Understanding the Basic Building Blocks of the Canadian Foreign Affiliate Rules

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Agenda

1) The Foreign Affiliate Regime: An Overview
2) What is a “foreign affiliate”?
3) What is a “controlled foreign affiliate”?
4) Canadian tax treatment of dividends from foreign affiliates
5) “Foreign Accrual Property Income”
6) Questions

The Foreign Affiliate Regime: An Overview

- Product of long-standing and evolving concerns about tax efficiency, neutrality and avoidance
- Early elements of Canada's foreign affiliate rules began to emerge in legislative tax reforms in 1948-51
- Policy discussions prompted further changes:
  - The Royal Commission on Taxation (1962)
  - Department of Finance "White Paper" for Tax Reform (1969)
- Revised foreign affiliate rules came into force in 1976

The Foreign Affiliate Regime: An Overview

- Subsequent stream of technical amendments and structural "enhancements"
  - Offshore Investment Fund Property Rules *(1984)*
  - Legislative amendments *(1994-95)*
  - Department of Finance "comfort letters" and further legislative proposals *(December 2002; February 2004; December 2009)*

The Foreign Affiliate Regime: An Overview

- Legislative focus attracted by significant outbound investment
  - Canadian direct investment abroad - $779.3 billion (2013)

Canadian Direct Outbound Investment

	2008 ($ billion)	2013 ($ billion)
United States	290.8	318.3
United Kingdom	65.1	86.1
Barbados	47.2	63.0
Cayman Islands	24.7	30.9
Luxembourg	6.2	30.2

Source: Pascal Tremblay, "Direct Investment Between Canada and the World" (Parliamentary Information and Research Service: August, 2014)

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The Foreign Affiliate Regime: An Overview

Basic fundamental implications of the Canadian foreign affiliate rules:

1. Active business income earned by a "**foreign affiliate**" of a Canadian corporate shareholder is generally subject to favourable Canadian tax treatment upon repatriation
2. Passive income earned outside of Canada by a "**controlled foreign affiliate**" of a Canadian taxpayer is frequently subject to taxation in Canada on a current, accrual basis

What is a "foreign affiliate"?

- At a high level, the statutory definition is relatively straightforward, yet contains a number of key components:

"**foreign affiliate**", at any <u>time</u>, of a taxpayer resident in Canada means a <u>non-resident</u> <u>corporation</u> in which, at that <u>time</u>,

(a) the taxpayer's <u>equity percentage</u> is not less than 1%, and

(b) the total of the <u>equity percentages</u> in the corporation of the taxpayer and each person <u>related</u> to the taxpayer…is not less than 10%, …

(Special interpretive rules apply to preclude double-counting)

What is a “foreign affiliate”?

Key Conditions:

1. A “foreign affiliate” must be a “**corporation**”
   - No definitive statutory definition of a “corporation” in the *Income Tax Act* (Canada) (the “**Tax Act**”)
   - The Canada Revenue Agency (the “**CRA**”) has expressed its views on what constitutes a “corporation” for the purposes of the Tax Act

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What is a “foreign affiliate”?

- In IT-343R, the CRA defined a “corporation” as:

  …an entity <u>created by law</u> <u>having a legal personality and existence separate and distinct from</u> the personality and existence of <u>those who caused its creation or those who own it</u>. A corporation possesses its <u>own capacity to acquire rights and to assume liabilities</u>, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it.

What is a “foreign affiliate”?

- The CRA generally applies a two-step approach to characterizing business associations:

  First, “determine the characteristics of the foreign business association under foreign commercial law”

  Second, “compare these characteristics with those of recognized categories of business associations under Canadian commercial law in order to classify the foreign business association under one of those categories”

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What is a “foreign affiliate”?

- The CRA will issue rulings on entity classification

  (Ruling requests must include (i) a complete description of the characteristics of the entity, (ii) the taxpayer’s analysis of the proper classification of the entity, and (iii) translated copies of both the legislation under which the entity was created and its organizational documents)

- The CRA has issued a large number of technical interpretations on the classification of different types of foreign entities

What is a "foreign affiliate"?

Key Conditions:

2. A "foreign affiliate" must be a "**non-resident**"

   - No definitive statutory definition of a "non-resident" in the Tax Act
   - Section 250 of the Tax Act contains certain residence deeming rules
     - Subsection 250(4) deems a corporation incorporated in Canada to be resident in Canada
     - Subsection 250(5) deems the determination of residence under a tax treaty to generally govern for the purposes of the Tax Act.

What is a “foreign affiliate”?

- Under the common law, the residence of a corporation is generally determined on the basis of the place of the “central management and control” of the corporation (the “**CM&C**”)
- The CM&C of a corporation is frequently situated where the corporation’s board of directors exercises its responsibilities; however, CM&C can also be situated in another jurisdiction (e.g., where a shareholder factually exercises control over the corporation)

What is a "foreign affiliate"?

Key Conditions:

3. "**Equity Percentage**" (subsection 95(4) of the Tax Act)

- A person's "equity percentage" in a particular corporation equals the sum of:

  (a) the person's "direct equity percentage" in the particular corporation, and

  (b) all percentages each of which is the product obtained when the person's equity percentage in any corporation is multiplied by that corporation's direct equity percentage in the particular corporation

What is a "foreign affiliate"?

"**<u>Direct Equity Percentage</u>**" (subsection 95(4) of the Tax Act)

- A person's "direct equity percentage" in a corporation is the percentage determined by the following rules:

  (a) for each <u>class</u> of the issued <u>shares of the capital stock</u> of the corporation, determine the proportion of 100 that the number of shares of that class owned by that person is of the total number of issued shares of that class, and

What is a "foreign affiliate"?

