a)(i) of the Act.

<sup>47</sup> Subparagraph 95(4)(a)(ii) of the Act.

CPC's direct equity percentage in the foreign corporation is 100 percent (the higher of 100 percent and 95 percent). Because the CPC's direct equity percentage (and equity percentage) in the foreign corporation is at least 10 percent, the foreign corporation is a foreign affiliate of the CPC. Canadian corporation B has a direct equity percentage in the foreign corporation of 5 percent. Because this is less than 10 percent and because the Canadian corporation does not have an indirect equity percentage in the foreign corporation, the foreign corporation is not a foreign affiliate of corporation B.

The Act recognizes that a CPC owning shares in a corporation, which itself owns shares in a chain of non-resident corporations, effectively enjoys a measurable equity interest in the foreign subsidiary corporations. The second component of a CPC's equity percentage, the indirect equity percentage, measures the degree of indirect ownership. The CPC's indirect equity percentage in a foreign corporation is calculated by multiplying the CPC's equity percentage in the subsidiary's parent by the latter's direct equity percentage in the foreign subsidiary.<sup>48</sup> The foreign parent's direct equity percentage is calculated in the same way as the Canadian's direct equity percentage. The following example illustrates the calculation.

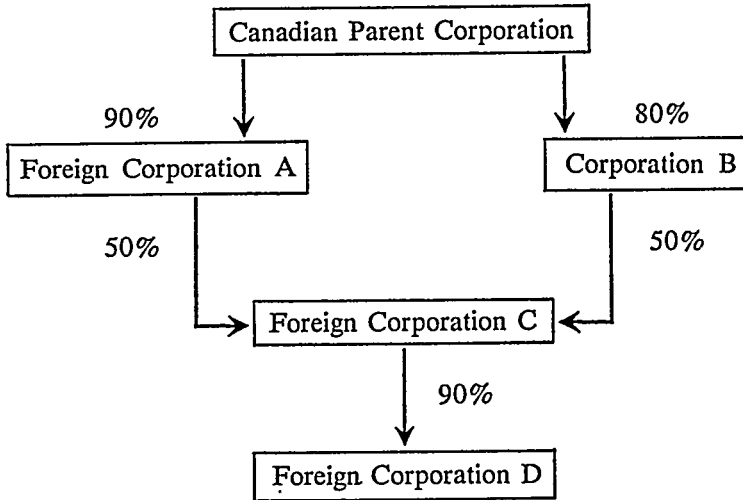
*Example: Indirect Equity Percentage*



The CPC has an indirect equity percentage (and equity percentage) in B of 18 percent. Multiply the CPC's equity percentage in A by A's direct equity percentage in B, (90% x 20%). If the CPC had a direct equity percentage in B, the CPC's equity percentage would be calculated by combining the CPC's indirect equity percentage with the CPC's direct equity percentage in B.

If the corporate structure is complex, the CPC because of its equity interests in the foreign affiliate's parents, may be able to calculate more than one indirect equity percentage in a foreign corporation. When this happens, the Canadian's indirect equity percentage is the total of all the possible indirect equity percentages.

<sup>48</sup> Subparagraph 95(4)(b)(ii) of the Act.

*Example: Indirect Equity Percentages*

The CPC has an indirect equity percentage in C, and hence an equity percentage in C of 95 percent. This is calculated by adding the Canadian parent's indirect equity percentage derived through A to the indirect equity percentage derived through B. The former value is 45 percent (90% x 50%) and the latter value 40 percent (80% x 50%). The CPC also has an indirect equity percentage in D equal to its equity percentage in C times C's equity percentage in D or 85 percent (95% x 90%).

Several conclusions can be made about the equity percentage rules:

- (1) The calculation of equity percentage ignores the rights, obligations, and restrictions attached to the outstanding shares. All shares are assumed to be identical.<sup>49</sup> This refusal to recognize any distinction between shares creates the possibility for any number of Canadians to have an equity percentage of 10 percent or more in the same foreign corporation.<sup>50</sup>
- (2) The insistence on measuring both direct and indirect equity involvement makes it possible for a resident corporation to have an equity percentage in a foreign affiliate in excess of 100 percent.<sup>51</sup> Little importance, however, is attached to a high percentage. The equity percentage test is used only to determine foreign affiliate status. The consequences to a Canadian parent corporation do not change once the 10 percent threshold has been achieved.<sup>52</sup>
- (3) Once it is established that a Canadian resident corporation has an equity percentage in a corporation (which need not be a foreign

<sup>49</sup> Bradley, *Shareholders of Foreign Affiliates and Beneficiaries of Non-Resident Inter-Vivos Trusts* (1974), 26 Can. Tax Foundation Conf. Rep. 225 at 229.

<sup>50</sup> Scace and Ewens, *Canadian Taxation of Foreign Affiliates* (1972), 10 Osgoode Hall L.J. 325 at 338; Baker, *Importance of Foreign Affiliate Status* (1971), 23 Can. Tax Foundation Conf. Rep. 172 at 183.

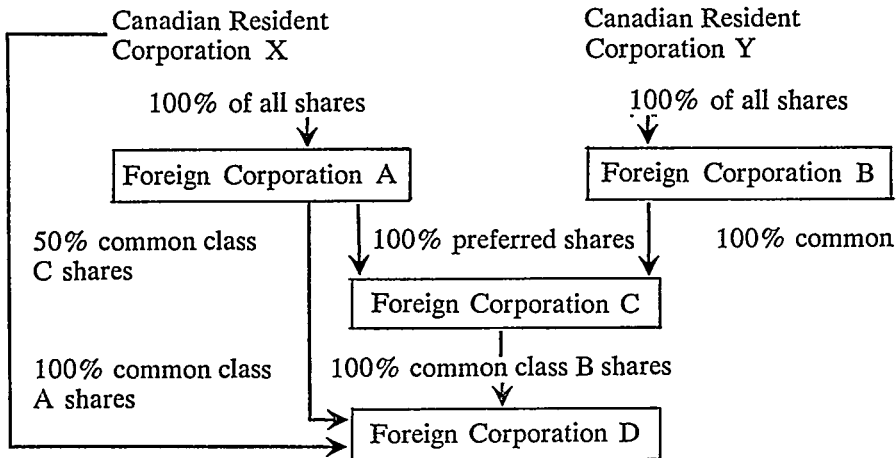
<sup>51</sup> Bradley, *supra* note 49, at 229; Baker, *id.* at 182.

<sup>52</sup> 3 Canada Tax Service at 91-108.

affiliate) the resident will have an indirect equity percentage in each of the corporation's foreign subsidiaries.<sup>53</sup>

- (4) There is no rule which aggregates the equity percentage of associated corporations.

*Example: Equity Percentage*



Canadian Corporation X's equity percentage in each of the foreign corporations is:

Foreign Corporation A:

Direct Equity Percentage	100%
Indirect Equity Percentage	0
Equity Percentage	<u>100%</u>

Foreign Corporation C:

Direct Equity Percentage	0
Indirect Equity Percentage	100%
(Equity Percentage in A, 100%, multiplied by A's Direct Equity Percentage in C, 100%)	
Equity Percentage	<u>100%</u>

Foreign Corporation D:

Direct Equity Percentage	50%
Indirect Equity Percentage	200%
(Aggregate of Indirect Equity Percentage through A, 100%, and through A and C, 100%)	
Equity Percentage	<u>250%</u>

Canadian corporation Y has an equity percentage in B of 100%.

Corporations X and Y have a total equity percentage in C of 200% and in D of 100%.

<sup>53</sup> Scace and Ewens, *supra* note 50, at 338.

The definition of equity percentage assumes that the capital structure of a foreign corporation is similar to the share structure of a Canadian corporation. This is not always true and peculiarities of structure flowing from different rules in the foreign jurisdiction may make it difficult to calculate a CPC's equity percentage. For example, under German law the capital of a private corporation (*Gesellschaft mit beschränkter Haftung* [hereinafter referred to as GmbH]) may be divided into shares of unequal amounts.<sup>54</sup> Thus, a GmbH may have a share capital expressed as follows: shareholder A has a share of DM 500,000, shareholder B has a share of DM 600,000 and shareholder C has a share of DM 1,000,000. Expressed in this way, each person has one share and a literal reading of paragraph 95(4)(a) would result in each having a direct equity percentage of  $33\frac{1}{3}$  percent. This would seem to be an incorrect result.<sup>55</sup> But, unless the foreign law is used to determine a person's relative equity interest in a foreign corporation, peculiar and perhaps inequitable results will occur.

For the purposes of the foreign affiliate rules, an income bond or debenture<sup>56</sup> issued by a non-resident corporation is deemed to be a share of the non-resident corporation unless any periodic payment made by the foreign corporation on the bond or debenture is deductible by the corporation when computing its income tax payable to its country of residence.<sup>57</sup> The language used by this deeming provision is difficult to interpret, but the effect of the subsection appears to be that each separate income bond or debenture, regardless of its principal amount relative to the principal amounts of other existing income bonds or debentures, is deemed to be a separate share of an unspecified class.<sup>58</sup>

## B. *The Surplus Accounts*

The existing rules relating to the taxation of foreign affiliate distributions should be viewed within the broader context of the legislative attack on tax haven abuses possible under the former Act. Tax reform produced two com-

<sup>54</sup> F. Wooldridge and V. Sharma, *The Private Company in German Law* (1975), 4 Anglo-Am. L. Rev. 40 at 46 *passim*.

<sup>55</sup> 3 Canada Tax Service 91-110. Revenue Canada's position is that where the ownership of the foreign entity is not divided into units entitled shares and the foreign entity is considered a corporation, the foreign entity is considered to have a capital stock of 100 issued shares. Each owner of a beneficial interest in the foreign entity is then considered to own a number of shares proportionate to his beneficial interest in the foreign business entity: Interpretation Bulletin IT-392, September 26, 1977. This means that in the example in the text, shareholder A would be deemed to own 23.8 shares  $\left(\frac{500,000}{2,100,000} \times 100\right)$ , shareholder B 28.6 shares  $\left(\frac{600,000}{2,100,000} \times 100\right)$ , and shareholder C 47.6 shares  $\left(\frac{1,000,000}{2,100,000} \times 100\right)$ .

<sup>56</sup> Income bond and income debenture are defined as a bond or debenture in respect of which interest or dividends are payable only when the debtor company has made a profit before taking into account the interest or dividend obligation: subsection 248(1) of the Act. See Interpretation Bulletin IT-52R2, February 3, 1975.

<sup>57</sup> Subsection 95(5) of the Act.

<sup>58</sup> Scace, *supra* note 45, at 683.

plementary sets of rules designed to eliminate the effectiveness of the most unacceptable international tax planning schemes. The first set of rules encountered by a CPC are the rules which tax a CPC currently on its share of a controlled foreign affiliate's foreign accrual property income (basically, passive property and business income; hereinafter referred to as FAPI) whether or not the FAPI is distributed to the CPC.<sup>59</sup> Termination of tax deferral negates the tax advantages of a tax haven subsidiary because current Canadian taxation of the income ensures that FAPI is subject to tax at a rate equal to the Canadian tax rate. The second set of rules included as part of the attack on tax haven abuses are the rules for the taxation of distributions from an affiliate.

Unlike the rules under the former Act which allowed a distribution from an affiliate to escape Canadian taxation if the CPC owned a sufficient number of shares of the foreign subsidiary, the present rules eliminate Canadian taxation of the distribution only when the level of foreign taxes paid on the foreign income underlying the payment approaches the Canadian corporate rate. If the foreign income taxes paid on the income are less than the Canadian corporate taxes, Canadian tax is levied on the distribution so that the global tax burden on the foreign income is the same as it would have been had the CPC earned the income directly.

## 1. Calculation of the Foreign Affiliate Surpluses

### a) The Basic Concepts

The Canadian tax consequences to a CPC on receipt of a dividend from a foreign affiliate are determinable only after the surplus account from which the dividend is deemed to be paid is identified. A foreign affiliate can have three surpluses: exempt surplus, taxable surplus or pre-acquisition surplus. A dividend from the affiliate's exempt surplus is not taxable when received by the CPC. A dividend paid from the affiliate's taxable surplus is subject to tax when received. A pre-acquisition surplus dividend is not taxable when received, but is taxable when the share upon which the dividend is paid is disposed of. Of the three surpluses, only the components of the affiliate's exempt and taxable surpluses are defined. Pre-acquisition surplus represents amounts that do not fall into either of the first two surpluses.

The allocation of income to either the affiliate's exempt surplus or taxable surplus can be made only after a detailed analysis of the "earnings" of the affiliate has been made. The definition of "earnings" refers to two kinds of income: active business income<sup>60</sup> and passive business income which is deemed to be active business income for the purposes of the foreign affiliate rules.<sup>61</sup>

The initial value for the earnings of a foreign affiliate from an active business carried on in a particular country is defined to be the income from

---

<sup>59</sup> Subsection 91(1) of the Act. FAPI is defined in subsection 95(1)(b) of the Act.

