Update

February 2, 2010

Draft and Recently-enacted Amendments Impact Canadian Outbound Investment Tax Rules

On December 18, 2009, the Canadian Department of Finance (Finance) released a package of proposed foreign affiliate amendments (the 2009 Proposals). This Update summarizes the impact of these proposals on outbound investment by Canadians, and reviews the status of various other proposed and recently-enacted changes to Canada's foreign affiliate rules. Finance's approach to certain proposed amendments in the 2009 Proposals, and in particular its focus on simplification and ease of compliance, holds promise for future amendments.

INTRODUCTION TO THE CANADIAN FOREIGN AFFILIATE RULES

There are, generally speaking, two sets of foreign affiliate rules in the *Income Tax Act* (Canada) (the Act) and the associated Regulations. The first, the "foreign accrual property income" or "FAPI" rules, consists of broad anti-deferral rules applicable to passive income earned by a controlled foreign affiliate of a Canadian taxpayer. Passive income for this purpose very generally includes income from property (such as rents, royalties, interest and non-foreign affiliate dividends) and income from certain businesses that either have a link to Canada or do not meet certain minimum employee and other requirements. FAPI does not include income from an active business carried on by a foreign affiliate. A Canadian shareholder is generally required to include, in its income for a taxation year, its share of any FAPI earned by any of its controlled foreign affiliate in such year, regardless of whether or not any amount is distributed by the controlled foreign affiliate to the shareholder.

The second set of rules relates to the treatment of dividends received by Canadian corporate shareholders from foreign affiliates, including dividends paid out of earnings generated through the conduct of an active business. Canada has a hybrid exemption and credit system for the repatriation of foreign affiliate earnings. Generally speaking, where earnings arise from an active business carried on by a foreign affiliate in a country with which Canada has entered into a tax treaty or tax information exchange agreement, such earnings are included in the foreign affiliate's "exempt surplus", which may be distributed as a dividend to Canada free of any additional Canadian corporate tax. Other earnings are included in "taxable surplus", which is taxable upon distribution as a dividend to

Canada, subject to a grossed-up deduction in respect of any underlying foreign tax paid on the earnings that generated the surplus.

SUMMARY OF THE 2009 PROPOSALS

The 2009 Proposals to amend the Act and associated Regulations include the following:

- *New "fill the hole" rules*: Where a foreign affiliate with "negative" exempt surplus, called an "exempt deficit", has a direct or indirect interest in another foreign affiliate with positive exempt surplus, the exempt deficit in the upper-tier affiliate (a so-called "blocking deficit") must be "filled" with exempt surplus dividends from the lower-tier affiliate before the upper-tier affiliate can itself pay exempt surplus dividends. The 2009 Proposals include new "fill the hole" rules that prevent such blocking deficits in upper-tier affiliates from being avoided.

- *Acquisition of control and "bump" rules*: When an arm's-length party acquires control of a Canadian corporation that has one or more foreign affiliates, Canadian tax rules provide a potential increase (or "bump") in the tax cost of those foreign affiliate shares upon a subsequent amalgamation or winding-up of the target with the acquiror. The 2009 Proposals include rules to address the interaction of the surplus rules with the tax bump rules. The 2009 Proposals also contain new rules—aimed at preventing trading in exempt surplus—that may reduce available exempt surplus upon an acquisition of control of a Canadian corporation holding foreign affiliates, regardless of whether or not a tax bump is claimed on the foreign affiliate shares.

- *FAPI losses*: The 2009 Proposals contain amendments extending the ability to carryover FAPI losses to other tax years, to bring the FAPI loss rules into line with the domestic non-capital loss carryover rules.

- *Surplus account computation rules*: The February 27, 2004 draft legislation contained proposals to effectively consolidate surplus accounts of foreign affiliates (in respect of subsection 93(1) deemed dividend elections and certain other transactions). The 2009 Proposals replace these earlier draft rules with new, more straightforward rules. The 2009 Proposals contain other changes to the surplus computation rules that apply on various share transfers and other transactions that result in changes to a taxpayer's entitlement to surplus.

- *Partnership rules*: Amendments that clarify the appropriate operation of the relevant provisions where foreign affiliates are held through a partnership are proposed in the 2009 Proposals.