"**<u>Direct Equity Percentage</u>**" (subsection 95(4) of the Tax Act)

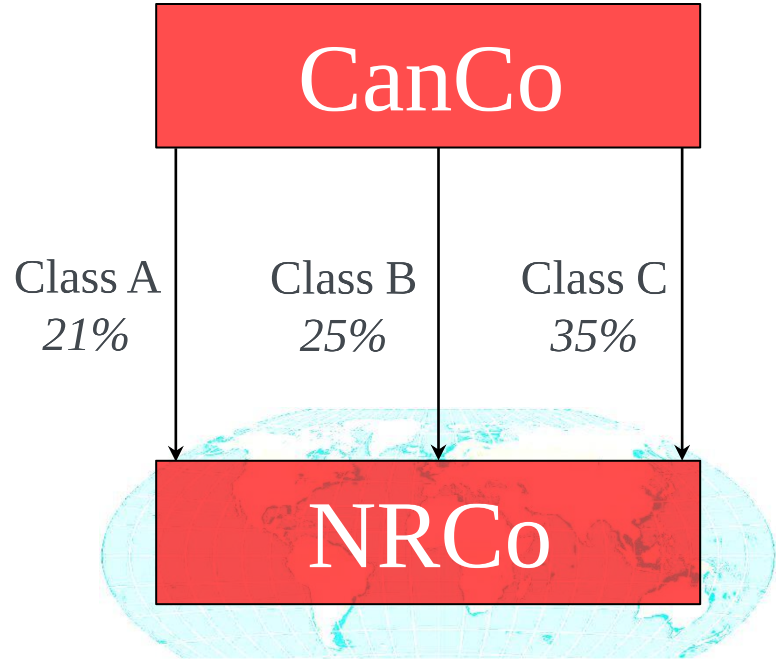
(b) select the proportion determined under paragraph (a) for that person in respect of the corporation that is not less than any other proportion so determined for that person in respect of the corporation

- *The proportion selected under paragraph (b), when expressed as a percentage, is that person's "direct equity percentage" in the corporation*

What is a "foreign affiliate"?

"Direct Equity Percentage" Example

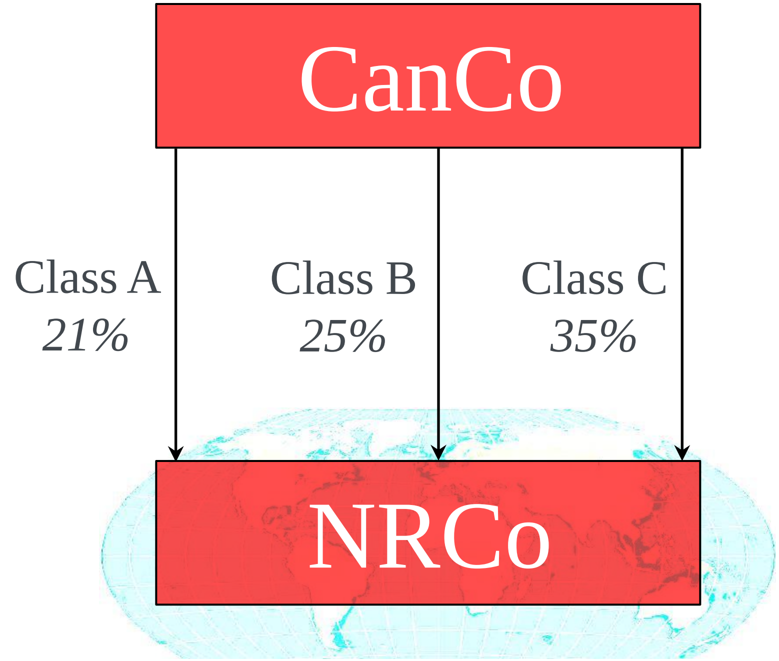
Class A	Voting (Common)
Class B	Voting (Preferred)
Class C	Non-Voting



What is a "foreign affiliate"?

"Direct Equity Percentage" Example

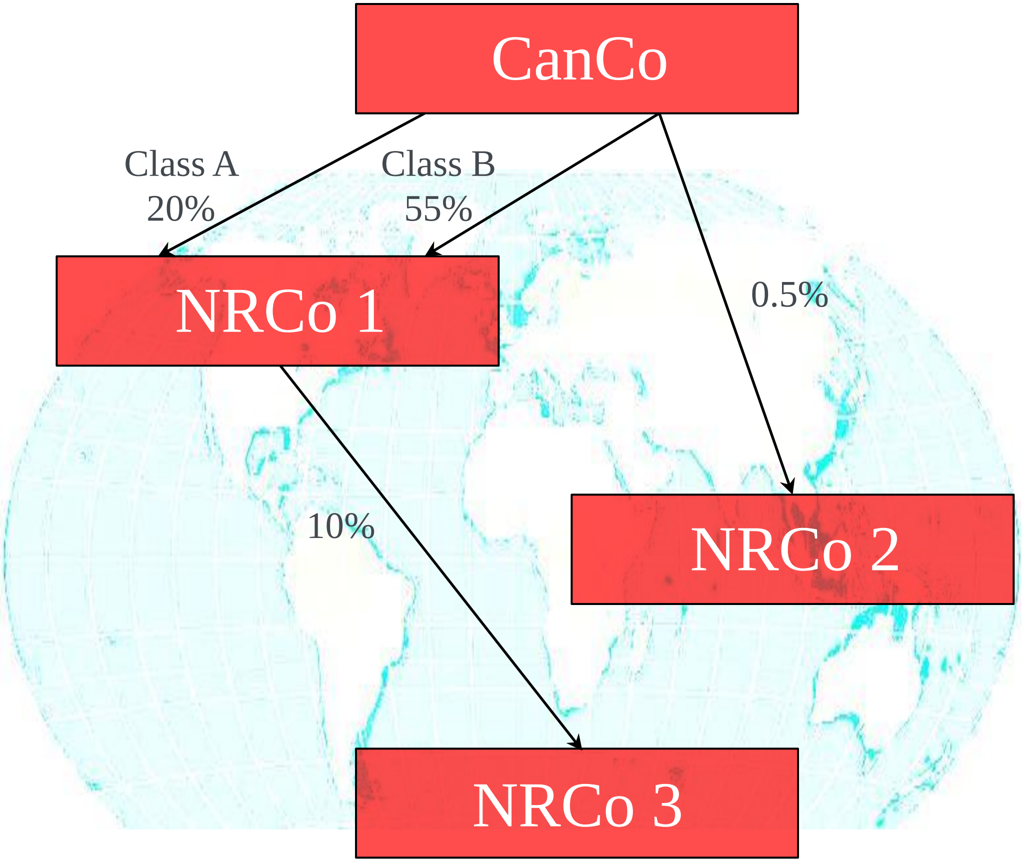
CanCo's "direct equity percentage" in NRCo is ***35%***



What is a “foreign affiliate”?