<sup>60</sup> Regulation 5907(1)(a)(i).

<sup>61</sup> Regulation 5907(1)(a)(ii).



the active business in that jurisdiction as determined for tax purposes under the following rules:

- (i) The income or profit from the active business as computed for the purposes of the income tax law of the affiliate's country of residence, if the country of residence requires the affiliate to compute the income or profit;<sup>62</sup>
- (ii) If the affiliate's country of residence does not require the affiliate to compute its income or profit from the active business, the earnings are the income and profits computed in accordance with the tax laws of the country in which the active business is carried on;<sup>63</sup>
- (iii) If neither of (i) or (ii) apply, the earnings of the affiliate are to be determined under the rules of Part I of the Income Tax Act on the assumption the business was carried on in Canada and that the affiliate was resident in Canada.<sup>64</sup>

The value of the affiliate's earnings from an active business determined under the above rules is only a preliminary calculation. This initial earnings value is then modified as follows:<sup>65</sup>

1. The income and expenditure accounts of the affiliate are adjusted to reflect the actual revenues and expenditures of the affiliate. This adjustment is made by eliminating the effects of any special tax incentives under the tax laws of the affiliate's country of residence. For example, if the affiliate is allowed to deduct an amount in excess of the actual value of an expenditure, the "excess" deduction is added back to the initial earnings value. Similarly, revenue earned by the affiliates not included in income by the foreign law, is added to the initial earnings amount.
2. The initial earnings amount is also adjusted to exclude the effect of any losses in other taxation years which were carried forward or back.
3. Any amounts included in the FAPI of the affiliate are excluded from earnings, as are net FAPI losses.
4. Net capital gains and losses of the affiliate, determined under Canadian rules are excluded from earnings.

The intention of the Regulations is to base the calculation of the foreign earnings on the applicable foreign tax law.<sup>66</sup> Utilization of the foreign rules has two advantages: it minimizes the number of adjustments required for Canadian tax purposes and it allows the foreign tax to be closely matched with the related foreign income.<sup>67</sup> The modifications made to the initial earnings amount calculated under the foreign rules are designed to eliminate the effects of foreign tax rules which are contrary to basic Canadian tax principles so that the final earnings value is consistent with Canadian tax concepts.

---

<sup>62</sup> Regulation 5907(a)(i)(A).

<sup>63</sup> Regulation 5907(a)(i)(B).

<sup>64</sup> Regulation 5907(a)(i)(C).

<sup>65</sup> Regulation 5907(2).

<sup>66</sup> Brown, *supra* note 2, at 46.

<sup>67</sup> *Id.*

There can be significant disparities between the affiliate's taxable income under the foreign laws and its "earnings" for the purposes of the surplus rules. Where the foreign laws contain tax incentives, such as fast write-offs or deductible rules, the affiliate's after-tax profit (for foreign tax purposes) will be higher than its earnings for Canadian tax purposes. If the affiliate distributes its profits, the value of the dividends can be greater than the aggregate of the affiliate's exempt and taxable surpluses, resulting in the inadvertent payment of a pre-acquisition surplus and a reduction in the adjusted cost base of the CPC's equity investment in the affiliate.<sup>68</sup>

One apparent deficiency of the definition of "earnings" is its failure to anticipate the accounting problems that arise when the foreign corporate group's activities are consolidated. There are no precise rules governing the computation of the value of an affiliate's earnings when its taxable income has been reduced by a loss incurred by another affiliate.<sup>69</sup> The existing provisions do not allow the profitable affiliate to increase its earnings by the amount of the consolidated loss. A related problem arises when one affiliate pays all of the taxes of a corporate group which consolidates its activities. The existing rules do not indicate how the foreign taxes are to be allocated among the affiliates forming the group.<sup>70</sup>

Income from an active business can be included in an affiliate's earnings only if the conditions in Regulation 5906 are met:

5906. (1) For the purposes of this Part, where a foreign affiliate of a corporation resident in Canada carries on an active business, it shall be deemed to carry on that business

- (a) in a country other than Canada only to the extent that such business is carried on through a permanent establishment situated therein; and
- (b) in Canada only to the extent that its income therefrom is subject to tax under Part I of the Act.

(2) Where the Government of Canada has concluded an agreement or convention with the government of another country for the avoidance of double taxation that has the force of law in Canada and in which the expression "permanent establishment" is given a particular meaning, for the purposes of subsection (1), that expression has that meaning with respect to a business carried on in that country and, in any other case, has the meaning assigned by subsection 400(2).<sup>71</sup>

It should be noted that the definition in Regulation 400(2) is narrower than some of the treaty definitions of permanent establishment.<sup>72</sup>

<sup>68</sup> D. Broadhurst, *Taxable and Other Surplus* (1976), 24 Can. Tax J. 372 at 378.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> An international tax treaty must be incorporated into a statute passed by Parliament before it can be part of the laws of Canada. Furthermore, the treaty may prescribe an administrative function, such as the exchange of instruments of ratification, which must be completed before the treaty comes into force.

It is possible under the Foreign Affiliate Regulations, as drafted, for a country to be classified as a treaty country because it has signed a tax treaty with Canada and yet have the question of whether an entity is a permanent establishment determined by the rules of Regulation 400(2) and not by the rules in the treaty. This will occur when the treaty is not the law of Canada because it has not been passed as a statute or because instruments of ratification have not been exchanged.

<sup>72</sup> R. Robertson and J. R. Wilson, "Foreign Affiliates and Non-Resident Trusts," in M. O'Brien, ed., *Canadian Income Tax* (Toronto: Butterworths, 1974) at 12.8.2.

Earnings from an active business that cannot be attributed to a permanent establishment in a particular country are to be attributed to the permanent establishment in the country in which the affiliate is resident.<sup>73</sup> If the affiliate is resident in more than one jurisdiction, the earnings are to be assigned to the permanent establishment in the country that may be regarded as the affiliate's principal place of residence.<sup>74</sup> The purpose of these rules is to impute earnings to a permanent establishment when the earnings arise from business activities in a jurisdiction where the affiliate does not maintain a permanent establishment.<sup>75</sup>

Whether the allocation rules accomplish their task depends upon how Regulation 5906(1) is interpreted. That Regulation states that an active business is deemed to be carried on by an affiliate in a country only to the extent the business is carried on through a permanent establishment in that country. Normally, a person is considered to be "carrying on a business" in a country only if that country is the territorial source of the income under the common law rules.<sup>76</sup> The absence of any definition of "carrying on business" in the Regulations suggests that the common law source rules are to be used in the interpretation of the regulation.

If the source rules treat income as having its source in a foreign country in which the affiliate does not maintain a permanent establishment, the income received cannot, because of Regulation 5906, be active business income. If the income is not active business income within the rules of Regulation 5906, the rule for assigning income to the permanent establishment in the affiliate's country of residence is inapplicable because it deals only with earnings from an active business.

This result can be illustrated by the following example. An affiliate resident in Britain and maintaining a permanent establishment in Britain performs engineering services in Italy. The affiliate does not maintain a permanent establishment in Italy. The common law territorial source rules would probably hold that the business was carried on in Italy because the services were performed in that country.<sup>77</sup> Because the affiliate maintains no permanent establishment in that country, by the rules of Regulation 5906, the affiliate's earnings are not active business income and, therefore, they cannot be assigned to the permanent establishment in Britain.

---

<sup>73</sup> Regulation 5907(1)(a).

<sup>74</sup> *Id.*

<sup>75</sup> B. Verchere, *Foreign Source Income—Tax Planning Concepts* (1975), 27 Can. Tax Foundation Conf. Rep. 603 at 622.

<sup>76</sup> *Id.* An excellent discussion of the common law territorial source rules appears in H. H. Stikeman, *Carrying on Business in Canada in Dominion Income Tax Law* (1942), 20 Can. Bar Rev. 77.

<sup>77</sup> The Canadian position appears to be that the territorial source of service income is the place where the services are performed: see clause 115(1)(a)(ii) of the Act. This is in accord with the Australian and South African position: see *Commissioner of Taxation v. Mitchum* (1964-65), 113 C.L.R. 401 (H.C.), and *Commissioner of Taxation v. Shein*, [1958] 3 S. Af. L.R. 12, respectively. However, it is contrary to the British rule: see *Foulsham v. Pickles*, [1925] A.C. 458, and *Bray v. Colenbrander* (1953), 34 T.C. 138.

Assuming this interpretation is correct, active business income earned by an affiliate in a country in which it does not have a permanent establishment appears to fall into the affiliate's pre-acquisition surplus. This result occurs because the income is, for the purposes of the definition of exempt surplus and taxable surplus, neither active business, nor deemed active business income, nor FAPI. The reason why the income is not active business income has been stated. The income is not deemed active business income because such income is limited to income covered by the rules in paragraph 95(2)(a) of the Act. The income is not FAPI because the rules of Regulation 5906 apply only to the definitions in the Regulations and do not affect the interpretation of the definition of FAPI in paragraph 95(1)(b) of the Act. That definition excludes from an affiliate's FAPI active business income. The Act does not prevent actual active business income from being excluded from FAPI because the income is not earned through a permanent establishment.

When a foreign affiliate carries on an active business in Canada, the income will qualify as "earnings" from an active business whether or not the affiliate has a Canadian permanent establishment. Regulation 5906 only requires that the income be subject to tax under Part 1 of the Act and this condition will always be met if a business is carried on in this country.<sup>78</sup> The income will also qualify as earnings, even if the income is not taxable by Canada, because the exemption from Canadian tax does not occur due to an exemption provided by Part 1, but due to the rules of the separate and overriding statute enacting the tax treaty between the affiliate's country of residence and Canada.

A second category of income included in the definition of "earnings" from an active business is after-tax passive income deemed to be active business income by paragraph 95(2)(a) of the Act.<sup>79</sup> The type of passive income deemed to be active business income is discussed below.<sup>80</sup> Unlike actual active business income, the deemed active business income is not subject to the adjustments designed to bring the initial earnings value in line with underlying Canadian tax principles.

The second basic concept common to the surplus account definitions is "net earnings."<sup>81</sup> The definition of net earnings also deals with two categories of income: net active business earnings and net FAPI. The net earnings from an active business are the affiliate's earnings, i.e., active business income, less income taxes paid by the affiliate on that income.<sup>82</sup> The "net FAPI earnings"

---

<sup>78</sup> Subsection 2(3) of the Act.

<sup>79</sup> Passive business income which is deemed to be active business income is income which pertains to or is incident to the active business of the affiliate and inter-affiliate payments deductible by the payor-affiliate from its active business income.

For a discussion of the meaning of "pertains to or is incident to," see Cumyn, *Foreign Accrual Property Income Under the 1974 Spring Budget* (1974), 26 Can. Tax Foundation Conf. Rep. 240 at 243.

<sup>80</sup> See text, *infra*, at 103.

<sup>81</sup> Net Earnings is defined by Regulation 5907(1)(f).

<sup>82</sup> Regulation 5907(1)(f)(i).

of an affiliate are the affiliate's FAPI, calculated before the application of the deductible loss provision, less foreign income taxes paid on the FAPI.<sup>83</sup>

The surplus calculations are adjusted downward for any losses sustained by an affiliate. To provide a basic starting point for the calculation of an affiliate's loss, the Regulations contain a definition of "loss"<sup>84</sup> which performs the same co-ordinating function as the concept of "earnings." In fact, the definition of loss from an active business is constructed from the definition of earnings from an active business. Regulation 5907(1)(e) states that an affiliate's loss from an active business carried on in a country is determined by applying the rules for the calculation of earnings from an active business *mutatis mutandis*. The loss from an active business is, therefore, calculated first under the tax laws of the country in which the affiliate is resident; if the country of residence does not tax the affiliate, the loss is determined by the rules of the country in which the business is conducted. If no foreign rules apply, the affiliate's loss is to be determined under the rules of Part I of the Act. As with the initial value of earnings, a loss value computed under foreign rules is modified to conform with Canadian tax principles.

The "loss" from an active business carried on by an affiliate does not directly affect the surplus values. Just as "earnings" are adjusted to an after-tax position (net earnings) before inclusion into the accounts, the affiliate's loss is similarly adjusted. The modification takes the form of reducing the loss by an amount equal to the value of any income or profit taxes refunded because of the loss.<sup>85</sup> The resulting value is called the affiliate's "net loss."<sup>86</sup>

The definitions of "loss" and "net loss" do not contain counterparts for each element in the definitions of earnings and net earnings. The loss definitions do not refer to losses sustained in a passive business, the income from which would form part of earnings, nor do they refer to FAPI losses. The former type of loss is not specifically dealt with by another provision that suggests that the drafters of the Regulations did not believe such a loss could occur. Because of the absence of any express rule dealing with losses from this form of passive business, a loss does not have to be recovered before dividends can be paid from the surplus accounts. FAPI losses are not dealt with by the definitions of "loss" and "net loss" because there are specific rules in the surplus account definitions prescribing the treatment of FAPI losses.<sup>87</sup>

## 2. The Basic Rules

The calculation of the surplus accounts, which are non-static,<sup>88</sup> begins the moment a foreign subsidiary of the CPC qualifies as a foreign affiliate. The starting point for the calculation is the first day of the taxation year in

---

<sup>83</sup> Regulation 5907(1)(f)(ii).