- *Foreign affiliate elections and previous changes*: Previous amendments to the foreign affiliate rules provided for taxpayers to voluntarily elect to have certain amendments apply earlier than they otherwise would apply. The 2009 Proposals introduce amendments to extend the period to make such elections, to permit the revocation of any such election, and to introduce a new election to open statute-barred years in respect of certain previously-enacted changes as well as in respect of the changes in the 2009 Proposals themselves. In addition, the 2009 Proposals propose amendments to the Regulations required by previously-enacted amendments to the Act.

- The 2009 Proposals contain other miscellaneous changes, discussed below.

Finance has indicated that it is accepting comments on the 2009 Proposals until February 15, 2010.

SUMMARY OF THE STATUS OF FOREIGN AFFILIATE AMENDMENTS

A significant number of changes to the foreign affiliate rules in the Act and the Regulations have been proposed over the past decade. While some changes have been recently enacted, many are still outstanding in draft form. The following table summarizes the current status of proposed and enacted foreign affiliate amendments:

Proposal Date/Bill	Status	Notes
March 21, 2001 draft Regulations	Not enacted	Superseded by 2009 Proposals
2002 Proposals (December 20, 2002)	Not enacted	Superseded by 2004 Proposals
2004 Proposals (February 27, 2004), and related comfort letters	Not enacted	Partially superseded by Bill C-28 and 2009 Proposals Still relevant for foreign affiliate reorganization and distribution rules, surplus and FAPL suspension rules
October 2, 2007 draft legislation/Bill C-28	Enacted (December 14, 2007)	Large package of amendments, including certain elements of 2004 Proposals and 2007 budget measures. No regulations included (TIEA regulations included in Bill C-10). Time to make various elections still open for non-calendar year taxpayers with taxation year end before December 14. 2009 Proposals extend election period, provide for revocation of all elections, and provide new elections (to open statute-barred years). Election to open statute-barred years in respect of any of the Proposals must be made by June 30, 2011.

Proposal Date/Bill	Status	Notes
July 14, 2008 draft legislation/Bill C-10	Enacted (March 12, 2009)	Election for currency and FAPI computation rules still open. Must be made by the later of March 12, 2010, and the filing-due date for the taxation year that includes March 12, 2009.
2009 Proposals	Not enacted	Comments may be provided before February 15, 2010. Election to open statute-barred years in respect of any of the Proposals must be made by June 30, 2011.

DETAILS OF THE 2009 PROPOSALS

The Deficit "Fill the Hole" Rules

The new "fill the hole" rules in the 2009 Proposals are aimed directly at transactions designed to circumvent so-called "blocking deficits". A blocking deficit is a deficit in an upper-tier affiliate that must be "filled" with dividends paid out of the surplus of underlying affiliates before the upper-tier affiliate may itself pay dividends. The fill the hole rules are intended to prevent the avoidance of blocking deficits through transactions involving the shares of lower-tier affiliates. The rules will apply where a foreign affiliate of a Canadian-resident corporate taxpayer has an exempt deficit, and any shares of a lower-tier affiliate in which the deficit affiliate has an equity percentage are acquired by the Canadian taxpayer or another foreign affiliate of the Canadian taxpayer in a manner that reduces the deficit affiliate's equity percentage. The acquisition of shares of the lower-tier affiliate (the "acquired affiliate") may occur on the sale of the shares, on the winding-up of the deficit affiliate, or on the issuance of shares of a lower-tier affiliate.

Where the rules apply, there is a deduction in computing the exempt surplus of the "acquired affiliate" equal to the lesser of the Canadian corporation's share of the deficit in the deficit affiliate, and the amount of the acquired affiliate's tax-free surplus balance. The "tax-free surplus balance", a newly-defined term, is the total of the exempt surplus of the affiliate and the amount of taxable surplus that would be fully supported by an underlying foreign tax deduction. The tax-free surplus balance is determined on an aggregate basis by deeming any lower-tier affiliate to have paid dividends equal to its net surplus up the chain to the top-tier affiliate (i.e., lower-tier surplus is "pulled up" to the top-tier affiliate for the purpose of determining the tax-free surplus balance). If there is more than one acquired affiliate, the taxpayer may designate the amounts to be deducted from each acquired affiliate's exempt surplus, provided that the total designated amounts equal the lesser of the deficit or the aggregate tax-free surplus account balances of the

acquired affiliates. A corresponding addition is made in computing the exempt surplus (or deficit) of the deficit affiliate.