“Equity Percentage” Example

Class A	Non-Voting (Common)
Class B	Voting (Preferred)



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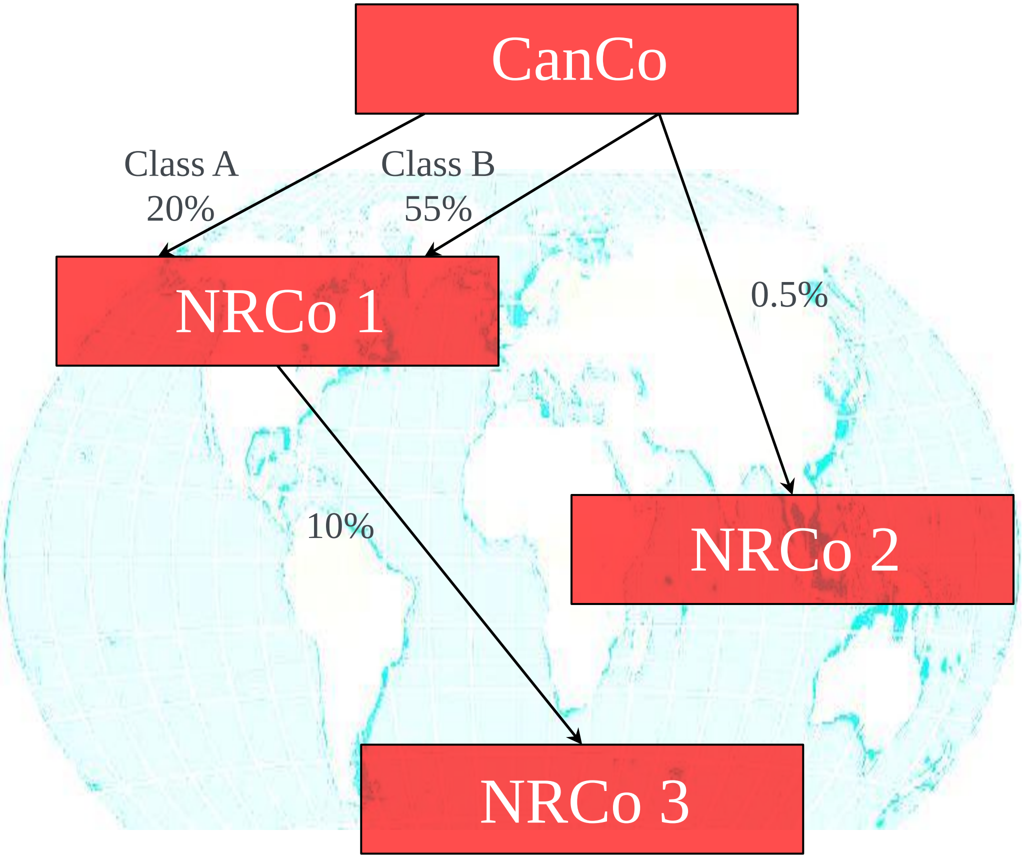
What is a "foreign affiliate"?

"Equity Percentage" Example



CanCo "Equity Percentages"

<u>NRCo 1</u>

Direct Equity Percentage 55%

<u>NRCo 2</u>

Direct Equity Percentage 0.5%

<u>NRCo 3</u>

Equity Percentage
(55% x 10%) 5.5%

What is a "foreign affiliate"?

"**foreign affiliate**", at any time, of a taxpayer resident in Canada means a non-resident corporation in which, at that time,

(a) the taxpayer's equity percentage is not less than 1%, and

(b) the total of the equity percentages in the corporation of the taxpayer and each person **related** to the taxpayer…is not less than 10%, …

(Special interpretive rules apply to preclude double-counting)

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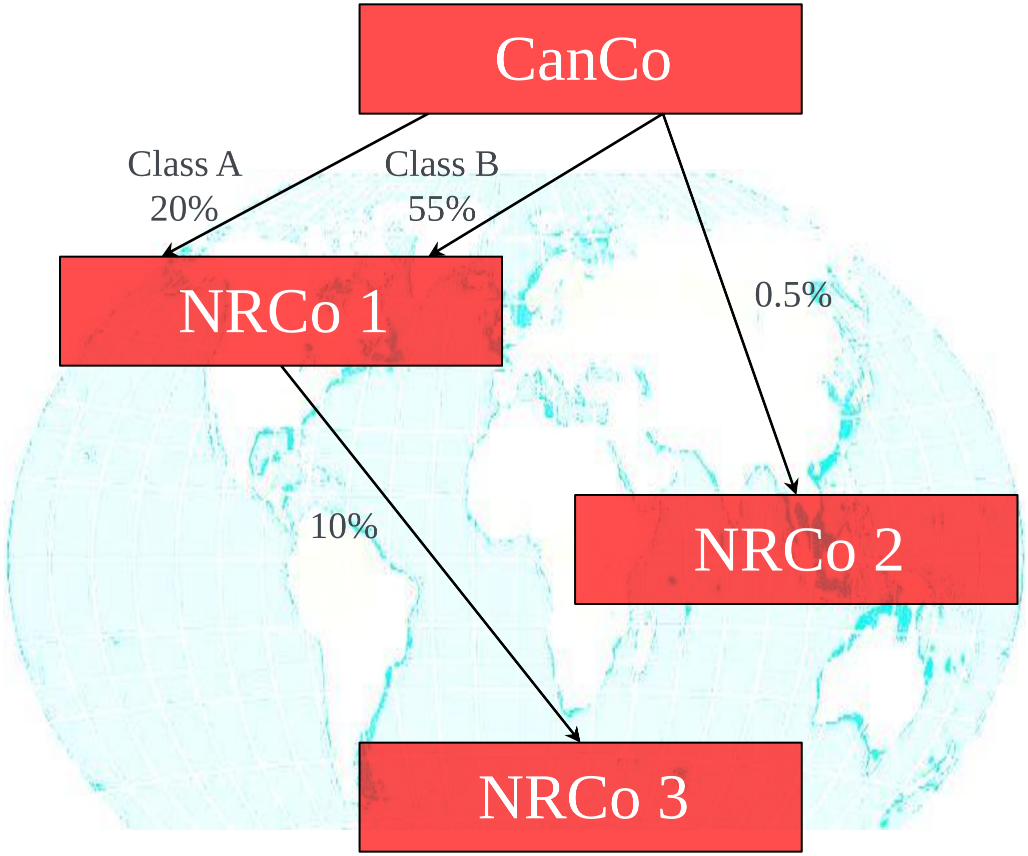
What is a “foreign affiliate”?