<sup>84</sup> Regulation 5907(1)(e).

<sup>85</sup> Regulation 5907(1)(g).

<sup>86</sup> *Id.*

<sup>87</sup> Regulations 5907(1)(c)(ii)(B); and 5907(1)(j)(ii)(B).

<sup>88</sup> C. F. Steiss and R. J. Dart, *The Foreign Affiliate* (1976), 24 Can. Tax J. 241 at 243.

which the non-resident corporation last becomes an affiliate.<sup>89</sup> The surplus calculations are applicable individually to each CPC, which means that separate accounts must be maintained for each CPC or the affiliate.<sup>90</sup> The accounts *vis-à-vis* a CPC disappear the moment a CPC's direct and indirect equity interest in the foreign corporation drops below the required 10 percent level, that is, when foreign affiliate status is lost. If the CPC subsequently reacquires sufficient shares to bring its equity interest up to the 10 percent level, the surplus calculations start afresh from nil. There is no provision which allows the surplus accounts to be carried forward from the last period in which the foreign corporation was a foreign affiliate. It follows that the surplus accounts of an affiliate *vis-à-vis* a particular CPC are not transferred to a second CPC when the latter acquires the shares of the first CPC unless the transfer of shares is made via a tax-free reorganization. The surplus calculations relating to the second CPC will start from zero at the beginning of affiliate's taxation year in which the shares are sold.<sup>91</sup>

Though separate records are kept in respect of each CPC of an affiliate, the surplus (and foreign tax) accounts are calculated as if each CPC owned 100 percent of the issued shares.<sup>92</sup> Each account reflects 100 percent of the qualifying income and taxes earned or paid in the year and each is reduced by the full amount of every deduction. When the CPC owns less than 100 percent of the issued shares, the rules ensure that the CPC receiving a dividend from the affiliate will be responsible only for its *pro rata* share of the relevant surplus account.<sup>93</sup> That share is determined by the CPC's portion of the dividend paid.<sup>94</sup>

Adjustments are made to the surplus accounts relating to a particular CPC when the CPC's equity participation in an affiliate is increased because the CPC or another corporation in which the CPC has an equity interest has acquired additional shares of the affiliate. The adjustment takes the form of a reduction<sup>95</sup> in the accounts so that the CPC's interest in the accounts remains constant. A CPC, therefore, cannot increase its interest in the exempt or taxable surplus account by increasing its participation in the affiliate.<sup>96</sup>

### 3. Exempt Surplus

The first of the three affiliate surplus accounts is exempt surplus. The value of the surplus is determined by adding the positive components of the surplus, the exempt earnings, exempt surplus inter-affiliate dividends, and Canadian source taxable dividends, and subtracting from that total the aggre-

---

<sup>89</sup> The earliest time a foreign corporation can be considered a foreign affiliate is January 1, 1972: ITAR 35(2).

<sup>90</sup> Steiss and Dart, *supra* note 88, at 243.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*; see Brown, *supra* note 2, at 52.

<sup>94</sup> Steiss and Dart, *supra* note 88, at 243.

<sup>95</sup> Regulation 5905. These rules are discussed below.

<sup>96</sup> Brown, *supra* note 2, at 52; Steiss and Dart, *supra* note 88, at 243.

gate of the affiliate's exempt loss, income and profit taxes paid on the inter-affiliate Canadian source dividends, and exempt surplus dividends paid by the affiliate.

a) The Positive Components of Exempt Surplus

(1) Exempt Earnings

A capital gain realized on the disposition of an asset used principally to earn active business income, less foreign income taxes on the gain, forms part of the affiliate's exempt earnings.<sup>97</sup> This rule applies to most non-FAPI capital gains even if the gain is realized on the sale of a capital asset that produced taxable surplus active business income.<sup>98</sup> Also included in exempt earnings is the non-taxable half of a FAPI capital gain, calculated after the payment of foreign income taxes.<sup>99</sup>

The only time a non-FAPI capital gain is excluded from exempt earnings is when the capital gain is realized by an affiliate on the transfer of shares of a second affiliate to a third affiliate. The portion of the capital gain excluded from exempt earnings is the amount by which the fair market value of the transferred shares, at the end of the transferor-affiliate's 1975 taxation year, exceeds the adjusted cost base of the shares.<sup>100</sup> The exclusion of an amount equal to the capital appreciation of the shares accrued to the end of the 1975 taxation year is necessary if the artificial creation of exempt earnings is to be prevented. Paragraph 95(2)(c) of the Act allows the transfer of the shares between affiliates to take place at any price (called the relevant cost base) chosen by the CPC as long as this price is not less than the adjusted cost base of the transferred shares and not more than the fair market value of the shares on the day of transfer.<sup>101</sup> Because any capital gain accrued prior to an affiliate's 1976 taxation year is excluded from the affiliate's FAPI, it is possible to use the roll-over provision to transfer shares to a newly incorporated affiliate at a value equal to their fair market value at the end of the transferor's 1975 taxation year and avoid Canadian taxation of the capital gain. The transfer would also create exempt earnings in the disposing affiliate if the exclusionary rule did not exist. The exclusion of the gain prevents the artificial realization of exempt earnings, and their tax-free transfer to the CPC, on the transfer of shares in an affiliate when there is no change in the ultimate beneficial ownership of the transferred shares.<sup>102</sup> Because the gain is excluded from the affiliate's exempt surplus and taxable surplus, the excluded gain falls into the transferor-affiliate's pre-acquisition surplus.

The treatment of capital gains not included in an affiliate's FAPI applies

---

<sup>97</sup> Regulation 5907(1)(b)(v).

<sup>98</sup> R. J. Dart, *Foreign Affiliates—Surplus Accounts and Reorganizations Provisions* (1975), 27 Can. Tax Foundation Conf. Rep. 859 at 861.

<sup>99</sup> Friesen and Timbrell, *Canadian Taxation of Income Arising in Non-Resident Corporations and Trusts* (Don Mills: CCH Canadian Limited, 1975) at 10.

<sup>100</sup> Regulation 5907(1)(b)(i).

<sup>101</sup> Paragraph 95(4)(c) of the Act.

<sup>102</sup> Dart, *supra* note 98, at 885.

to all affiliates regardless of the jurisdiction in which the affiliate is resident. In this respect the treatment of capital gain differs from the treatment of ordinary income.

### (2) Ordinary Income Earned Before the Affiliate's 1976 Taxation Year

The affiliate's net earnings, after-tax active business income and FAPI,<sup>103</sup> and after-tax deemed active business income,<sup>104</sup> earned during its 1975 or any preceding taxation year are included in the affiliate's exempt surplus. This rule, like the capital gains rule, applies to all foreign affiliates. The effect of this rule is to allow an affiliate to enter its 1976 taxation year with a pool of accumulated earnings that can be distributed to the CPC free of Canadian tax.

### (3) Ordinary Income Earned By An Affiliate After Its 1975 Taxation Year

After 1975, inclusion of ordinary income in an affiliate's exempt earnings depends upon three factors: the character of the income, the territorial source of the income, and the residence of the affiliate. Beginning with an affiliate's 1976 taxation year, the affiliate will be able to include active business income in its exempt surplus only if it is resident in a prescribed country (commonly referred to as a "treaty" country)<sup>105</sup> and only if the active business income (net earnings) is from a business carried<sup>106</sup> on in Canada or in a treaty country.<sup>107</sup> Active business income earned by an affiliate not resident in a treaty country, and active business income earned by an affiliate resident in a treaty country (a treaty country affiliate) from a non-treaty country business, qualifies as taxable surplus income and not as exempt earnings.

Similar conditions have been placed on deemed active business income received by a treaty country affiliate. Passive income, calculated after payment of foreign income taxes, which is deemed to be active business income because it pertains to or is incidental to an active business carried on in a foreign country, will be included in exempt earnings only if the related active business is carried on in a treaty country.<sup>108</sup>

Inter-affiliate payments treated as active business income because they

---

<sup>103</sup> Regulation 5907(1)(b)(ii).

<sup>104</sup> Regulation 5907(1)(b)(iii).

<sup>105</sup> The prescribed countries are the: Commonwealth of Australia, Republic of Austria, Kingdom of Belgium, Federative Republic of Brazil, Kingdom of Denmark, Dominican Republic, Republic of Finland, French Republic, Federal Republic of Germany, Republic of Indonesia, Irish Republic, State of Israel, Italy, Jamaica, Japan, Kenya, Republic of Korea, Republic of Liberia, Malaysia, Kingdom of Morocco, Kingdom of the Netherlands, New Zealand, Kingdom of Norway, Islamic Republic of Pakistan, Republic of the Philippines, Republic of Portugal, Socialist Republic of Romania, Republic of Senegal, Republic of Singapore, Republic of South Africa, Kingdom of Spain, Kingdom of Sweden, Swiss Confederation, Trinidad and Tobago, Republic of Tunisia, United Kingdom of Great Britain and Northern Ireland, United States of America, Republic of Zambia: Regulation 5907(11).

<sup>106</sup> The business must be carried on through a permanent establishment: Regulation 5906.

<sup>107</sup> Regulation 5907(1)(b)(iv).

<sup>108</sup> Regulation 5907(1)(b)(iv)(B)(I).



are deductible by the payor-affiliate from its income under the tax laws of its country of residence, are included in the recipient treaty-country affiliate's exempt earnings only if the payor-affiliate can deduct the payments from its exempt earnings.<sup>109</sup> This condition placed on inter-affiliate payments means that, as a general rule, only inter-affiliate payments between treaty country affiliates will fall into the recipient's exempt earnings because a non-treaty country affiliate normally will not earn exempt earnings after its 1975 taxation year.<sup>110</sup> The major exception to this general rule arises on inter-affiliate payments which are applied against capital gains realized by the payor-affiliate. Capital gains, except taxable FAPI capital gains, qualify as exempt earnings (exempt surplus) of the affiliate disposing of the capital asset<sup>111</sup> regardless of the affiliate's country of residence. If the payor-affiliate can establish that the inter-affiliate payment is deductible from the gain, the payment should qualify as exempt earnings of the recipient affiliate. One example of an expense that would qualify is a selling commission paid to the recipient affiliate. An affiliate's capital gain is computed according to the rules of Part I of the Act<sup>112</sup> and under the rules of the Act the cost of selling a capital asset, e.g., a sales commission is deductible by the taxpayer when computing his gain.<sup>113</sup> This implies that the expense is deductible from the payor's exempt earnings.<sup>114</sup>

The last component of an affiliate's exempt earnings is income that would normally be taxable surplus income because it is earned in a non-treaty country but is included in exempt earnings because it is subject to a "tax-sparing" investment incentive in the host jurisdiction.

A developing country whose supply of indigenous investment capital is insufficient to support the country's economic development may legislate incentives designed to attract private foreign investment. A common form of investment incentive is the "tax-spared" incentive. Under a tax-spared incentive, the host country agrees to forego the tax it would normally levy against the income generated by the investment.<sup>115</sup> By sparing part or all of the tax the host country hopes to make the investment's after-tax return to the private investor higher than the after-tax return of alternative investments.

The effectiveness of the tax-spared incentive in attracting private foreign investment does not depend upon the tax rules of the host country but on the tax laws of the private investor's home country.<sup>116</sup> If the home country does not recognize the foreign taxes foregone, the global tax burden on the foreign income and the after-tax return to the investors after the income's repatriation,

---

<sup>109</sup> Regulation 5907(1)(b)(iv)(B)(II).

<sup>110</sup> Brown, *supra* note 2, at 49.

<sup>111</sup> Regulation 5907(1)(b).

<sup>112</sup> Regulation 5907(5).

<sup>113</sup> Clause 40(1)(a)(i) of the Act.

<sup>114</sup> Regulation 5907(1)(b).

<sup>115</sup> Surrey, *The Pakistan Tax Treaty and "Tax Sparing"* (1958), 11 Nat. Tax J. 156 at 157.

<sup>116</sup> P. B. Musgrave, *Fiscal Systems* (New Haven: Yale University Press, 1969) at 255.

will equal the global tax burden which would have existed had the investment incentive not been granted. Furthermore, there will be a transfer of income from the treasury of the host country to the treasury of the home country equal to the amount of the tax foregone. These two effects can be illustrated by the following example:

*Example:*

It is assumed that the affiliate earns \$100 of taxable surplus income and that the non-treaty country exempts the income from tax under a tax-spared incentive. Had the incentive not existed the affiliate would pay a \$20 income tax on the income. It is also assumed that the affiliate distributes all of its income in the year.