Since the application of the fill the hole rules results in the deficit in the deficit affiliate being filled, in whole or in part, by the surplus of the acquired affiliate, the rules operate on the theory that amounts had been distributed to the deficit affiliate as dividends, and then reinvested in the capital of the underlying affiliates. The rules therefore also provide for an increase in the adjusted cost base of each directly held affiliate in the chain (that is either the acquired affiliate or that had an equity interest in the acquired affiliate) to the extent that the acquired affiliate's surplus has been reduced. The cost base adjustments are treated as "exempt dividends" for the purpose of the loss denial rule in subsection 93(2), on the basis that they represent (in theory) exempt surplus dividends paid up the chain.

In summary, the new fill the hole rules, where applicable, have three effects:

- they increase the exempt surplus (or reduces the exempt deficit) of the deficit affiliate;
- they reduce the exempt surplus of the acquired affiliate; and
- they increase the tax cost in shares of the acquired affiliate (and any affiliate below the deficit affiliate in the chain that had an equity interest in the acquired affiliate).

The Explanatory Notes accompanying the 2009 Proposals contain examples of the manner in which the fill the hole rules are intended to operate.[1]

The premise of many of the amendments to the surplus adjustment provisions in the 2009 Proposals is that adjustments need only be made to the surplus accounts of the top-tier affiliate: for example, in the case of a subsection 93(1) election that reduces surplus,[2] or as a result of the application of the new acquisition of control rule discussed below. The alternative approach, proposed in the February 27, 2004, proposals, is a complex "consolidation" system that attempts to make appropriate adjustments to the surplus, deficit and underlying foreign tax account of each foreign affiliate. The Department of Finance accurately characterizes this premise that adjustments need only be made at the level of the top-tier affiliate as a "significant compliance-saving measure". The fill the hole rules appear to be a logical consequence of adopting this approach. Generally speaking, the rules appear to appropriately allocate available tax attributes in a transaction where shares of an underlying affiliate are transferred out from under a deficit affiliate, in a manner that is consistent with the policy underlying the surplus adjustment rules. However, it remains to be seen whether these rules give rise to any inappropriate or unexpected consequences in practice.

The fill the hole rules apply to acquisitions of foreign affiliate shares occurring after December 18, 2009.

1 See page 30 of the Explanatory Notes, available at http://www.fin.gc.ca/drleg-apl/itaDec09-eng.asp

2 A subsection 93(1) election allows some or all of the proceeds of disposition arising from the sale of shares of a foreign affiliate to be recharacterized as a dividend paid by the affiliate.

Tax "Bump" and Acquisition of Control Rules — Reduction to Surplus Accounts

Where there has been an acquisition of control by an acquiror of a target, various rules in the Act reduce or restrict the use of the favourable tax attributes of the target and its subsidiaries. Moreover, when the acquisition is followed by the winding-up of the target into its parent (or the amalgamation of the target with its parent), the Act permits (under certain circumstances and within certain limits) the acquiror to cause the adjusted cost base of certain of the target's capital properties, such as shares of subsidiaries, to be increased or "bumped up" to an amount not exceeding the property's fair market value at the time of the acquisition of control. These rules, in paragraph 88(1)(d), are designed to permit an acquiror's "outside" basis in the target to be pushed down to the "inside" basis that the target has in certain of such properties. The 2009 Proposals contain rules designed to prevent the duplication of tax attributes where the property to be "bumped" is shares of a foreign affiliate of the target. These rules reflect the fact that the beneficial tax attributes of foreign affiliates of the target, in the form of exempt surplus and tax-sheltered taxable surplus, survive an acquisition of control and remain available to the acquiror.

Two sets of rules are proposed. An interim set of rules (based on prior proposals) will apply to a winding-up or amalgamation of one Canadian corporation (target) into another (acquiror) that occurs after February 27, 2004, where the relevant acquisition of control occurred before December 19, 2009. A second set of rules will apply where the relevant acquisition of control occurs after December 18, 2009.

Acquisitions Made Before December 19, 2009

Under the interim rules, where there has been an amalgamation or winding-up and the acquiror has elected to "bump" the shares of a foreign affiliate of the target, all surplus, deficit and underlying foreign tax balances of the foreign affiliate whose shares are bumped (and those of any lower-tier affiliate in which it has a direct or indirect equity interest) are eliminated, except to the extent the amounts arose after the acquisition of control and before the winding-up or amalgamation. These rules generally mirror the 2004 Proposals. An additional rule reduces the "bump room" in respect of a share of a foreign affiliate to the extent that exempt surplus dividends (or taxable surplus dividends sheltered by a deduction for underlying foreign tax) have been paid out of surplus that existed at the time of the acquisition of control. This will prevent the surplus elimination rule from being avoided through the payment of post-acquisition of control, pre-bump dividends. Thus, the acquiror is forced to choose between claiming the bump or inheriting the surplus accounts of the target's foreign affiliates. The interim rules are a blunt instrument, since all pre-existing surplus account balances are eliminated if a foreign affiliate's shares are bumped by even one dollar.