“**related**” (section 251 of the Tax Act)

- Detailed statutory definition captures a number of enumerated relationships, including:
  - A person and a corporation that it controls
  - Corporations under common control
  - A corporation and a member of a “related group” that controls the corporation

What is a “foreign affiliate”?

“Foreign Affiliate” Example



CanCo “Equity Percentages”

<u>NRCo 1</u>

Direct Equity Percentage 55%

<u>NRCo 2</u>

Direct Equity Percentage 0.5%

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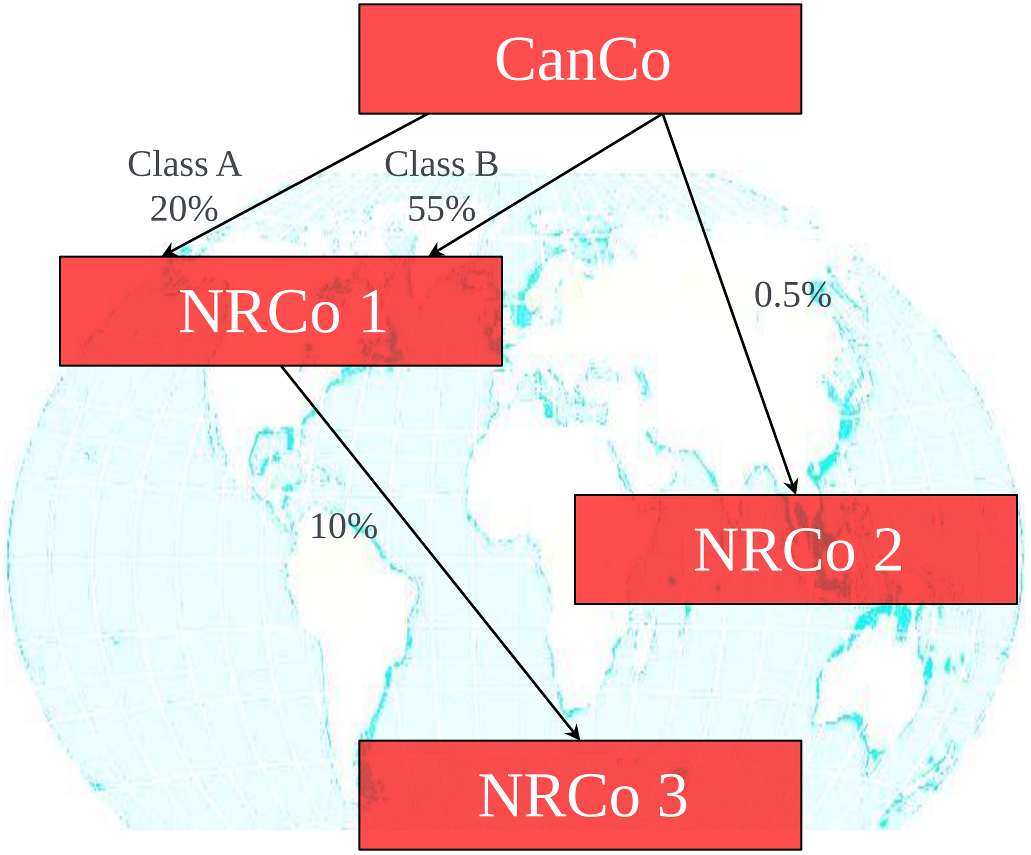
Equity Percentage
(55% x 10%) 5.5%

What is a “foreign affiliate”?

“Foreign Affiliate” Example



“Foreign Affiliate” Status

<u>NRCo 1</u>

CanCo's Equity % **55%**

<u>NRCo 2</u>

CanCo's Equity % 0.5%

CanCo/Related Equity % 0.5%

<u>NRCo 3</u>

CanCo's Equity % **5.5%**

CanCo/Related Equity % **10%**

NRCo 1 and NRCo 3 are foreign affiliates of CanCo

What is a “foreign affiliate”?

- Certain provisions of the Tax Act deem a foreign entity to be a foreign affiliate of a Canadian taxpayer for certain purposes
    - *Paragraph 95(2)(n) – may be operative in respect of a particular corporation where (i) a non-resident corporation is a foreign affiliate of another corporation that is resident in Canada and that is related to the particular corporation, and (ii) the other corporation has a “qualifying interest” in respect of the non-resident corporation*
    - *Subsection 94.2(2) – deems certain non-resident trusts to be non-resident corporations controlled by certain beneficiaries of the trust*

What is a "controlled foreign affiliate"?

- Complex statutory definition (subsection 95(1) of the Tax Act)
- A foreign affiliate of a taxpayer can constitute a "controlled foreign affiliate" of the taxpayer in one of two ways:

Test #1: The "foreign affiliate" is controlled by the taxpayer

  - "Control" is ***de jure*** control
  - Common law "Buckerfield's test" – *de jure* control of a corporation "contemplates the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors"

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What is a “controlled foreign affiliate”?