No tax-sparing	
Taxable surplus dividend received by CPC	\$ 20.00
Underlying foreign tax deduction (\$20 x 1.1739)	<u>23.48</u>
Taxable Income	<u>\$ 56.52</u>
Tax at 46%	<u>\$ 26.00</u>
Total Taxes Paid	
Foreign Taxes	\$ 20
Canadian Taxes	<u>26</u>
	<u>\$ 46</u>
Tax-Spared Situation	
Taxable surplus dividend received by CPC	\$ 100.00
Underlying foreign tax deduction	<u>—</u>
Taxable Income	<u>\$ 100.00</u>
Tax at 46%	<u>\$ 46.00</u>
Total Taxes Paid	
Foreign Taxes	—
Canadian Taxes	<u>\$ 46*</u>
	<u>\$ 46</u>

\*\$20 of tax formerly received by the developing country is now received by Canada.

Regulation 5907(10) provides that active business income earned by an affiliate in a non-treaty country is to be included in the affiliate's exempt earnings and not in its taxable earnings if certain conditions are met. The effect of this rule is to convert income that would be taxed by Canada when distributed to the CPC to income which is not subject to Canadian tax when received by the CPC.

The conditions that must be met before the taxable earnings are transformed into exempt earnings are:

1. The actual rate of tax applied against the active business income must be less than the normal rate of income or profit taxes;
2. The reduction in the normal tax rate or the complete exemption from income or profit taxes, must be provided for in a law intended to promote investment pursuant to a programme of economic development;

3. The reduction or exemption from tax must not be an export incentive.
4. The affiliate must have qualified for tax-spared relief in respect of an investment made prior to January 1, 1976 or in respect of an investment or project undertaken pursuant to a written agreement signed before 1976.

Neither the Act nor the Regulations contain any indication of Canadian attitudes towards investment incentives offered to a CPC after 1975. However, if Canada believes that it has a duty to assist a developing nation in attracting Canadian source development capital and that Canadian tax rules should be an instrument of that policy, future rules must reflect investor attitudes to be effective. If the CPC intends to reinvest the income produced by the investment in the host country, the initial outflow of capital will be encouraged by Canadian tax deferral and by high Canadian tax rates. If the CPC intends to repatriate the foreign income, tax deferral will not act as an incentive but a preferential Canadian tax rate will be effective. As an inducement to reinvest the capital already in place, Canada must maintain tax deferral but a preferential rate on distributed income would have the opposite effect.<sup>117</sup>

The exempt earnings of an affiliate are added to the affiliate's exempt surplus only at the end of the taxation year. The value of the affiliate's exempt surplus, therefore, does not reflect active business and deemed active business income earned in the current taxation year until that year has ended.<sup>118</sup>

#### (4) Dividend Income

The exempt surplus of an affiliate, whether resident in a treaty country or non-treaty country, includes inter-affiliate and Canadian source dividends. A dividend received by the parent-affiliate which is paid out of the subsidiary-affiliate's exempt surplus is included in the parent's exempt surplus when received.<sup>119</sup> A Canadian source dividend will also be included in the recipient affiliate's exempt surplus when received if the payor corporation is either resident or incorporated in Canada, and the dividend is not paid from the payor's 1971 capital surplus, 1971 tax-paid undistributed income, or capital dividend account.<sup>120</sup>

The exempt surplus account is reduced by the amount of any withholding taxes paid by the affiliate on an inter-affiliate dividend<sup>121</sup> or Canadian source dividend.<sup>122</sup>

#### b) The Negative Components of Exempt Surplus

Since the function of the exempt surplus account is to provide a record of retained earnings which can be distributed, any event that diminishes the

---

<sup>117</sup> *Id.* at 256.

<sup>118</sup> Regulation 5907(1)(d)(v).

<sup>119</sup> Regulation 5907(1)(d)(vi).

<sup>120</sup> Regulation 5907(1)(d)(vii).

<sup>121</sup> Regulation 5907(1)(d)(x).

<sup>122</sup> *Id.*

distributable exempt surplus funds of the affiliate reduces the value of the account.

#### (1) Exempt Losses

The exempt loss of an affiliate is calculated in similar fashion to the affiliate's exempt earnings. For the affiliate's taxation years preceding its 1976 taxation year, the affiliate's exempt loss is the aggregate of its non-FAPI capital losses less any tax refunds generated by those losses,<sup>123</sup> the affiliate's net losses<sup>124</sup> from an active business carried on in a country,<sup>125</sup> and the amount by which its FAPI property and business losses exceeds its FAPI property and business income.<sup>126</sup> The last value is not reduced by any taxes refunded because of the loss. The absence of a reduction for a tax refund appears to be an oversight that favours National Revenue over the CPC. When positive FAPI is added to the exempt surplus, it is reduced by the amount of any foreign taxes paid because the foreign taxes reduce the distributable funds. When a FAPI loss is incurred, any tax refund increases the income that can be distributed and, as such, the refund should be reflected in the exempt surplus account.

An affiliate's exempt loss for its 1976 and subsequent years is the aggregate of its non-FAPI capital losses less tax refunds where the affiliate is resident in a treaty country, its net losses from an active business carried on in a treaty country,<sup>127</sup> and losses included in exempt losses by the "tax-sparing" rule.<sup>128</sup>

An affiliate's exempt loss for the year is subtracted from its exempt surplus at the end of the taxation year.

#### (2) Exempt Surplus Dividends

An affiliate's exempt surplus is reduced by each exempt surplus dividend paid.<sup>129</sup> The adjustment in the account is made when the dividend is paid.<sup>130</sup>

### 4. Taxable Surplus

The second surplus of an affiliate whose elements are specifically defined is the affiliate's taxable surplus.

#### a) The Positive Components of Taxable Surplus

##### (1) Taxable Earnings

An affiliate's taxable surplus has only two positive elements. The first is the affiliate's taxable earnings. The taxable earnings of any affiliate do not

<sup>123</sup> Regulation 5907(1)(c)(i).

<sup>124</sup> Regulation 5907(1)(c)(ii)(A).

<sup>125</sup> The business must be carried on through a permanent establishment: Regulation 5906.

<sup>126</sup> Regulation 5907(1)(c)(ii)(B).

<sup>127</sup> Regulation 5907(1)(c)(iii).

<sup>128</sup> Regulation 5907(1)(d)(iv).

<sup>129</sup> Regulation 5907(1)(d)(xi).

<sup>130</sup> *Id.*

include any income included in the affiliate's exempt earnings.<sup>131</sup> Taxable earnings, therefore, never include capital gains realized by the affiliate except taxable FAPI capital gains realized after the affiliate's 1975 taxation year, ordinary income earned by the affiliate prior to its 1976 taxation year,<sup>132</sup> and "tax-spared" income. After its 1975 taxation year, the taxable earnings of an affiliate resident in a non-treaty country will include all of its after-tax active business income and after-tax FAPI.<sup>133</sup> The taxable earnings of an affiliate resident in a treaty country will, after its 1975 taxation year, include its after-tax business income earned in a non-treaty country, its after-tax FAPI, and its after-tax deemed active business income that pertains to an active business carried on in a non-treaty country; and any inter-affiliate payment not deductible from the payor's exempt earnings.<sup>134</sup>

The affiliate's taxable earnings are added to its taxable surplus account, not as earned but at the end of the affiliate's taxation year.<sup>135</sup>

## (2) Dividend Income

The second positive element of an affiliate's taxation surplus is inter-affiliate dividends paid from the payor-affiliate's taxable surplus less<sup>136</sup> withholding taxes and income taxes paid on the dividend.<sup>137</sup> The dividend is added to the taxable surplus when received.<sup>138</sup>

## b) The Negative Components of Taxable Surplus

### (1) Taxable Losses

An affiliate's taxable surplus is reduced by the affiliate's taxable losses for the year. A taxable loss can arise only after an affiliate's 1975 taxation year<sup>139</sup> and does not include any amount included in the affiliate's exempt loss for the year.<sup>140</sup> The taxable loss of a non-treaty country affiliate equals the aggregate of its active business losses (net losses)<sup>141</sup> and its FAPI losses.<sup>142</sup> If the affiliate is a treaty country affiliate, its taxable loss is the aggregate of its active business losses from businesses carried on in a non-treaty country<sup>143</sup> and its FAPI losses.<sup>144</sup>

---

<sup>131</sup> Regulation 5907(1)(i).

<sup>132</sup> Regulation 5907(1)(i)(i).

<sup>133</sup> Regulations 5907(1)(i)(ii)(A) & (B).

<sup>134</sup> Brown, *supra* note 2, at 49.

<sup>135</sup> Regulation 5907(1)(k)(v).

<sup>136</sup> Regulation 5907(1)(k)(vi).

<sup>137</sup> Regulation 5907(1)(k)(ix).

<sup>138</sup> Regulation 5907(1)(k)(vi).

<sup>139</sup> Regulation 5907(1)(j)(i).

<sup>140</sup> *Id.*

<sup>141</sup> Regulation 5907(1)(j)(ii)(A).

<sup>142</sup> Regulation 5907(1)(j)(ii)(B).

<sup>143</sup> Regulations 5907(1)(b)(iv)(A) and 5907(1)(j)(ii)(A).

<sup>144</sup> Regulation 5907(1)(j)(ii)(B).

Taxable losses are subtracted from the affiliate's taxable surplus only at the end of the taxation year in which they occur.

## (2) Taxable Surplus Dividends

An affiliate's taxable surplus is reduced by any taxable surplus dividend which the affiliate pays<sup>145</sup> or is deemed to have paid.<sup>146</sup> The deduction from taxable surplus is made when the dividend is paid.

## 5. Pre-Acquisition Surplus

An affiliate's third surplus is its pre-acquisition surplus. The elements of this account are not specifically defined, implying that any income that is not included in the affiliate's exempt surplus or taxable surplus is included in its pre-acquisition surplus.<sup>147</sup> Pre-acquisition surplus, therefore, always includes the affiliate's income earned prior to the first day of the taxation year in which the foreign subsidiary becomes an affiliate. The surplus account can also include income earned after affiliate status is acquired. Interest income earned by an affiliate and excluded from FAPI by sub-clause 95(1)(b)(i)(A)<sup>148</sup> is classified as pre-acquisition surplus as are pre-acquisition surplus dividends received from other affiliates. Also included in pre-acquisition surplus are capital gains realized on the sale of shares of an affiliate when such gains are excluded from FAPI and exempt surplus. It also appears that income from an active business which is excluded from "earnings from an active business" because it was not earned through a permanent establishment are included in pre-acquisition surplus.

This surplus account is the only surplus to be calculated without a deduction for income taxes paid on the qualifying income. No tax advantage, however, results from failure to adjust for taxes. It is the adjusted cost base (a.c.b.) of the affiliate's shares held by the CPC that limits the amount of pre-acquisition surplus that can be returned to the CPC free of Canadian tax and not the value of the pre-acquisition surplus account. A pre-acquisition surplus dividend in excess of the a.c.b. of the affiliate's shares would activate the negative adjusted cost base rules<sup>149</sup> causing the CPC to realize an immediate capital gain equal to the amount by which the dividend exceeds the share's a.c.b. The a.c.b. of the shares of the affiliate will then be restored to nil.<sup>150</sup>

## C. *Reduction of an Affiliate's Exempt Surplus, Taxable Surplus and Underlying Foreign Tax Account*

The Regulations recognize that a CPC's percentage interest in a particular affiliate may increase because the CPC or an intermediary corporation

---

<sup>145</sup> Regulation 5907(1)(k)(x).

<sup>146</sup> Regulation 5907(1)(k)(xi).

<sup>147</sup> Brown, *supra* note 2, at 44; Steiss and Dart, *supra* note 88, at 243.

<sup>148</sup> The interest income excluded from FAPI is income received on bonds or debentures the CPC received when its foreign utilities business was nationalized.

<sup>149</sup> Subsection 40(3) of the Act.

<sup>150</sup> Paragraph 53(1)(a) of the Act.

in which the CPC has an equity percentage has acquired additional shares in the affiliate or because the affiliate itself has purchased its own shares.<sup>151</sup> When as a result of one of these acts the aggregate participating percentage<sup>152</sup> of all of the shares owned by the CPC in respect of the affiliate increases, the exempt surplus (or exempt deficit), taxable surplus (or taxable deficit) and underlying foreign tax of the affiliate *vis-à-vis* the CPC are adjusted to reflect the CPC's increased percentage interest. The adjustment is a reduction to the account.<sup>153</sup> The result of the reduction is that the CPC's share of the affiliate's accounts after the increase is identical to its share of the surplus accounts before its increase in its participating percentage.<sup>154</sup> Because the accounts associated with the CPC remain at a constant value, the CPC cannot increase the percentage of an affiliate's exempt surplus payable to it by the acquisition of more shares. Conversely, the CPC is not responsible for a larger portion of the affiliate's taxable surplus and, therefore, does not pay Canadian tax on taxable surplus dividends payable to it and attributable to its increased interest.<sup>155</sup> The CPC's increased participation in the affiliate is simply reflected in its interest in the pre-acquisition account of the affiliate.