Acquisitions Made After December 18, 2009

The second set of rules, applicable where the relevant acquisition of control occurs after December 18, 2009, takes a different approach with two separate but interrelated provisions.

First, where an acquisition of control of a Canadian corporation that owns shares of a foreign affiliate occurs, such affiliate's exempt surplus is reduced to the extent that the aggregate "good" tax attributes in respect of the shares of the affiliate exceed the fair market value of the shares at the time of the acquisition of control. The rule applies whether or not any bump is claimed on the shares.

The favourable tax attributes consist of the underlying "tax-free surplus balance" plus the Canadian corporation's tax cost in the shares of the affiliate. Such tax cost is determined after taking into account the application of subsection 111(4) of the Act (which could apply to adjust the tax cost of capital property on an acquisition of control). As noted above, the "tax-free surplus balance" is the total of the exempt surplus of the affiliate and the amount of taxable surplus that would be fully supported by an underlying foreign tax deduction, determined on an aggregate basis by deeming any lower-tier affiliate to have paid dividends equal to its net surplus up the chain to the top-tier affiliate. If the total of the Canadian corporation's share of the tax-free surplus balance and the tax cost of its top-tier affiliate shares exceeds the fair market value of those shares at the time of the acquisition of control, the excess is deducted in computing the exempt surplus of the top-tier affiliate in respect of the corporation.[3] This could result in a deficit in the top-tier affiliate, and the new "fill the hole" rules discussed above are aimed at transactions that attempt to circumvent such a deficit.

Finance's Explanatory Notes provide examples of the application of the acquisition of control rule.[4] The acquisition of control rule ensures that the acquiror is not permitted to benefit from aggregate tax attributes relating to foreign affiliates that exceed the fair market value of the shares of the top-tier foreign affiliate at the time of the acquisition of control. This acquisition of control rule would prevent, for example, the trading in "exempt surplus" that might otherwise occur if a target owned an affiliate with high exempt surplus but low value. This would not be expected to occur frequently, but could arise, for example, in a situation where a previously-successful foreign affiliate had reinvested its earnings in a business that was ultimately unsuccessful. This rule is consistent with the other rules in the Act that prevent unaffiliated parties from trading in tax attributes.

A second rule applies for the purpose of determining the "bump room" available in respect of the shares of the top-tier affiliate. Generally speaking, the bump room for a particular property is determined by deducting the target's tax cost of that property from its fair market value at the time of the acquisition of control; i.e., the amount of the unrealized gain. For foreign affiliate shares, however, the bump room will also be limited to the extent of the underlying tax-free surplus balance (as it may have been reduced, as described above, to take into account any excess of the aggregate tax attributes of the foreign affiliate over the fair market value of the shares). If the tax cost of the shares plus the Canadian corporation's share of the affiliate's aggregate tax-free surplus balance

3 Or, more precisely, the amount deducted is the excess divided by the corporation's surplus entitlement percentage in the top-tier affiliate.

4 See page 23 of the Explanatory Notes, available at http://www.fin.gc.ca/drleg-apl/itaDec09-eng.asp

(taking into account any prior deduction resulting from the application of the acquisition of control rule) equals or exceeds the fair market value of the shares, no bump is permitted. This rule does not affect the ability to "bump" the tax cost of property other than foreign affiliate shares held by the target.

The approach in the 2009 Proposals appears to achieve the policy goal of preventing the duplication of tax attributes. It also ensures that only the appropriate amount of surplus is eliminated, correcting a flaw that exists in the interim version of the rules. It is nevertheless possible that anomalous results could occur in some circumstances, so the application of these rules should be carefully considered, in particular in advance of any acquisition of control.

FAPL Rules

Under the current rules, a foreign affiliate's FAPI loss (FAPL) may be carried forward for five years, and may not be carried back. Draft Regulations released in March 2001 would have permitted a three-year carryback and a seven-year carryforward. The 2009 Proposals ensure that the carryback and carryforward periods for FAPLs mirror the domestic rules relating to non-capital losses—a three-year carryback and 20 year carryforward. The changes apply to foreign affiliate taxation years beginning after November 1999, with appropriate transitional rules, especially relating to the carryforward period, which moves from seven to ten to 20 years on the same basis as the corresponding change to the domestic rules for non-capital losses of Canadian taxpayers.