- Buckerfield’s test refined by the Supreme Court of Canada in the *Duha Printers* case
    - Does the majority shareholder enjoy “effective control” over the affairs of the corporation, as manifested in the right to elect a majority of the directors?
    - “Effective control” is determined by reference to the corporation’s governing law, share register, and any unique limitations on the election of directors or the powers of the board, as manifested in the constating documents of the corporation or any unanimous shareholder agreement

What is a “controlled foreign affiliate”?

Test #2: The “foreign affiliate” would be controlled by the taxpayer if the taxpayer owned all of the shares of the foreign affiliate owned by:

(i) the taxpayer;

(ii) persons who do not deal at “<u>arm’s length</u>” with the taxpayer;

What is a “controlled foreign affiliate”?

(iii) persons, in any set of persons not exceeding four, who

(A) are resident in Canada,

(B) are not described in (i) or (ii) above, and

(C) own shares of the foreign affiliate (each, a “**relevant Canadian shareholder**”); **and**

(iv) persons who do not deal at “arm’s length” with any relevant Canadian shareholder

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What is a "controlled foreign affiliate"?

- "Arm's length" is defined in section 251 of the Tax Act
  - Captures both "related persons" and persons who factually do not deal with one another at arm's length
- Sets of "relevant Canadian shareholders" are to be "determined without reference to the existence or absence of any relationship, connection or action in concert between those persons"

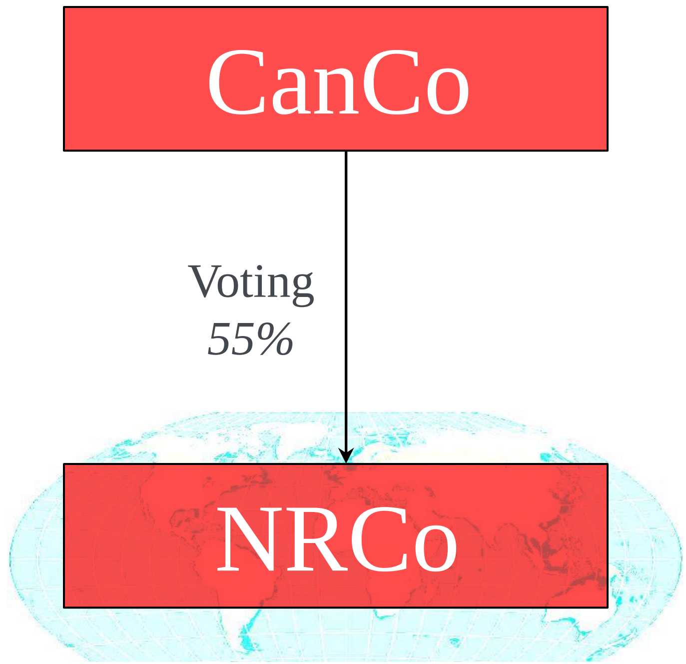
What is a "controlled foreign affiliate"?

"Look-Through" Rules

- For the purpose of applying the second test, subsections 95(2.01) and (2.02) of the Tax Act provide special "look-through" rules that ascribe ownership of shares held indirectly to particular taxpayers based on the relative fair market value of their interests in the intermediary entity

What is a “controlled foreign affiliate”?

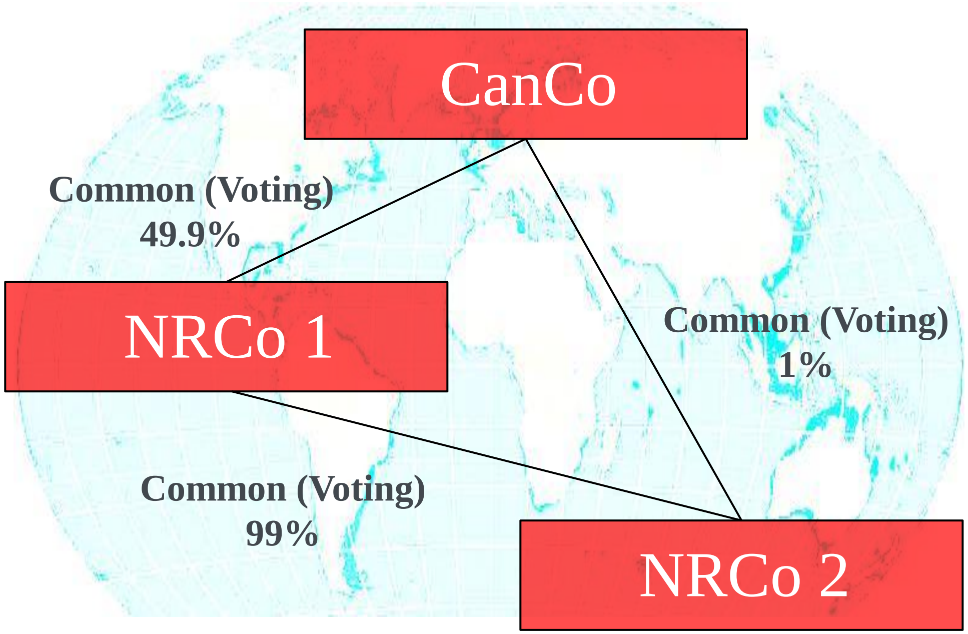
Example #1 – *De Jure* Control by the Taxpayer



Absent other special limitations, NRCo is a “**controlled foreign affiliate**” of CanCo

What is a “controlled foreign affiliate”?