The reduction to the accounts is made by multiplying the accounts, determined before the increase in the CPC's percentage interest, by a fraction, the numerator of which is the CPC's participating percentage before the increase and the denominator of which is the CPC's participating percentage after the increase.

*Example: Reduction of Surplus Accounts*

It is assumed that the CPC initially owned 60 percent of the issued shares of the affiliate and subsequently acquired an additional 20 percent of the issued shares. It is also assumed that the CPC's equity percentage in the affiliate equals its participating percentage and that the affiliate's exempt surplus is \$8,000 and its taxable surplus is \$7,000.

Reduction of the Surplus Accounts:

(i) Exempt surplus

$$\$8,000 \times \frac{60\%}{80\%} = \$6,000$$

(ii) Taxable surplus

$$\$7,000 \times \frac{60\%}{80\%} = \$5,250$$

If the affiliate had made a complete distribution of its surpluses before the CPC purchased the additional 20 percent interest, the CPC would have received an exempt surplus dividend of \$4,800 ( $\$8,000 \times 60\%$ ) and a taxable surplus dividend of \$4,200 ( $\$7,000 \times 60\%$ ). If the complete distribution is delayed

<sup>151</sup> Steiss and Dart, *supra* note 88, at 243.

<sup>152</sup> Regulation 5905(1).

<sup>153</sup> *Id.*

<sup>154</sup> Steiss and Dart, *supra* note 88, at 243.

<sup>155</sup> *Id.*

until after the acquisition by the CPC of the extra 20 percent interest, the CPC would still receive an exempt surplus dividend of \$4,800 ( $\$6,000 \times 80\%$ ) and a taxable surplus dividend of \$4,200 ( $\$5,250 \times 80\%$ ).

The CPC's participating percentage in the affiliate is used to calculate the adjustment because that percentage measures the CPC's percentage share of the affiliate's surplus accounts. The CPC's equity percentage in the affiliate cannot be used in the adjustment calculation because it does not accurately reflect the CPC's ownership of the affiliate's surpluses. The CPC may have an equity percentage in an affiliate that exceeds 100 percent even though its participating percentage in the affiliate is less than 100 percent. Furthermore, an increase in the CPC's equity percentage does not automatically produce an increase in the CPC's share of the affiliate's surplus accounts.

#### D. Order of Surplus Distributions

A foreign affiliate paying a dividend to its CPC or to another affiliate of its CPC is not free to designate the surplus from which the distribution is made. The order in which dividends flow from the surplus accounts is prescribed by the Regulations.

##### 1. Dividends Paid Within the First 90 Days of an Affiliate's Taxation Year

A dividend paid on a class of shares (the total dividend paid on the class is called a "whole dividend")<sup>156</sup> within the first 90 days of an affiliate's taxation year is deemed to be paid out of the affiliate's exempt surplus to the extent of the lesser of the amount of the whole dividend and the amount by which the affiliate's exempt surplus exceeds its taxable deficit.<sup>157</sup> If the whole dividend is greater than the affiliate's distributable exempt surplus, the excess portion of the whole dividend is deemed to be paid from the affiliate's taxable surplus to the extent of the lesser of the amount of the whole dividend not treated as an exempt surplus dividend and the amount of the affiliate's taxable surplus (technically the amount by which the affiliate's taxable surplus exceeds its exempt deficit).<sup>158</sup> Any portion of the whole dividend which is not allocated to either the affiliate's exempt surplus or taxable surplus is deemed to be paid from the affiliate's pre-acquisition surplus.<sup>159</sup>

#### *Example: Order of Distribution of a Dividend Paid Within the First 90 Days of An Affiliate's Year End*

It is assumed that the affiliate has an exempt surplus of \$25,000 and a taxable deficit of \$15,000. On the first day of the affiliate's 1979 taxation year a \$55,000 dividend is paid.

---

<sup>156</sup> Regulation 5907(1)(n).

<sup>157</sup> Regulation 5901(1)(a). The amount by which the deductions from the affiliate's taxable surplus exceeds the additions to the surplus equals the affiliate's taxable deficit: Regulation 5907(1)(k).

<sup>158</sup> Regulation 5901(1)(b). The amount by which the deductions from the affiliate's exempt surplus exceed the additions to the surplus equals the affiliate's exempt deficit: Regulation 5907(1)(d).

<sup>159</sup> Regulation 5901(1)(c).



**Exempt Surplus Dividend:**

- (a) lesser of
- (i) the whole dividend (\$55,000)
  - (ii) exempt surplus less taxable deficit (\$25,000-\$15,000) \$ 10,000

**Taxable Surplus Dividend:**

- (a) lesser of
- (i) whole dividend less exempt surplus dividend (\$55,000-\$10,000)
  - (ii) taxable surplus minus exempt deficit (nil) —

**Pre-Acquisition Surplus Dividend:**

Amount of whole dividend not allocated to exempt surplus or taxable surplus \$ 45,000

**2. Dividends Paid More Than 90 Days After the Commencement of the Affiliate's Taxation Year**

The order of the surplus distribution is compulsorily changed when a whole dividend is paid more than 90 days after the beginning of the affiliate's taxation year and a portion of the whole dividend would, under the first set of rules (the "basic rules"), be treated as a pre-acquisition surplus dividend.<sup>160</sup> The whole dividend paid is notionally reduced to equal the aggregate of the affiliate's exempt and taxable surplus, eliminating the portion of the actual whole dividend distributed from pre-acquisition surplus.<sup>161</sup> The portion of the whole dividend that was the pre-acquisition surplus dividend (the amount by which the actual whole dividend exceeds the notional whole dividend paid at that time) is deemed to be paid from the affiliate's exempt surplus and taxable surplus to the extent it would flow from those accounts if the excess was paid as a separate whole dividend immediately after the end of the current taxation year.<sup>162</sup> To ensure that the provisions work properly, it is also assumed that no dividends are paid before the notional dividend is paid at the beginning of the subsequent taxation year.<sup>163</sup>

If a dividend is actually paid after the particular whole dividend and before the end of the current taxation year, it is treated as paid after the distribution of the notional dividend.

*Example: Order of Distributions When a Dividend is Paid More Than 90 Days After the Commencement of An Affiliate's Taxation Year*

---

<sup>160</sup> Regulation 5901(2).

<sup>161</sup> *Id.*

<sup>162</sup> *Id.* By deeming the day of payment to be after the end of the current taxation year the rules ensure that any taxable surplus dividend carries its proper amount of underlying foreign tax.

<sup>163</sup> *Id.*

It is assumed that the affiliate is wholly-owned and that it has both exempt and taxable surplus and that the taxation year coincides with the calendar year.

<u>Preliminary Calculation</u>	<u>Exempt Surplus</u>	<u>Taxable Surplus</u>	<u>Pre-Acquisition Surplus</u>
Opening Balance 1980	\$20,000	\$ 5,000	
Dividend paid January 15 (within first 90 days) – \$15,000	5,000	5,000	
Dividend paid July 1 (after first 90 days) – \$17,000	—	—	(\$ 7,000)
Dividend paid October 1 – \$8,000			(\$15,000)
<b>Final Calculation</b>			
Exempt Earnings	\$11,000		
Taxable Earnings	\$18,000		
Balance at beginning of 1979 before consideration of July and October dividends	\$16,000	\$23,000	
July dividend deemed paid January 1, 1979 – \$17,000	—	22,000	
October dividend deemed paid after July dividend – \$8,000	—	\$ 4,000	
Closing Values	<u>\$ —</u>	<u>\$ 4,000</u>	

The special rule for the treatment of dividends paid after the first 90 days is intended to provide a mechanism for the current distribution of exempt and taxable earnings. An affiliate's exempt earnings and taxable earnings for a taxation year are not added to the affiliate's exempt surplus and taxable surplus accounts until the end of the taxation year.<sup>164</sup> Distribution of those earnings in the year in which they arose would be impossible in the absence of a special dividend rule. The effect of the 90-day rule is to create a system for the distribution of current year's earnings after accumulated earnings from previous years have been exhausted.<sup>165</sup>

The wording of the regulation that contains the rules for the distribution of currently earned exempt earnings and taxable earnings implies that the affiliate must be an affiliate at the beginning of the subsequent taxation year.<sup>166</sup> If the CPC's equity percentage falls below 10 percent before the end of the current taxation year, there would be no exempt surplus or taxable surplus, *vis-à-vis* the original CPC, at the beginning of the new taxation year, from which the otherwise pre-acquisition surplus dividend could be paid.

<sup>164</sup> Regulations 5907(1)(d)(v) and 5907(1)(k)(v).

<sup>165</sup> Dart, *supra* note 98, at 872.

<sup>166</sup> *Id.*

A CPC will receive a dividend equal to the whole dividend paid by the affiliate only if it owns all of the shares of the class on which the dividend is paid. When a CPC owns less than 100 percent of the class of shares, the percentage of the whole dividend it receives will equal its percentage ownership of the class of shares on which the dividend is paid. Furthermore, the CPC will receive only its *pro rata* share of each amount deducted from the affiliate's exempt surplus, taxable surplus and pre-acquisition surplus.<sup>167</sup>

*Example: Dividend Received By a CPC Owning Less than 100% of the Class of Shares*

It is assumed that the affiliate pays an exempt surplus dividend of \$10,000 and a taxable surplus dividend of \$8,000, and that the CPC owns 25% of the affiliate's one class of issued shares.

Exempt Surplus Dividend Received	Dividend Actually Received	Whole Dividend Paid Out of Affiliate's Exempt Surplus
	=	$\frac{\text{Whole Dividend Paid}}{\text{Whole Dividend Paid}}$
	= \$4,500	\$10,000 (Note a)
	( $\frac{1}{4}$ of \$18,000)	X $\frac{\$18,000}{\$18,000}$
	= \$2,500	
Taxable Surplus Dividend Received	Actual Dividend Received	Portion of Whole Dividend Paid from Affiliate's Taxable Surplus
	=	$\frac{\text{Portion of Whole Dividend Paid from Affiliate's Taxable Surplus}}{\text{Whole Dividend}}$
	= \$4,500	X $\frac{\$8,000}{\$18,000}$ (Note b)
	= \$2,000	

*Note a:* The whole \$10,000 exempt surplus dividend paid by the affiliate is subtracted from the exempt surplus applicable to the CPC.

*Note b:* The whole \$8,000 taxable surplus dividend paid by the affiliate is subtracted from the taxable surplus applicable to the CPC.

A CPC receiving an exempt surplus dividend (other than a dividend subject to a sub-section 93(1) election) may designate a portion or all of the exempt surplus dividend as a taxable surplus dividend.<sup>168</sup> When the designation is made, the affiliate's surplus accounts and underlying foreign tax accounts are adjusted to reflect the "extra" taxable surplus dividend and reduced exempt surplus dividend.<sup>169</sup> A CPC will convert the non-taxable exempt surplus dividend<sup>170</sup> (and conserve the affiliate's exempt surplus) into a tax-

<sup>167</sup> Regulation 5900(1).

<sup>168</sup> Regulation 5900(2).

<sup>169</sup> *Id.*

<sup>170</sup> See text, *infra*, at 115.

able surplus dividend, which is normally subject to tax,<sup>171</sup> when the deductions available to the CPC shelter the taxable surplus dividend from tax. This will occur when the value of the underlying foreign tax associated with the taxable dividend prevents taxation of the dividend or when the CPC's accumulated losses will offset the taxable surplus dividend.<sup>172</sup> The election to treat an exempt surplus dividend as a taxable surplus dividend will be valuable in another situation. If the taxable surplus of the affiliate includes FAPI on which the CPC has paid Canadian taxes, and if the FAPI is subject to withholding taxes on distribution, the deemed receipt of the FAPI may give rise to a refund of Canadian taxes.<sup>173</sup>

The right to convert an exempt surplus dividend into a taxable surplus dividend applies only to dividends received by the CPC and not to inter-affiliate exempt surplus dividends.

#### E. Canadian Taxation of Foreign Affiliate Dividends

All dividends received by a CPC from its foreign affiliate are included in income regardless of the surplus from which they are paid.<sup>174</sup> The difference in the tax treatment of the dividends from each of the surplus accounts occurs because the rules for the calculation of the CPC's taxable income differentiate between the surplus dividends.

##### 1. Exempt Surplus Dividends

A dividend that is paid from an affiliate's exempt surplus is deducted from the taxable income of the CPC.<sup>175</sup> An exempt surplus dividend, therefore, is not subject to Canadian tax. The rationale for this tax treatment is very similar to the rationale that supported the enactment of paragraph 28(1)(d) of the former Act. Underlying the distinction between treaty and non-treaty countries is the assumption that treaty countries levy corporate income and withholding taxes whose combined rates equal or exceed the Canadian corporate rate.<sup>176</sup> A complete exemption from Canadian taxes does not result in any loss of revenue because the foreign tax credit that would be given if the dividends were taxable would eliminate any Canadian taxes. Administration of the Act is easier if the income is simply excluded from taxable income.