Surplus Adjustment Rules

A foreign affiliate's surplus and underlying foreign tax account balances in respect of a Canadian taxpayer need to be established or adjusted in a number of circumstances. Various rules in the Regulations apply

- where a Canadian taxpayer's surplus entitlement in respect of a foreign affiliate has increased, to reduce the amount of pre-existing surplus;
- where there is an amalgamation or winding-up of a Canadian taxpayer or a sale of foreign affiliate shares to a related Canadian taxpayer, to establish the opening surplus account balances in respect of the amalgamated company, the parent, or the acquiror, respectively;
- where there is a liquidation and dissolution or foreign merger involving a foreign affiliate, to provide for the appropriate continuity of surplus accounts; and
- where a subsection 93(1) election has been made to treat proceeds of disposition of a share of a foreign affiliate as a dividend.

In addition, surplus accounts need to be adjusted to take into account the application of the deemed active business income rules in paragraph 95(2)(a), to ensure there is no duplication of surplus.

The 2004 Proposals contained amendments to the various rules that adjust surplus accounts. These amendments became, at times, extraordinarily complex. This was particularly the case for the rules relating to the subsection 93(1) elected amount. The theory behind the subsection 93(1) election is that, on a sale of shares of a foreign affiliate, a taxpayer should be entitled to take advantage of the underlying surplus of the affiliate by electing to treat a portion of its proceeds of disposition (which would otherwise give rise to a capital gain) as a dividend. Among other things, this rule allows access to underlying surplus without requiring an actual dividend distribution (which could trigger a foreign withholding tax liability).

In order to determine the surplus that should be available for a subsection 93(1) election, the 2004 Proposals required surplus to be computed on a consolidated basis, with subsequent adjustments to the surplus accounts and tax cost of various foreign affiliates in the group. This resulted in a difference between the amount available on a deemed dividend resulting from a subsection 93(1) election compared with an actual dividend, and required many complicated adjustments.

The current rules — and the rules in the 2009 Proposals — operate by deeming each affiliate, starting at the lowest tier, to pay a dividend equal to its net surplus up the chain and then determining the aggregate net surplus that would exist in the top-tier affiliate (whose shares are being disposed of). While deficits in intervening affiliates would reduce the amount of aggregate net surplus available, a deficit at the bottom tier (or a remaining deficit in an intervening affiliate) would not affect such aggregate net surplus. Much of the complexity in the 2004 Proposals arose from the rules relating to the determination of the "consolidated net surplus" that was available in respect of a subsection 93(1) election where there has been a partial disposition of shares (or a share redemption), and the corresponding adjustments to each relevant underlying affiliate's accounts. The complexity appeared aimed at preventing a single perceived mischief—the ability to avoid taking deficits into account to the extent they exist in the bottom-tier affiliates, or to the extent that deficits in intervening affiliates remain after taking into account the net surplus dividends deemed to have been received from lower-tier affiliates. Analogous rules in the liquidation context had a similar apparent goal.

These proposals have mercifully been abandoned, in favour of a much simpler set of rules, including the new "fill the hole" rule that prevents the most egregious forms of tax avoidance as it relates to foreign affiliate deficits.

With respect to a subsection 93(1) election, the 2009 Proposals generally revert to the method of determining the amount of consolidated surplus available in respect of a subsection 93(1) election on the shares of an affiliate. As noted, this involves deemed dividends of net surplus up the chain of affiliates, starting at the lowest tier, until the net surplus of the affiliate whose shares are being disposed of is established.[5] The amount of surplus deemed to be paid as a dividend on a subsection 93(1) election is then deducted from the surplus accounts of the affiliate whose shares have been sold. These surplus

---

5 As discussed above, this is the same method used to determine an affiliate's tax-free surplus balance.

accounts are then adjusted again to take into account the change in the surplus entitlement resulting from the disposition. If a deficit is created in the affiliate whose shares are disposed of, the new "fill the hole" rules, discussed above, would apply to any transaction designed to avoid such deficit. The Explanatory Notes contain an example of the application of the rules.[6]

The 2009 Proposals also make changes to the other surplus adjustment rules, largely aimed at simplifying the organization of the rules and at filling gaps in the current rules. For example, if a Canadian corporation's surplus entitlement in respect of a particular foreign affiliate is reduced because it transfers shares of a foreign affiliate to another foreign affiliate (because, for example, the other foreign affiliate is owned in part by an unrelated party), there is currently no rule to increase the transferred affiliate's surplus account balances. An increase would be appropriate to preserve the Canadian corporation's pre-existing entitlement to such surplus balances. This problem is solved under the 2009 Proposals (for transactions occurring after December 18, 2009).