Example #2 – Application of “Look-Through” Rules

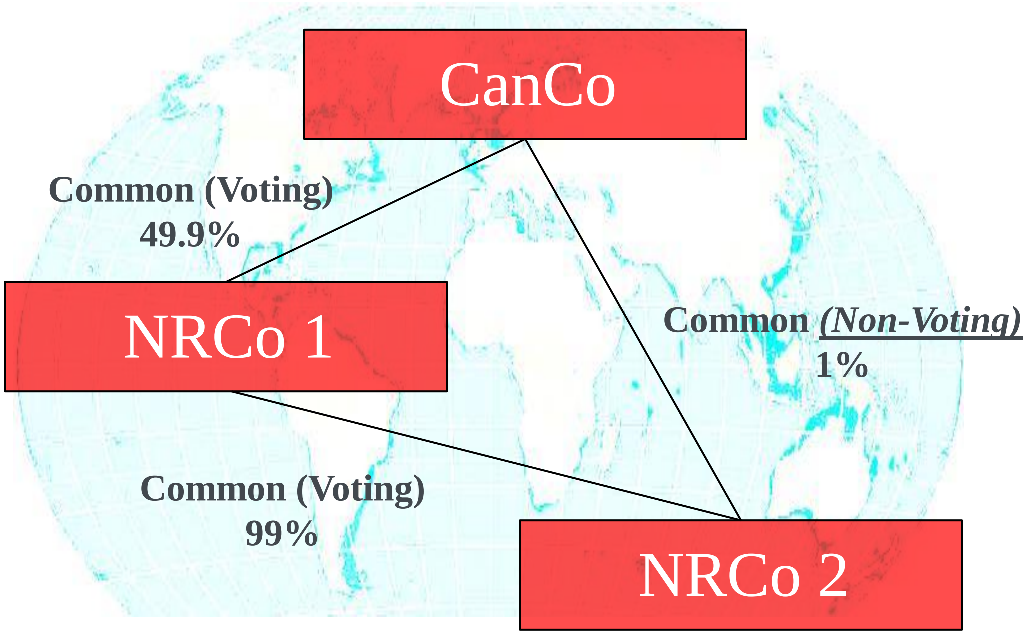


NRCo 1 **<u>is not</u>** a “controlled foreign affiliate” of CanCo

NRCo 2 **<u>is</u>** a “controlled foreign affiliate” of CanCo

What is a “controlled foreign affiliate”?

Example #2a – Application of “Look-Through” Rules

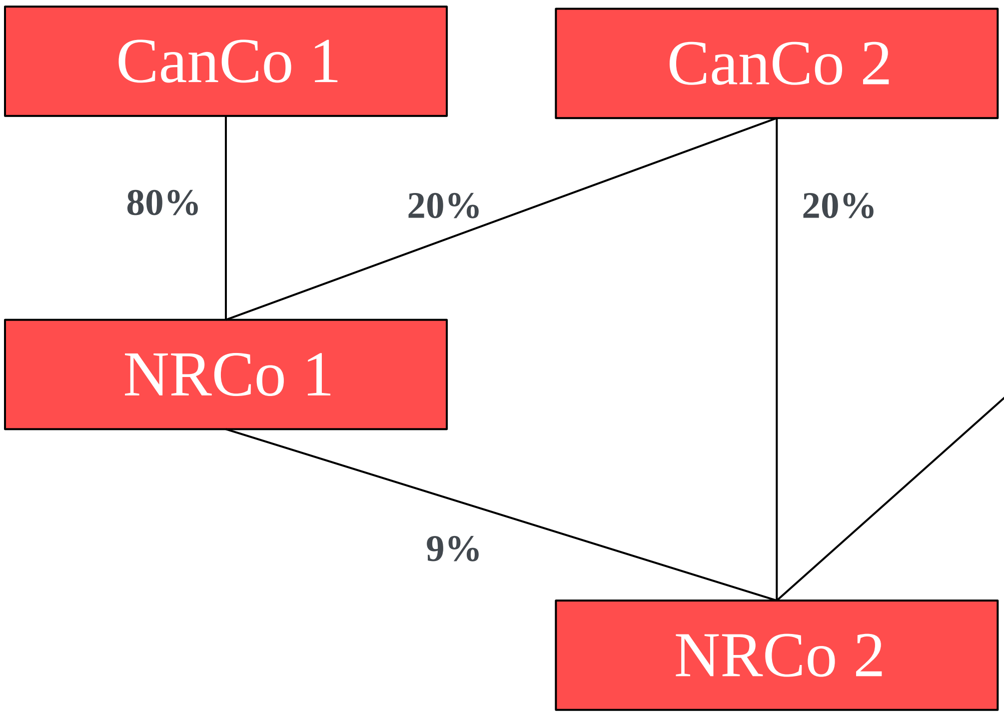


NRCo 1 **is not** a “controlled foreign affiliate” of CanCo

NRCo 2 **is not** a “controlled foreign affiliate” of CanCo

What is a "controlled foreign affiliate"?

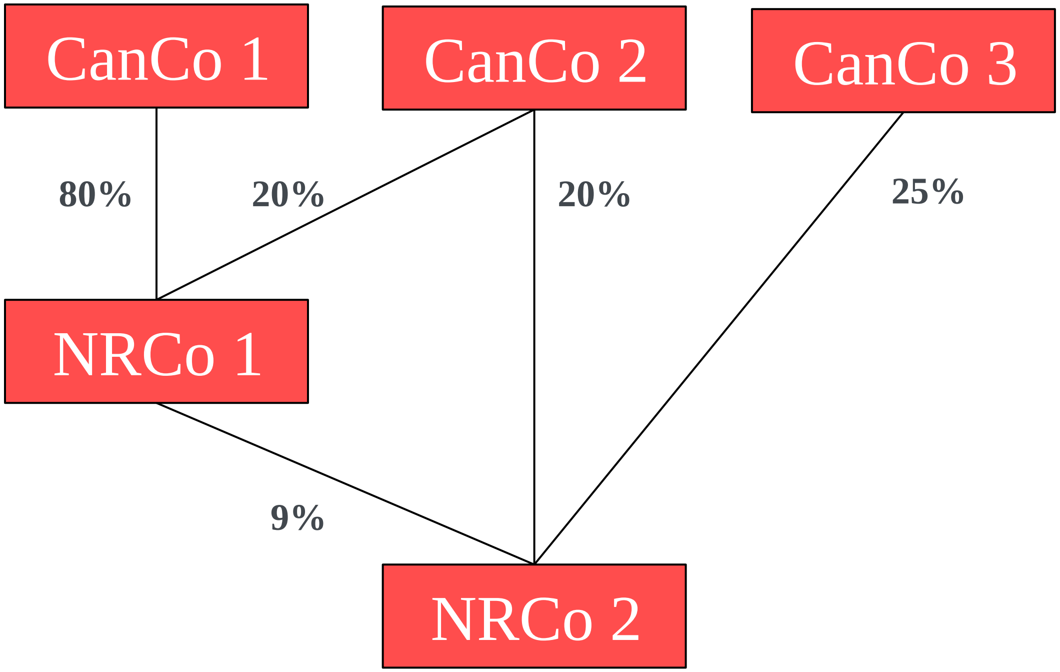
Example #3 – Hypothetical Deemed Control by the Taxpayer



Assume the CanCos deal with one another at arm's length and all other shareholders of the NRCos are unrelated parties

What is a “controlled foreign affiliate”?