Withholding taxes paid by a CPC on an exempt surplus dividend are not creditable because no Canadian taxes are payable on the dividend.

##### 2. Taxable Surplus Dividends

A CPC receiving a taxable surplus dividend must include the dividend in both its income and taxable income. Whether or not any Canadian tax is pay-

---

<sup>171</sup> See text, *infra*, at 116.

<sup>172</sup> Broadhurst, *supra* note 68, at 376.

<sup>173</sup> *Id.*

<sup>174</sup> Section 90 and paragraph 12(1)(k) of the Act.

<sup>175</sup> Paragraph 113(1)(a) of the Act.

<sup>176</sup> Dart, *supra* note 98, at 873-74.

able will depend upon whether the foreign tax deductions and special elections available to the CPC offset the dividend.

The first deduction that can be claimed by a CPC receiving a taxable surplus dividend is for the foreign income and profit taxes (collectively called the underlying foreign tax applicable) associated with the taxable surplus income distributed.<sup>177</sup> Because double taxation of the dividend would not be avoided if the deduction were limited to the actual value of the foreign taxes paid (a deduction of one dollar of foreign taxes would reduce the CPC's Canadian taxes by less than one dollar), the actual deduction available equals the underlying foreign taxes applicable grossed-up by the factor of 1.1739. This factor equals the relevant tax factor minus one.<sup>178</sup> The total underlying foreign deduction may not, however, exceed the taxable surplus dividend received.<sup>179</sup>

*Example: Underlying Foreign Tax Deduction*

It is assumed that the CPC receives a taxable surplus dividend of \$30,000 and that the underlying foreign tax applicable is \$10,000. It is also assumed that the combined federal/provincial tax rate is 46%.

Taxable Surplus Dividend included in income	\$ 30,000
Deduction for underlying foreign tax applicable (\$10,000 x 1.1739)	11,739
Taxable Income	<u>18,261</u>
Tax @ 46%	<u>\$ 8,400</u>

The combined tax on \$40,000 of pre-tax taxable surplus income is:

(i) Foreign Tax	\$10,000
(ii) Canadian Tax	<u>8,400</u>
TOTAL	<u>\$ 18,400</u>

The total tax equals 46% of \$40,000.

The underlying foreign tax applicable to the taxable surplus dividend received by the CPC is calculated by multiplying the underlying foreign tax associated with the whole taxable surplus dividend paid by the affiliate by the percentage of the whole taxable surplus dividend received by the CPC.<sup>180</sup>

<sup>177</sup> Paragraph 113(1)(b) of the Act.

<sup>178</sup> The relevant tax factor is defined to be 1 divided by the nominal corporate tax rate for the taxation year as set by section 123 of the Act: Paragraph 95(1)(f). For the CPC's 1976 and subsequent taxation years, the relevant tax factor is  $1/.46 = 2.1739$ .

<sup>179</sup> Clause 113(1)(b)(ii) of the Act.

<sup>180</sup> Regulation 5900(1)(d).

*Example: Calculation of Underlying Foreign Tax Applicable*

It is assumed that the affiliate pays a whole taxable surplus dividend of \$20,000 and \$5,000 is received by the CPC. It is also assumed that the underlying foreign tax associated with the whole dividend is \$10,000.

Underlying Foreign Tax Applicable to the Dividend Received by the CPC equals:

$$\begin{array}{r}
 \text{Underlying foreign tax} \\
 \text{on whole dividend}
 \end{array}
 \times
 \frac{\text{taxable surplus} \\
 \text{dividend received by} \\
 \text{CPC}}{\text{whole taxable surplus} \\
 \text{dividend}}
 =
 \begin{array}{r}
 10,000 \times \frac{\$ 5,000}{\$20,000} = \$2,000
 \end{array}$$

The normal underlying foreign tax associated with a whole taxable surplus dividend paid by an affiliate is calculated by multiplying the affiliate's underlying foreign tax account by the ratio of the taxable surplus dividend to the affiliate's taxable surplus dividend account prior to the dividend payment.<sup>181</sup> This calculation ensures that the percentage of the affiliate's underlying foreign tax account flowing with a whole taxable surplus dividend equals the same percentage of the taxable surplus distributed. Thus, if the affiliate distributes one-quarter of its taxable surplus, one-quarter of the affiliate's underlying foreign tax flows with the whole dividend.

An affiliate's underlying foreign tax account is defined to be the amount by which the aggregate of:<sup>182</sup>

- (1) the foreign income or profits taxes paid to a government by the affiliate on its accumulated taxable earnings (except the current year's taxable earnings);
- (2) the foreign withholding taxes paid by the affiliate on taxable surplus dividends received from other affiliates;
- (3) the income taxes paid to its home government on inter-affiliate dividends; and
- (4) the underlying foreign tax applicable to the taxable surplus dividends received from other affiliates

exceeds the aggregate of:

- (5) any foreign income or profit tax refunds received in respect of prior years' taxable losses;
- (6) the underlying foreign tax associated with previously paid taxable surplus dividends; and

<sup>181</sup> Regulation 5907(1)(m).

<sup>182</sup> Regulation 5907(1)(l).

- (7) the underlying foreign tax associated with taxable surplus dividend arising from a sub-section 93(1) election.

*Example: Underlying Foreign Tax Calculation*

It is assumed all opening balances were zero.

		To Taxable Surplus	To Underlying Foreign Tax
Earnings from a non-treaty country active business	\$100,000		
Foreign Taxes applicable	<u>40,000</u>	\$60,000	\$40,000
FAPI	\$40,000		
Foreign Taxes applicable	<u>10,000</u>	30,000	10,000
Dividend received out of taxable surplus of another affiliate	5,000		
Underlying foreign tax applicable	<u>1,000</u>	4,000	1,000
Loss from non-treaty country active business	(13,000)		
Foreign tax refund applicable	<u>3,000</u>	10,000	(3,000)
Dividend paid out of taxable surplus		(21,000)	
Underlying foreign tax applicable			(12,000)
Balance of accounts immediately after payment of dividend		<u><u>\$63,000</u></u>	<u><u>\$63,000</u></u>

The important feature of the underlying foreign tax deduction is that it represents a claim by the CPC for foreign income and profits taxes paid by its affiliates on the taxable surplus income underlying the dividend as that income moved through the affiliate chain from the source affiliate to the CPC. The CPC is, in effect, allowed a deduction equivalent to an indirect foreign tax credit.

The present rules merge the distributed taxable surplus income of a subsidiary-affiliate with that of its parent-affiliate. This means that if the subsidiary-affiliate and parent-affiliate are resident in separate jurisdictions that impose different tax rates on business income, the tax rates of the two countries are averaged as the taxable surplus of the subsidiary-affiliate flows through the parent affiliate. This averaging of tax rates can result in a larger or smaller underlying foreign tax deduction to the CPC from operating through a tiered foreign affiliate corporate arrangement rather than through directly owned foreign affiliates.

*Example:*

Assume that a CPC owns all of the shares of foreign affiliate A which in turn owns all of the shares of foreign affiliate B. Both A and B are resident in a non-treaty country. In 1977 B earns \$300 of taxable surplus and pays income taxes of \$60.00. During that year, B pays a \$120 dividend to A. A, in 1977, has taxable earnings of \$200 and receives a \$120 dividend from B and pays \$120 in foreign taxes, leaving A with a taxable surplus of \$200. In 1978, A pays a dividend to the CPC of \$120.

## (a) Underlying Foreign Tax deductible by CPC when tiered arrangement

1. Total Profits of B	\$ 300
2. Foreign taxes paid by B	60
3. Taxable Surplus	<u>\$ 240</u>
4. Dividend to A	<u>\$ 120</u>
5. Underlying foreign tax associated with dividend to A (added to A's underlying foreign tax account).	
$\frac{\$120}{\$240} \times \$ 60$	<u>\$ 30</u>
6. Total Profits of A	
Business Profits	\$ 200
Dividend Income	120
TOTAL	<u>\$ 320</u>
7. Foreign Taxes paid by A	<u>\$ 120</u>
8. Underlying foreign tax of A (\$120 + \$30)	<u>\$ 150</u>
9. Taxable Surplus of A	<u>\$ 200</u>
10. Dividend to CPC	<u>\$ 120</u>
11. Underlying foreign tax associated with dividend	
$\frac{\$120}{\$200} \times \$150$	\$ 90

## (b) Direct Ownership of B by CPC

1. Business Profits of B	\$ 300
2. Foreign taxes	\$ 60
3. Taxable Surplus	<u>\$ 240</u>
4. Underlying foreign tax associated with \$120 to CPC	
$\frac{\$120}{\$240} \times \$60$	<u>\$ 30</u>

This example shows that by routing the \$120 of taxable surplus income earned by B through A, the CPC receives an underlying foreign tax deduction that is larger than the deduction it would have been allowed if B had been



owned directly. The channelling of B's income through A has merged the income and taxes of B and A at the parent-affiliate's level. This results in the attribution to the dividend from B of that portion of the total deductible taxes paid by A that the dividend from B bears to the total profits of A. This will occur whenever the parent-affiliate has paid qualifying foreign income taxes regardless of whether the parent was required to pay any profits tax on the dividend received from the subsidiary affiliate.<sup>183</sup>

As the taxable surplus dividend moves through the parent-affiliate, an additional foreign tax will ordinarily be incurred by the parent. Whether the transmission of taxable surplus through the parent-affiliate will be advantageous depends upon the amount of additional tax incurred compared to the amount of additional underlying foreign tax acquired.<sup>184</sup>

When an affiliate pays more than one deductible tax in a year it does not matter whether the underlying foreign tax deduction is calculated in the aggregate or separately for each tax paid. So long as the portion of the foreign tax payments that is deductible is calculated by using the same quantity in the denominator of the underlying foreign tax applicable fraction, it makes no difference in results whether the calculation is made separately for each tax or for the total underlying foreign taxes paid by the affiliate.<sup>185</sup>

*Example:*

Assume that an affiliate has \$5,000 of taxable earnings and pays a \$750 income tax and a \$250 excess profits tax. Further, assume that at the end of the year it pays a \$1,000 taxable surplus dividend to its CPC.

(a) Aggregate Calculation:

$$\begin{array}{r} \$1,000 \text{ (aggregate foreign income} \\ \text{income and profits taxes)} \end{array} \quad \times \quad \frac{\$1,000 \text{ taxable surplus dividend}}{\$4,000 \text{ taxable surplus}} \\ = \underline{\underline{\$250}}$$

(b) Separate Calculation:

$$\begin{array}{r} \$250 \text{ (foreign excess} \\ \text{profit tax)} \end{array} \quad \times \quad \frac{\$1,000 \text{ (taxable surplus dividend)}}{\$4,000 \text{ (taxable surplus)}} = \$ 62.50$$

$$\begin{array}{r} \$750 \text{ (foreign income} \\ \text{tax)} \end{array} \quad \times \quad \frac{\$1,000 \text{ (taxable surplus dividend)}}{\$4,000 \text{ (taxable surplus)}} = \$187.50$$

$$\underline{\underline{\$250.00}}$$

This parity occurs only because the denominator in the above fractions remains constant. It remains constant because the two taxes are related to the same amount, the taxable surplus of the affiliate. The rules of foreign laws that result in different foreign tax bases do not produce different bases for Canadian

<sup>183</sup> See E. T. Owens and G. T. Ball, *The Indirect Credit*, Vol. 1 (Cambridge, Mass: Harvard Law School, 1975) at 100-01.

<sup>184</sup> *Id.* at 102.

<sup>185</sup> *Id.* at 87-88.

tax purposes because an affiliate's income, for Canadian tax purposes, is determined by the definition of earnings.<sup>186</sup>

Under certain circumstances, the CPC may elect to have additional underlying foreign tax added to the normal underlying foreign tax associated with a taxable surplus dividend. Where throughout a taxation year an affiliate has no more than one class of shares outstanding, the CPC may elect to increase the underlying foreign tax associated with the whole dividend by an additional amount equal to the lesser of:

- (a) the amount by which the taxable surplus dividend exceeds the normal underlying foreign tax; and
- (b) the amount by which the affiliate's underlying foreign tax account exceeds the normal underlying foreign tax.

The benefit of the election of the additional underlying foreign tax can be illustrated by the following example. It is assumed that the affiliate has taxable surplus of \$8,000 and underlying foreign tax of \$2,000 and that it paid a taxable surplus dividend of \$1,000.

Taxable Surplus Dividend included in the CPC's income	\$1,000.00
Deduction for Underlying Foreign Tax (no election) (\$250 x 1.1739)	293.48
Taxable Income	<u>706.52</u>
Tax Payable @46%	<u><u>\$ 325.00</u></u>

The CPC could reduce the Canadian tax payable to nil if it were to elect to have the underlying foreign tax normally associated with the taxable surplus dividend increased by a portion of the underlying foreign tax associated with its undistributed taxable surplus. The additional amount of tax elected would be \$601.86, so that the total underlying foreign tax would equal \$851.86. To reduce the Canadian taxes payable on the dividend to nil, the value of the additional foreign taxes elected is less than the taxable income remaining after the normal underlying foreign tax deduction because of the "grossing up" of the taxes.