The 2004 Proposals contained rules applicable where clause 95(2)(a)(ii)(D) applies to interest paid by one foreign affiliate to another, and deems the interest income to be active business income to the recipient. Clause 95(2)(a)(ii)(D) applies where the interest-payer has borrowed money to acquire (or owes unpaid purchase price in respect of) the shares of a third affiliate. In line with the focus on consolidation and consequential surplus adjustments, the 2004 Proposals required that the amount of interest paid be deducted in computing the surplus accounts of the payer affiliate, then of the affiliate whose shares were acquired, then of any other underlying affiliate, before ultimately creating a deficit in the payer affiliate. The 2009 Proposals abandon this approach and revert to the current approach of causing a deduction, in the payer affiliate, for the interest paid, in computing its active business income (and for this purpose the payer affiliate is deemed to carry on an active business in the country in which it is resident). Transactions designed to circumvent any deficits created by this approach are dealt with through the new "fill the hole" rules, discussed above.

The surplus adjustment rules generally apply prospectively only, and there are no transitional measures, which could prove inconvenient for taxpayers who have attempted to compute surplus accounts in accordance with the 2004 Proposals.

Partnership Rules

The 2009 Proposals introduce new Regulation 5908, which provides rules which ensure that the surplus regulations apply appropriately to partnerships. Rules, similar to subsection 93.1(1) of the Act, are proposed to allocate ownership of shares of foreign affiliates owned by a partnership to its partners for the purposes of the surplus adjustment rules and to determine the consequences when shares are disposed of or acquired. In addition, the prescribed rules for determining a foreign affiliate's adjusted cost base in a partnership interest are moved from Regulation 5907(12) to new Regulation 5908(10).

---

6 See page 13 of the Explanatory Notes, available at http://www.fin.gc.ca/drleg-apl/itaDec09-eng.asp

Foreign Affiliate Elections

As discussed in greater detail below, Bill C-28 (enacted in December 2007) made significant changes to certain of the foreign affiliate rules, including changes to the deemed active business rules in paragraph 95(2)(a). As a result of the long history associated with many of the changes, and the practice of making amendments applicable as of the time they are announced, the coming-into-force provisions associated with the changes enacted in Bill C-28 are extremely complex and in many cases contain transitional versions of the changes. Many of the rules applied to taxation years beginning after 1999 or after December 20, 2002. In addition, the coming-into-force rules allowed taxpayers to make one-time elections to have many of the changes apply earlier than would otherwise be the case (to taxation years beginning after 1994).

The rules governing these elections are complex. Certain changes were included in the so-called "global election", applicable to a package of amendments, whereby the taxpayer could elect to have all of these amendments apply in the earlier elective period. Other individual elections could be made in respect of other changes. An election applies in respect of all of the foreign affiliates of the taxpayer, and under Bill C-28 only the global election could be revoked. The elections were originally due, for calendar year taxpayers, at the end of June 2008.

On June 27, 2008, the government announced an 18-month extension for filing these elections, i.e., to December 31, 2009 for calendar year taxpayers.[7] The 2009 Proposals will enact this extension, and will also provide that *any* of the Bill C-28 elections (and not just the global election) may be revoked by the taxpayer. The revocation must be made on or before the filing-due date for the taxation year that includes December 14, 2010, i.e., by June 30, 2011 for calendar year taxpayers.

The 2009 Proposals also include an additional and distinct election to allow statute-barred years to be reopened to take into account any foreign affiliate amendments in Bill C-28 (other than those in respect of which the global or any other election was made). This new election, which also applies to all foreign affiliates of a taxpayer, must be made on or before June 30, 2011. A similar election applies in respect of the 2009 Proposals.