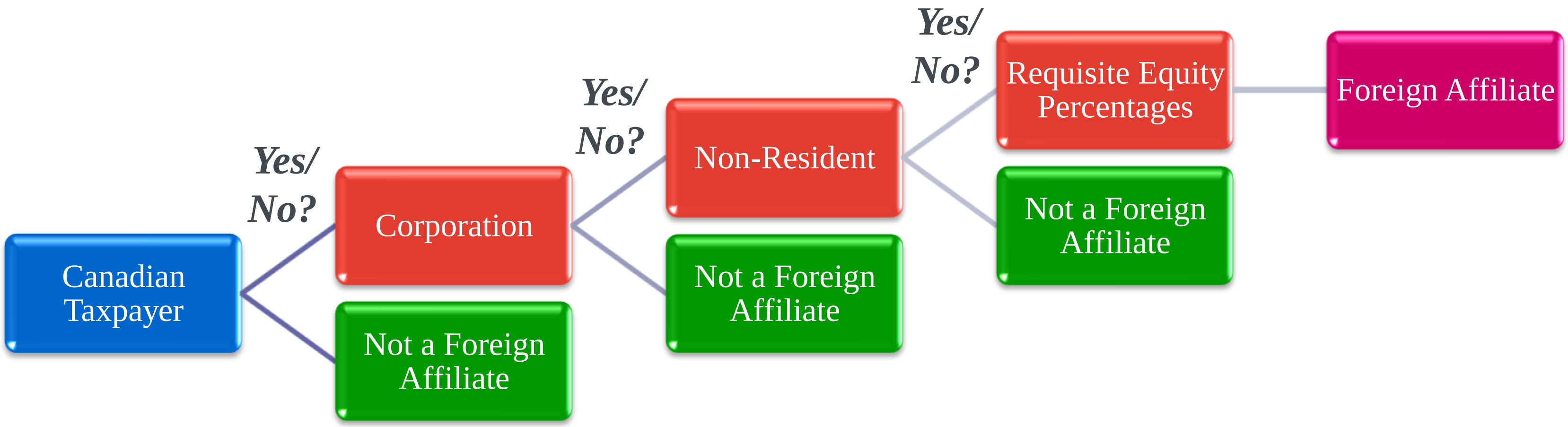
Example #3 – Hypothetical Deemed Control by the Taxpayer



NRCo 1 is a controlled foreign affiliate of CanCo 1 and CanCo 2

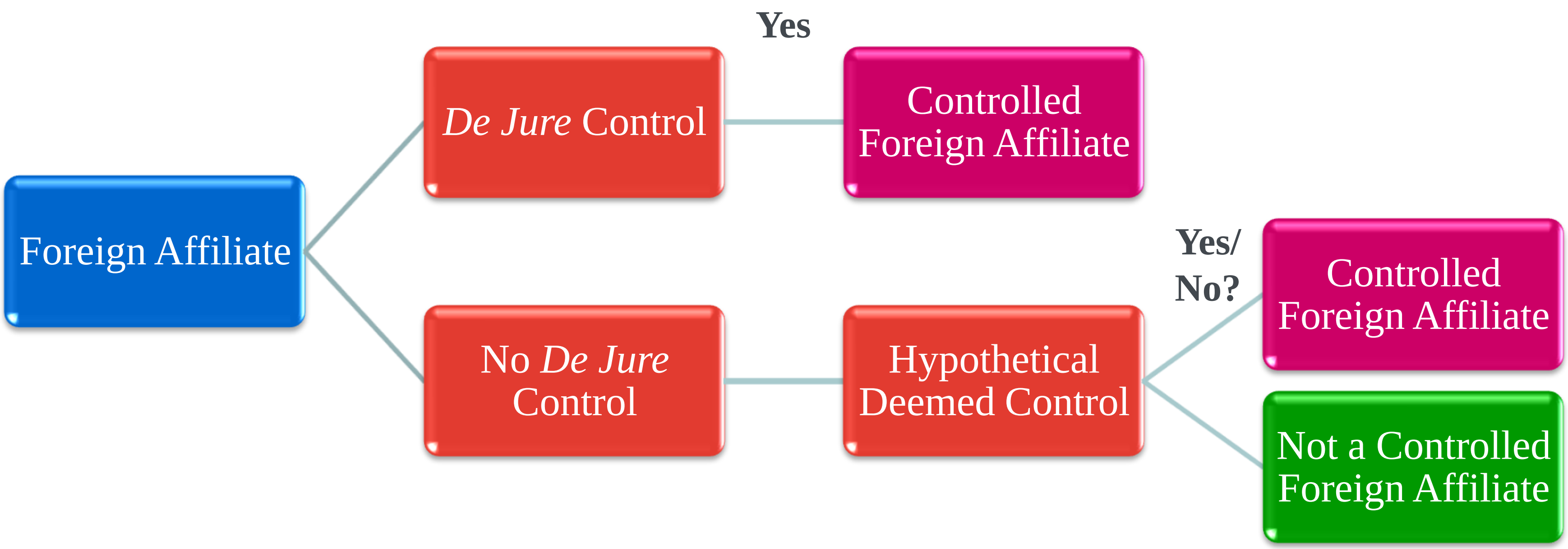
NRCo 2 is a controlled foreign affiliate of CanCo 2 and CanCo 3