Taxable Surplus Dividend included in the CPC's income	\$1,000
Deduction for Underlying Foreign Tax (\$851.86 x 1.1739)	1,000
Taxable Income	<u><u>Nil</u></u>

If the election is made, the underlying foreign tax associated with the affiliate's

<sup>186</sup> See Regulations 5907(1) and 5907(2) (the definition of earnings) and Regulation 5907(1)(i) (the definition of taxable earnings).

undistributed taxable surplus will be \$148.13, exposing the undistributed taxable surplus to a higher level of Canadian tax when (and if) remitted to the CPC.

Dividend of Remaining Taxable Surplus Income	\$7,000.00
Underlying Foreign Tax Deduction (\$148.13 x 1.1739)	173.89
Taxable Income	<u>6,826.11</u>
Tax @ 46%	<u>\$3,140.00</u>

The global tax burden of \$4,140, \$3,140 of Canadian tax and \$1,000 of foreign tax on \$8,000 of pre-tax taxable surplus income equals the nominal Canadian corporate rate of 46 percent.

The regulation permitting the election of the additional underlying foreign tax is not entirely clear on this point, but it appears that the CPC can make the election on inter-affiliate taxable surplus dividends.<sup>187</sup> If this is the case, the CPC can elect to have excess underlying foreign tax follow a taxable surplus dividend as the dividend moves up the foreign affiliate chain. The effect of such elections would be the accumulation of a larger underlying foreign tax account in the top foreign affiliate, which could be used by the CPC to offset taxable surplus dividends paid to it.

The election of additional underlying foreign tax means that a CPC can defer the payment of Canadian tax on taxable surplus dividends until the value of the dividends received exceeds 1.1739 times the foreign taxes paid by the affiliate on the underlying income.<sup>188</sup> The election, therefore, will be particularly valuable when the affiliate is operating in a non-treaty country having a modest tax and there is no need for the affiliate to distribute all of its income in each year.<sup>189</sup> The election will also be useful in situations where total distribution of an affiliate's taxable surplus is prohibited by foreign exchange restrictions in the host jurisdiction of the affiliate. The right to elect excess foreign tax means that the CPC will receive full credit for the foreign taxes paid even though it is prohibited from distributing all the income earned by the affiliate.

The effects of the foreign tax deduction rule closely parallel those which are produced under a foreign tax credit system. Permitting a "grossed-up" deduction when computing taxable income, however, does offer the taxpayer several advantages not possible under a tax credit regime. The major taxpayer benefit of the deduction system is that it ensures that a credit is allowed at the actual effective Canadian tax rate applied against foreign source income.<sup>190</sup> The present Canadian tax rules result in several different effective tax rates

<sup>187</sup> Broadhurst, *supra* note 68, at 374.

<sup>188</sup> *Id.*

<sup>189</sup> Brown, *supra* note 2, at 53.

<sup>190</sup> Dart, *supra* note 98, at 866.

depending on the source of the income.<sup>191</sup> A foreign tax credit calculated at the average effective Canadian tax rate on total income may not always produce a full credit for the foreign taxes paid on the foreign source income subject to relatively high Canadian taxes.<sup>192</sup> The deduction approach is also advantageous to a corporate resident taxpayer which is in a loss position for the taxation year because the granting of a deduction for foreign taxes, instead of a tax credit, ensures that the equivalent of a foreign tax credit is not lost in a year in which there is no Canadian tax liability. The loss created by the foreign tax deduction is carried forward under the existing Canadian loss carried forward provisions.<sup>193</sup>

Furthermore, in a federal state such as Canada, the deduction system has the advantage of dividing the credit between the federal and provincial governments without the enactment of an independent, and often complex provincial calculation.<sup>194</sup>

Only foreign income and profits taxes paid by the affiliate are added to its underlying foreign tax account. Other taxes imposed by a foreign jurisdiction in addition to or in lieu of an income or profit tax are not reflected in the account. As a general proposition, an income or profits tax is a tax that becomes payable only when income is earned and which is measured by reference to the income or profits. In the words of Buckley J.:

The tax is not, in my judgment, a tax which is of the same character as Income or Excess Profits Tax; it is not a tax which can only be measured and the liability to which can only be ascertained after the profits position of the Company has been finally determined in any year.<sup>195</sup>

In characterizing a foreign tax, the fact that the tax is not called an income tax and is collected under a statute other than the general income tax statute is immaterial when the tax has all of the features of an income or profits tax.<sup>196</sup> It follows that a tax is called an income tax by the enabling legislation will not be treated as an income tax if, in fact, it is not measured by reference to the taxpayer's income.<sup>197</sup> A tax is not disqualified because the foreign income tax rules do not closely resemble the Canadian laws.<sup>198</sup>

Though an income or profits tax is always based on income, this is only a necessary prerequisite; it is not in itself conclusive as to the nature of the tax. A tax that meets this condition will not be considered as an income or profits tax if it has a purpose or function other than the taxing of income. Thus, in the *Exolon* case,<sup>199</sup> the Tax Appeal Board ruled that certain taxes

---

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 867.

<sup>193</sup> Paragraph 111(1)(a) of the Act allows a taxpayer to carry non-capital losses forward for 5 years and back 1 year.

<sup>194</sup> Dart, *supra* note 98, at 866.

<sup>195</sup> *Harrods (Buenos Aires) Ltd. v. Taylor Gooby*, 41 T.C. 450 at 461 (C.A.).

<sup>196</sup> *Seley v. M.N.R.*, D.T.C. 565 (T.A.B.),

<sup>197</sup> *National Gypsum (Canada) Ltd. v. M.N.R.*, 68 D.T.C. 268 (T.A.B.).

<sup>198</sup> *British Columbia Insurance Company v. M.N.R.*, 54 D.T.C. 422 (T.A.B.).

<sup>199</sup> *The Exolon Company v. M.N.R.*, 51 D.T.C. 205 (T.A.B.).

paid by the taxpayer to the states of Massachusetts and New York were franchise taxes and not income or profits taxes because they were imposed for the privilege of doing business. This finding was reached even though the taxes were measured on the basis of the income earned by the taxpayer.

The taxes that cannot be considered as income or profit taxes are:

- (a) Franchise taxes that are collected for the privilege of doing business;
- (b) Turn-over taxes imposed on the transfer of goods, the provision of commercial services, and on the importation or exportation of goods when the taxes are based on the price of the goods and services and not on the profit from the transaction. Important turn-over taxes are sales taxes and value added taxes;
- (c) Import and export duties; and
- (d) Taxes based on the capital employment in the business or the salaries paid.<sup>200</sup>

The narrow definition of qualifying taxes can be supported on the ground that the Canadian tax is an income tax and, under an income tax, all costs are deducted first to arrive at net receipts before applying the income tax rate. Other Canadian taxes, except income taxes, are considered expenses and so should other foreign taxes.<sup>201</sup>

It can be argued, however, that the underlying foreign tax definition should recognize other types of foreign taxes. A widely accepted position is that the principal criterion for the deduction of a tax should not be its nature but its economic incidence:

On analysis, it appears that the chief determinative factor in deciding whether a tax qualifies for the [deduction] should be whether or not the tax is shifted or passed on by the person paying the tax. Double taxation of a taxpayer's income occurs only if the taxpayer has borne the burden of both the [domestic] income tax and the foreign tax for which [the deduction] is claimed. Strictly speaking, therefore the [underlying foreign tax deduction should be allowed] only if the taxpayer could demonstrate the incidence of the foreign tax and [domestic] tax is such that he could prove that his potential income was in fact reduced.<sup>202</sup>

Accepting that the crucial factor is the incidence of the tax, capital, net worth, property and franchise taxes should be included in the list of deductible taxes because it is assumed that such taxes cannot be shifted.<sup>203</sup> This test does not require the qualifying taxes to be extended to sales, turn-over excise, or other product taxes if such taxes are applied uniformly to all products in the country of sale because such taxes are not applied to profits. When these

---

<sup>200</sup> Peterson, *Canada's Foreign Tax Credit System*, (1971), 19 Can. Tax J. 89 at 91-92.

<sup>201</sup> Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, (1956), 56 Columbia L.R. 815 at 820.

<sup>202</sup> E. A. Owens, *The Foreign Tax Credit* (Cambridge, Mass: Harvard Law School, 1961) at 84. These comments were made on the restrictions of the American foreign tax credit rules. It is submitted that they are relevant to the Canadian "double deduction" rules.

<sup>203</sup> P. B. Musgrave, *United States Taxation of Foreign Investment Income* (Cambridge, Mass: Harvard Law School, 1969) at 147.

taxes are applied to all investors, they are normally recovered by their incorporation in product prices.

If the underlying foreign tax deduction is less than the taxable surplus dividend received, the Canadian parent corporation can claim a foreign tax deduction based on the non-business income taxes paid by it on the taxable surplus dividend received.<sup>204</sup> The non-business tax deduction allowable, which is the equivalent of a direct foreign tax credit, is the lesser of: (a) the non-business income tax multiplied by the relevant tax factor; or (b) the amount by which the taxable surplus dividend exceeds the underlying foreign tax deduction.<sup>205</sup>

The Foreign Affiliate provision incorporates by reference the foreign tax credit definition of non-business income taxes.<sup>206</sup> As defined, the most common qualifying taxes are withholding taxes paid to foreign governments.

*Example: Taxation of Taxable Surplus Dividend (No FAPI)*

Assumptions:

1. The CPC owns all of the shares in the foreign affiliate that is resident in a non-treaty country.
2. The affiliate has active business income in 1976 of \$100,000 on which it paid \$20,000 in taxes.
3. The affiliate pays a \$40,000 taxable surplus dividend on which a 25% withholding tax is paid.
4. There are no special elections made by the parent corporation. The Canadian tax rate is 46%.

Taxable Surplus Dividend included in the CPC's income		\$ 40,000
Deductions:		
(a) Deduction for underlying foreign tax (\$10,000 x 1.1739)		\$ 11,739
(b) Deduction for withholding taxes (\$10,000 x 2.1739)		<u>21,739</u>
Total Deduction		<u>33,478</u>
Taxable Income		<u>\$ 6,622</u>
Tax at 46%		<u>\$ 3,000<sup>1</sup></u>
Total taxes paid on \$50,000 of pre-tax taxable surplus income:		
Foreign taxes	\$ 10,000	
Withholding taxes	10,000	
Canadian taxes	<u>3,000</u>	
	<u>\$ 23,000<sup>2</sup></u>	

<sup>204</sup> Paragraph 113(1)(c) of the Act.

<sup>205</sup> *Id.*

<sup>206</sup> Paragraph 113(3)(b) of the Act.

- Note:* 1. This number has been rounded-off.  
2. This is the equivalent of a tax of 46% on \$100,000 of income.

Because the deduction for foreign withholding taxes is available only if the underlying foreign tax deduction does not completely off-set the taxable surplus dividend, and cannot exceed the excess of the dividend, the total deductions for all foreign taxes cannot exceed the taxable surplus dividend received. The foreign tax deductions, therefore, cannot be used to create a loss or shelter other income from tax.

### 3. FAPI Deduction

Since the taxable surplus of a controlled foreign affiliate includes after-tax FAPI<sup>207</sup> on which the CPC has already paid Canadian tax, the amended Act allows the FAPI to be distributed as a tax-free taxable surplus dividend.<sup>208</sup> A statutory presumption is made that the controlled foreign affiliate's FAPI is distributed first when the affiliate pays a taxable surplus dividend.<sup>209</sup> The FAPI thus distributed escapes additional Canadian tax when received by the parent corporation because the parent may claim a deduction from income equal to the lesser of the total taxable dividend received minus the underlying foreign tax deduction, and the amount by which the additions to the adjusted cost base of the affiliate's shares with respect to previously taxed FAPI exceeds all such deductions.<sup>210</sup>

The FAPI deduction is available only when the CPC has a direct equity interest in the controlled foreign affiliate paying the dividend,<sup>211</sup> but no injustice occurs because of this condition. FAPI earned by second-tier and lower controlled affiliates is imputed, by sub-section 91(1), to the shares of the first-tier parent controlled affiliate owned directly by the Canadian parent. It is the adjusted cost base of the shares of the first-tier affiliate that are increased under sub-section 92(1) when the FAPI is included in the parent's income. Because the general limitation on the total FAPI deduction is the increase in the adjusted cost base of the top affiliate's shares, credit is given for all FAPI of the affiliate group previously taxed to the Canadian parent corporation. A double exemption for previously taxed FAPI is avoided because the adjusted cost base of the shares is reduced by the amount of any FAPI deduction taken.<sup>212</sup>

The CPC can claim the FAPI deduction in addition to the basic underlying foreign tax and foreign non-business tax deductions.

---

<sup>207</sup> Regulation 5907(1)(i)(ii)(B).

<sup>208</sup> 3 Canada Tax Service at 91-117.