Previously-enacted Amendments

The 2009 Proposals will enact the changes to the Regulations that are consequential to the changes to the Act made by Bill C-28 and Bill C-10 (enacted in March 2009). Most importantly, paragraph (d) of the definition of "exempt earnings" in Regulation 5907(1) is amended to take into account amendments to paragraph 95(2)(a). This provision deems income from property to be active business income in certain circumstances, such as where income arises from a payment that is deductible in computing the active business earnings of the payer. The amendments ensure that the rules for determining

7 The deadline is 18 months after the filing due-date for the taxpayer's taxation year that includes December 14, 2007. Many non-calendar year taxpayers will have additional time (if the taxation year ends prior to December 14). For example, the deadline for a taxpayer with an October 31 taxation year end would be October 31, 2010.

the surplus of a foreign affiliate track the rules in the Act relating to the determination of deemed active business income.

In order to generate exempt earnings in a given taxation year (which are included in computing a foreign affiliate's exempt surplus at the end of its taxation year), the affiliate must be resident in a designated treaty country. There is currently no rule to establish at which point in the year residence must be established, suggesting that treaty residence at the end of the taxation year could suffice. The 2009 Proposals introduce a requirement that treaty-country residence exist "throughout the taxation year". Thus, it would no longer be possible to satisfy the treaty-country residence requirement merely by ensuring that such requirement is satisfied at the end of the affiliate's taxation year. This amendment will be effective for taxation years beginning after December 18, 2009.

Other Miscellaneous Changes

The 2009 Proposals contain certain other changes, including:

- The introduction of a common "permanent establishment" definition for all of the foreign affiliate provisions in the Act and the Regulations.
- In the context of consolidated groups where compensatory payments are made among the members of the group:
  - a proposal (first introduced in the 2004 Proposals) to treat a compensatory payment made in respect of a tax credit of an affiliate used by another member of the group in the same way as a payment for the use of a loss of an affiliate; and
  - a proposal (first introduced in the 2004 Proposals) to treat a payment made by one affiliate to another, as a compensatory payment in respect of the use of a loss of the recipient of the payment, as "foreign accrual tax" only to the extent that the loss would have been a FAPL;
    - there would appear to be a glitch in the way that draft Regulation 5907(1.4), which implements this proposal, is drafted, since it could be interpreted to inappropriately restrict the compensatory payments that may be treated as foreign accrual tax; we anticipate that this glitch will be rectified in due course.
- A proposal to eliminate the prohibition against using the Canadian dollar as the calculating currency for surplus account balances. This proposal is beneficial in the case where a foreign affiliate is entitled to use the Canadian dollar as its functional currency for accounting and foreign tax purposes.
- A proposal (first proposed in the 2002 Proposals) to treat certain foreign oil and gas levies as income or profits tax for the purpose of the surplus account Regulations.

STATUS OF FOREIGN AFFILIATE AMENDMENTS

Draft Regulations were released on March 16, 2001 and draft amendments to the Act and the Regulations were released on December 20, 2002 (the 2002 Proposals). The 2002 Proposals proposed to correct various technical deficiencies, and contained relatively minor changes to the foreign affiliate reorganization rules.

The 2002 Proposals were entirely superseded by extensive draft amendments to the Act and the Regulations released on February 27, 2004 (the 2004 Proposals). The 2004 Proposals contained the more technical (and less controversial) improvements to the rules that were in the 2002 Proposals. They also:

- proposed dramatic changes to the foreign affiliate reorganization rules relating to mergers and liquidations and dissolution of foreign affiliates;
- proposed changes respecting the treatment of distributions from foreign affiliates, especially the rules applicable to distributions to Canadian-resident shareholders (draft subsection 88(3));
- proposed new "surplus suspension" and "FAPI loss suspension" regimes, aimed at preventing the inappropriate creation of valuable tax attributes in related-party transactions; and
- proposed complex changes to the foreign affiliate Regulations dealing with the surplus available for, and the consequences of, an elective or automatic application of subsection 93(1) in respect of the sale of shares of a foreign affiliate, as well as various other changes.

The 2004 Proposals were followed by a series of Finance "comfort letters" and other public announcements, relating principally to the foreign affiliate reorganization and distribution rules. The Finance correspondence set out the details of expected revisions to the rules, including substantive changes such as the introduction of a "foreign paid-up capital" or "FPUC" concept. The comfort letters relating to FPUC (and to certain other foreign affiliate reorganizations) are notably prescriptive, containing detailed descriptions of the expected new rules, and suggest that the changes they propose will apply retroactively (subject to opt-out elections in certain cases). For planning purposes, therefore, these letters have generally been treated as having a "quasi-legislative" status, with many taxpayers taking them into account (along with the current rules of the Act and the actual draft legislation) in planning and implementing transactions.