“Foreign Affiliate” – Determination Tree*



** Also necessary to confirm no applicable deeming rules*

"Controlled Foreign Affiliate" – Determination Tree*



** Also necessary to confirm no applicable deeming rules*

Dividends from Foreign Affiliates

- Dividends received from non-resident corporations by a Canadian taxpayer are required to fully be included in income for Canadian tax purposes (subsection 90(1) of the Tax Act)

Dividends from Foreign Affiliates

- Corporations resident in Canada that receive dividends from a foreign affiliate may be entitled to claim a deduction when computing income equal to at least a portion of the amount of the dividend received (the "**FA Dividend Deduction**") (section 113 of the Tax Act)
- The amount of the FA Dividend Deduction is dependent on the portion of the dividend prescribed to be paid out of different pools of "surplus" of the relevant foreign affiliate

Dividends from Foreign Affiliates

- Various types of "surplus" are defined in Part LIX of the Regulations to the Tax Act
- The "surplus" of a foreign affiliate in respect of a particular Canadian-resident corporation is generally divided into the following categories:

  "**Exempt Surplus**" generally captures

  - "net earnings" of a foreign affiliate resident in a "designated treaty country" from an active business carried on by it in Canada or a designated treaty country,

Dividends from Foreign Affiliates

- certain deemed active business income, and
- dividends received from other foreign affiliates of the taxpayer prescribed to have been paid out of the other affiliate's exempt surplus in respect of the taxpayer

"**Hybrid Surplus**" generally captures

- capital gains on the sale of partnership interests and shares of other foreign affiliates of the Canadian corporation

Dividends from Foreign Affiliates

"**Taxable Surplus**" generally captures

- "net earnings" from an active business carried on by the foreign affiliate in a country and in respect of its "foreign accrual property income"

  (However, such portion of the foregoing amounts that are included in an affiliate's "exempt earnings" are excluded from its "taxable surplus")

"**Pre-Acquisition Surplus**" generally serves as a residual category of surplus for amounts not considered to have been paid out of other surplus pools

“Foreign Accrual Property Income”: An Overview

- All or a portion of the “foreign accrual property income” (“**FAPI**”) earned by a controlled foreign affiliate of a taxpayer resident in Canada (a “**CFA**”) is generally taxed in the hands of the Canadian taxpayer on a current basis (section 91 of the Tax Act)
- The required income inclusion occurs in respect of each share of the CFA owned by the Canadian taxpayer (a “**CFA Share**”) and is based on that share’s “participating percentage” in the CFA

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“Foreign Accrual Property Income”: An Overview

- The definition of FAPI is contained in subsection 95(1) of the Tax Act and is complex
- Very generally, FAPI is passive income of a CFA

“Foreign Accrual Property Income”: An Overview

- FAPI generally includes:
  - Income from property
  - Income from a business other than an active business
  - Income from a “non-qualifying business”
  - Certain taxable capital gains from the disposition of property (other than “excluded property”)

"Foreign Accrual Property Income": An Overview

- Deductions from FAPI generally include:
  - Losses from property
  - Losses from a business other than an active business
  - Losses from a "non-qualifying business"
  - Certain allowable capital losses from the disposition of property (other than "excluded property")
- A "foreign accrual property loss" may frequently be carried forward 20 years and carried back 3 years for application against FAPI incurred in those years.

“Foreign Accrual Property Income”: An Overview

- The attribution of FAPI is intended to eliminate the Canadian tax deferral that could result from using offshore holding companies to hold investments
- The amount of FAPI included in the Canadian taxpayer’s income is reduced to take into account foreign taxes paid (or deemed paid) on the income

"Foreign Accrual Property Income": An Overview

- The deduction in respect of foreign taxes from FAPI is generally computed as follows:

"foreign accrual tax" ("**FAT**") applicable to FAPI

x

the Canadian taxpayer's "relevant tax factor" ("**RTF**")

- RTF is meant to reflect Canadian tax rates.
  - RTF of a corporation = 1/(0.25) = 4

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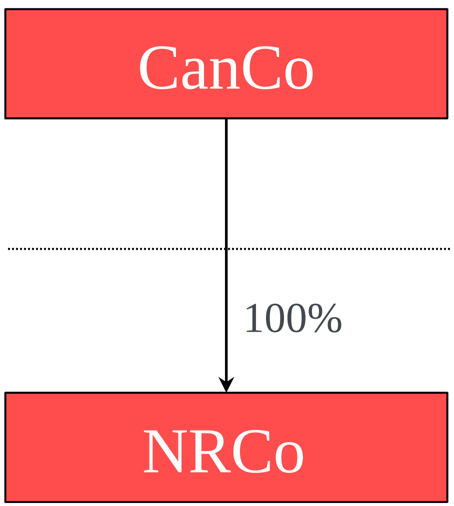
“Foreign Accrual Property Income”: An Overview

FAPI Computation Example



FAPI: ***$10,000***
FAT: ***$1,500***

Gross FAPI income inclusion (s. 91(1)):	$10,000
Deduction (FAT x RTF) (s. 91(4)) = $1,500 x 4:	($6,000)
Net FAPI income inclusion:	*$4,000*

CanCo must include $4,000 in its income in Canada.

"Foreign Accrual Property Income": An Overview

- The net amount of FAPI included in a Canadian taxpayer's income is added to the adjusted cost base (the "**ACB**") of its CFA Shares (section 92 of the Tax Act)
- An offsetting deduction is available in respect of a dividend received by the Canadian taxpayer that is prescribed to have been paid out of the taxable surplus of a CFA (up to the net amount by which the ACB of the taxpayer's CFA Shares was increased as a result of earlier FAPI inclusions)

Questions?

Cautionary Note

The foregoing commentary is summary in nature and does not address all of the issues and considerations that may be relevant under any particular set of circumstances.

The statements and material presented herein do not represent legal or tax advice.

No transactions should be executed on the basis of the foregoing statements and commentary.

<u>Formal legal, tax, and accounting advice should be obtained prior to making any investment or executing any transaction.</u>

Understanding the Basic Building Blocks of the Canadian Foreign Affiliate Rules

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