<sup>209</sup> Brown, *supra* note 2, at 51.

<sup>210</sup> Subsection 91(5) of the Act.

<sup>211</sup> 3 Canada Tax Service, at 91-117.

<sup>212</sup> Paragraph 92(1)(b).

*Example:* Taxable Surplus Dividend out of FAPI.

Assumptions:

1. The controlled foreign affiliate is wholly owned by the Canadian parent corporation.
2. All of the affiliate's income is FAPI.
3. The affiliate is subject to a 25% corporate tax rate and a 20% withholding tax applies on dividends to non-residents.
4. The Canadian corporate tax rate is 46%.
5. No special elections are made.

*Year 1*

FAPI of the Controlled Foreign Affiliate	\$ 100,000	
Corporate taxes	25,000	
Net FAPI (to taxable surplus)	<u>\$ 75,000</u>	
Canadian parent corporation's FAPI income	\$ 100,000	
Deduction for foreign taxes on FAPI (25,000 x 2.1739)	54,350	
Net taxable income	<u>\$ 46,650<sup>1</sup></u>	
Taxes at 46%	<u>\$ 21,000</u>	

*Year 2*

The affiliate has no income		
Pays a dividend of	\$ 75,000	
Withholding taxes	15,000	
Dividend included in Canadian parent's income	\$ 75,000	
Deductions:		
(a) Underlying foreign taxes x relevant tax factor - 1 (25,000 x 1.1739)	\$ 29,350	
(b) Withholding tax deduction lesser of:		
(i) withholding tax x relevant tax factor (15,000 x 2.1739)		
(ii) taxable surplus dividend - (a) above	32,600	<u>(\$61,950)</u>
(c) Previously taxed FAPI lesser of:		
(i) Dividend - (a) above (75,000 - 29,350)	45,650	
(ii) Net additions to a.c.b. of shares	45,650	<u>(\$45,650)<sup>2</sup></u>
Net amount deducted from income from all sources		<u>(\$32,600)</u>
Net Canadian tax relief at 46%		<u>\$15,000</u>



*Summary*

## Canadian taxes:

Year 1: \$21,000

Year 2: (\$15,000)      \$ 6,000

## Foreign taxes:

Year 1: \$25,000

Year 2: \$15,000      \$ 40,000TOTAL TAXES:      \$ 46,000<sup>3</sup>*Note:*<sup>1</sup> The a.c.b. of the shares are increased by this amount.<sup>2</sup> The a.c.b. of the shares are decreased by this amount.<sup>3</sup> This equals a Canadian tax of 46% on \$100,000 of pre-tax income.

This example illustrates that where FAPI previously taxed to the CPC attracts additional foreign taxes on its distribution as a taxable surplus dividend, the combined impact of the foreign tax deductions and FAPI deduction may produce a deductible loss in Canada. This loss may be used to off-set the taxes paid on the FAPI in the year in which it was earned but undistributed.<sup>213</sup> Accordingly, a CPC may wish to compel its controlled foreign affiliates to pay taxable surplus dividends so that it can obtain the deductions for the additional foreign taxes, thereby making an effective adjustment of the amount of income previously taxed by Canada.

## 4. Election to Treat a Taxable Dividend as a Return of Capital

A CPC receiving a taxable surplus dividend is not completely sheltered from Canadian tax; after the CPC has claimed the foreign tax deductions, it may be able to use the deduction provided in sub-section 113(2) of the Act to remove the excess taxable surplus dividend from its taxable income. That sub-section allows the CPC to treat the portion of taxable surplus dividend, not otherwise deductible, as a tax-free return of capital. The amount of the dividend so deducted from income must be credited against the adjusted cost base of the shares on which the dividend is paid.<sup>214</sup> The maximum cumulative amount that can be treated as a return of capital is the adjusted cost base of the affiliate's shares at the end of the CPC's 1975 taxation year, less the aggregate of: (1) previously received pre-acquisition surplus dividends; (2) any post-1975 additions to the a.c.b. of the shares arising from the attribution of the affiliate's FAPI to the CPC; and (3) any other repayments of capital.<sup>215</sup>

The adjusted cost base of shares of an affiliate owned by a CPC at the end of its 1971 taxation year, as well as, at the end of its 1975 taxation year,

---

<sup>213</sup> Brown, *supra* note 2, at 51.

<sup>214</sup> Paragraph 53(2)(b) of the Act.

<sup>215</sup> Paragraph 113(2)(b) of the Act.

will be determined under sub-section 26(3) of the Income Tax Application Rules.

Since it is a prerequisite to the election that the shares of the affiliate be owned by the CPC at the end of its 1975 taxation year, the right to the election will be lost if those shares disappear. For instance, if the shares that were so owned by the CPC were exchanged for other shares of the affiliate in the course of a reorganization of capital, the right to claim the deduction would be irretrievably lost.<sup>216</sup> Similarly, if the shares were split after the 1975 taxation year of the CPC, the right might be lost because it would be difficult to establish that the CPC owned the shares at the end of its 1975 taxation year.<sup>217</sup>

The sub-section 113(2) election results in the conversion of any otherwise fully taxable dividend into a tax deferred dividend, which will be taxed at rates not exceeding those that apply to a capital gain on the disposition of the shares. From a tax planning perspective, this means that active business income earned by an affiliate incorporated in a tax haven jurisdiction after 1975 may be repatriated to Canada at a Canadian tax cost not exceeding half the normal Canadian corporate rates. Continuation of tax haven operations can, therefore, still produce significant benefits, if the tax haven affiliate does not generate FAPI.<sup>218</sup>

##### 5. Pre-Acquisition Surplus Dividends

The Canadian tax treatment of a pre-acquisition surplus dividend received by a CPC represents a position midway between complete exemption from taxation and the immediate taxation of the dividend. A CPC receiving a pre-acquisition surplus dividend from an affiliate must include the dividend in its income for the year.<sup>219</sup> The dividend is deducted by the parent, however, when calculating its taxable income.<sup>220</sup> At the same time, the parent must reduce the adjusted cost base of its shares by the amount of the dividend less the foreign withholding taxes paid by it on the dividend.<sup>221</sup> The downward adjustment to the adjusted cost base should increase the parent's taxable capital gain on the future disposition of the shares. Taxation of the pre-acquisition surplus is deferred, therefore, until the disposition of the shares.

A pre-acquisition surplus dividend greater than the adjusted cost base of the shares will be considered a capital gain to the extent it exceeds the adjusted cost base.<sup>222</sup> Half of this gain, that is, the taxable capital gain, must be included in the parent's taxable income for the year.

A foreign affiliate receiving a pre-acquisition surplus dividend from an

---

<sup>216</sup> 3 Canada Tax Service 113-107.

<sup>217</sup> *Id.* at 113-107-108.

<sup>218</sup> Broadhurst, *supra* note 68, at 375.

<sup>219</sup> Section 90 of the Act.

<sup>220</sup> Paragraph 113(1)(d) of the Act.

<sup>221</sup> Paragraphs 53(2)(b) and 92(2)(b)(c) and (d) of the Act.

<sup>222</sup> Subsection 40(3) of the Act.

other affiliate must make the same adjustment to the adjusted cost base of its shares of the payor-affiliate.

## 6. Stock Dividends

A stock dividend is not taxed in the same manner as a cash dividend. Sub-section 95(7) provides that for the purposes of sections 90 through 95 and sub-section 52(3) the value of a stock dividend paid by an affiliate is considered as nil. By virtue of Regulation 5907(7), the value of a stock dividend is also to be considered as nil for the purposes of the rules in the Regulations. Therefore, the dollar equivalent of a stock dividend is not included in the CPC's income, which is an exception to the rule in section 90. Furthermore, the rules of section 113 do not apply, because no amount is deemed to be paid out of the affiliate's exempt, taxable, or pre-acquisition surplus.

If a stock dividend is paid on a share of the affiliate acquired by the CPC prior to 1972 and the stock dividend is identical<sup>223</sup> to the share on which it is paid, the CPC has the option to treat the stock dividend as capital property owned by it on December 31, 1971.<sup>224</sup> If the election is made, the adjusted cost base of the stock dividend is determined under the rules of Income Tax Application Rule 26(8) and not under the normal rates that apply to capital property acquired after 1971.<sup>225</sup> In the absence of the election, the payment of a pre-acquisition surplus dividend subsequent to the payment of a stock dividend could trigger a capital gain. The reduction to the adjusted cost base of the share received as a stock dividend by the amount of the pre-acquisition surplus dividend would exceed the nil cost base of the share. Sub-section 40(3) would then deem the CPC to have realized a capital gain equal to the negative adjusted cost base. The election privilege gives the CPC the opportunity to avoid this adverse tax consequence because exercise of the election results in the stock dividend acquiring an adjusted cost base in excess of nil.

## 7. Interest Paid on an Income Bond or Income Debenture

The anti-avoidance rule of sub-section 95(5) deems an income bond or income debenture issued by an affiliate to be a share of the affiliate unless certain conditions are met. Interest paid on an income bond deemed to be a share is considered a dividend<sup>226</sup> and is included in income by section 90. However, it is not clear whether the interest is to be considered a dividend for the purposes of section 113. Section 113 applies to dividends paid on a share, and as the deeming rule of sub-section 95(5) does not apply to section 113 (it applies only to sections 90 through 95), the word "share" must be given its ordinary meaning. As defined by the Act, "share" means "a share

---

<sup>223</sup> The share received on the stock dividend is identical to the share on which it is paid if both shares are of the same class: See Interpretation Bulletin IT-78 para. 2. Nov. 27/72.

<sup>224</sup> ITAR 26(8.3) of the Act.

<sup>225</sup> *Id.*

<sup>226</sup> Subsection 15(4) of the Act.

or fraction thereof of the capital stock of a corporation"<sup>227</sup> and "capital stock" does not include an income bond or income debenture.

The effect on the surplus accounts of the affiliate paying the interest *qua* dividend is also uncertain, because the Regulations also require a dividend to be paid out of an affiliate's surpluses on a share.

#### 8. Part IV Tax and Refundable Tax

A CPC that is a private corporation as defined in paragraph 89(1)(f) of the Act may be liable for Part IV tax on a dividend received from a foreign affiliate. Such tax could also rise as a result of an election to convert the proceeds of disposition, received on the sale of the affiliate's shares, into a dividend.

Sub-section 186(1) of the Act provides that the 33 $\frac{1}{3}$  percent<sup>228</sup> tax applies to the amounts deducted by the CPC under paragraphs 113(1) (a), (b) and (d) and sub-section 113(2). With respect to the tax on the deduction claimed under paragraph 113(1)(d), which refers to a pre-acquisition surplus dividend, the tax only applies to a dividend received after May 6, 1974. Since the special Part IV tax is designed to impose a tax on income received by a corporation which has received preferential treatment in comparison with the same type of income received by an individual,<sup>229</sup> it does not apply to an amount deducted under paragraph 113(1)(c) which refers to foreign withholding taxes.

The special 33 $\frac{1}{3}$  percent tax is refundable in accordance with section 129 of the Act. In addition,, paragraph 129(4) (b) of the Act provides that a dividend received from a foreign affiliate, less all amounts deducted under section 113 (including paragraph (c)) constitutes foreign investment for the purposes of the refundable tax.

#### CONCLUSION

The existing rules for the taxation of distributions from a foreign affiliate are part of the set of new provisions enacted at the time of tax reform to prevent the tax haven abuses permitted by the pre-reform *Income Tax Act*. The new distribution rules and the foreign accrual property income rules have effectively achieved this objective. The new rules, however, do more than eliminate the tax effectiveness of the "incorporated tax haven pocket-book." They also regulate the foreign business activity of a Canadian-based multi-

---

<sup>227</sup> Subsection 248(1) of the Act. Revenue Canada has stated that it will permit the deductions allowed by subsection 113(1) in respect of those income bonds which are treated as shares. The result will be to permit a deduction in respect of applicable foreign tax in the same manner as if the interest from income bonds had been received as dividends: Interpretation Bulletin IT-388, April 15, 1977.

<sup>228</sup> After 1977 the Part IV tax will be 25%. "Notice of Ways and Means Motion—Income Tax," in *Supplementary Budget Papers* (March 31, 1977—Department of Finance Canada) at 100.

<sup>229</sup> Friesen and Timbrell, *supra* note 99, at 39.

national corporation. A Canadian multi-national corporation is now confronted with an array of complex, and at times, ambiguous set of tax rules which affect the whole spectrum of foreign operations. A Canadian multi-national corporation must now engage in sophisticated, long-term tax planning if it wishes to minimize its Canadian tax exposure on distributions from its foreign subsidiaries. It is no longer sufficient for the Canadian corporation merely to consider the share structure of the foreign corporate group. The new rules compel the Canadian multi-national corporation to base its decisions affecting its foreign operations not only on the general business considerations, but also an increasing number of tax factors, including the place of residence of the foreign subsidiary, the nature of the subsidiary's income, and the territorial sources of that income.