As part of the International Tax Fairness Initiative in its 2007 budget (most notable for its ill-fated "anti-tax haven" measures), the federal government announced plans to narrow the scope of the deemed active business income rules in paragraph 95(2)(a) of the Act. Generally speaking, these rules allow certain passive income earned by a foreign affiliate to be recharacterized as active to the extent it relates to an active business carried on by another non-resident corporation. Under the proposed changes, the relevant Canadian taxpayer would be required to have a "qualifying interest"

(i.e., minimum 10% equity interest, measured by votes and value) in the "active business" foreign affiliate (as opposed to being merely "related"). The purpose of this change was generally to prevent non-Canadian controlled multi-national groups from taking advantage of the deemed active business rules. The government also proposed to extend the availability of the beneficial "exempt surplus" system, until then applicable exclusively to tax treaty countries, to countries that entered into a comprehensive tax information exchange agreement (TIEA) with Canada.[8] In addition, in November 2007, the government formed the International Tax Advisory Panel, which issued its final report in December 2008.[9] In the meantime, the government indicated that the 2004 Proposals were still under review.

Draft legislation released in October 2007, which would become Bill C-28, contained the 2007 budget proposals relating to the deemed active business rules and TIEAs. Bill C-28 also included many of the non-controversial or technical provisions in the 2004 Proposals, including:

- amendments to the "controlled foreign affiliate" and "excluded property" definitions;
- amendments to the deemed active business rule in paragraph 95(2)(a);
- amendments to the deemed inactive business rules in paragraphs 95(2)(a.1) and (b);
- expansion of the "qualifying interest" concept through new paragraph 95(2)(n); and
- various other technical changes.

Bill C-28 did not include the changes to the foreign affiliate reorganization and distribution rules, or changes to the foreign affiliate currency and income computation rules that were included in the draft legislation (released on October 2, 2007) that would become Bill C-28. Nor were any significant amendments to the Regulations included in Bill C-28.[10] Bill C-28 was enacted, coming into force on December 14, 2007.

On July 14, 2008, draft legislation containing further amendments to the foreign affiliate rules were released. These amendments revised paragraphs 95(2)(f) and (f.1) (in respect in particular to the manner in which pre-acquisition amounts should be excluded from the computation of FAPI) and added the foreign affiliate currency and income computation rules in paragraphs 95(2)(f) to (f.15).[11] Legislation was tabled as Bill C-10 (not to be confused with a prior Bill C-10 containing the foreign investment entity and non-resident trust rules!) on November 28, 2008. Bill C-10 entered into force on March 12, 2009. The changes to paragraph 95(2)(f) and (f.1) and the other foreign affiliate income computation and currency rules are generally favourable to taxpayers.

8 A corresponding measure would treat active business income as FAPI if it were earned in a country that had declined Canada's invitation to negotiate a TIEA or that had dragged its feet in negotiations for more than five years.

9 See http://www.apcsit-gcrcfi.ca/07/index-eng.html.

10 Regulations implementing the TIEA proposals were included in Bill C-10.

11 These changes were foreshadowed in the October 2, 2007 draft legislation but were deleted when this draft legislation was tabled as Bill C-28 in November 2008.

They apply to taxation years of foreign affiliates that begin after October 2, 2007. There is yet another election available, however, to permit these changes to apply, in respect of all foreign affiliates of a taxpayer, to taxation years of a foreign affiliate beginning after one of three dates: December 31, 1994, December 20, 2002, or February 27, 2004. The election must be made by the later of March 12, 2010, and the taxpayer's filing due-date for its taxation year that includes March 12, 2009 (e.g., June 30, 2010 for calendar year taxpayers). This election, which is generally favourable to taxpayers, is not revocable.

Navigating the foreign affiliate rules is difficult at the best of times. The myriad of recent changes, both enacted and proposed, makes it even more difficult. Osler's international tax practitioners deal with these rules every day, and are among the nation's foremost experts. If you have any questions about how these rules affect you, please contact any member of our Tax Department.

This *Update* has been authored by:

Patrick Marley pmarley@osler.com **416.862.6583**

Drew Morier dmorier@osler.com **416.862.5971**

This Osler Update is available in the Publications & News section of osler.com. This memorandum is a general overview of the subject matter and cannot be regarded as legal advice. Subscribe to a full range of updates at osler.com. You can unsubscribe at any time at osler.com or http://unsubscribe.osler.com. © Osler, Hoskin & Harcourt LLP