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Canada’s Foreign Affiliate Rules: A Decade of Proposals Nearing Completion

On October 24, 2012, the Minister of Finance released a detailed Notice of Ways and Means Motion to implement outstanding technical tax amendments, including significant amendments to Canada’s income tax rules applicable to Canadian corporations with foreign affiliates (the Proposals). The Proposals apply to most distributions from, and reorganizations of, foreign affiliates of Canadian corporations, and contain new rules applicable to certain loans received from foreign subsidiaries that remain outstanding for at least two years, among other significant changes. In addition to certain important new measures, the Proposals replace numerous proposed amendments that were released at various times over the past decade, and in many cases will have retroactive effect (in some cases with elections available to extend their application to prior years). It is expected that the current majority Conservative government will enact the Proposals into law later this year. This update summarizes the key foreign affiliate changes in the Proposals. For a discussion of prior versions of the Proposals, see Osler Updates from August 22, 2011 and February 2, 2010. Other aspects of the technical tax amendments will be addressed in further Osler Updates.

BACKGROUND - OVERVIEW OF THE CANADIAN FOREIGN AFFILIATE RULES

There are, generally speaking, two sets of foreign affiliate rules in the Income Tax Act (Canada) and the associated Regulations. The first, the “foreign accrual property income” or “FAPI” rules, are broad anti-deferral rules applicable to passive income earned by a controlled foreign affiliate of a Canadian taxpayer. Passive income for this purpose 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 generally does not include income from an active business carried on by a foreign affiliate (or income that is deemed to be included in income from an active business – such as income derived from certain inter-affiliate payments). Canadian shareholders are required to include, in their income for a taxation year, their share of any FAPI earned by a 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 combined exemption and credit system for the repatriation of foreign affiliate earnings. 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 added in computing “exempt surplus,” which may be distributed as a dividend to a Canadian corporation free of any additional Canadian 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 such surplus. The Proposals add a third category of “hybrid surplus” — which is essentially a combination of the exempt surplus and taxable surplus regimes.

While the Proposals relate principally to the surplus distribution regime, some aspects of the Proposals also apply to the FAPI anti-deferral regime.

**SUMMARY OF KEY FOREIGN AFFILIATE CHANGES IN THE PROPOSALS**

The Proposals contain many detailed and technical changes to the foreign affiliate rules, including the following key measures:

**“Upstream” Loans from Foreign Affiliates:** The Proposals contain rules that apply to certain loans made by a foreign affiliate to a Canadian shareholder or to certain other persons that are not dealing at arm’s length, including non-residents of Canada, other than a non-resident corporation controlled by the Canadian shareholder or by certain other related Canadian residents. The Proposals also apply to indebtedness owing by such persons to a foreign affiliate. Subject to certain conditions being satisfied, the Proposals treat a proportionate amount of such loaned amounts or indebtedness as ordinary income for the Canadian shareholder. A deduction is permitted when the loan is repaid (other than as part of a series of loans and repayments).

The new rules do not apply if the loan or indebtedness is made by or owing to a non-resident corporation that is controlled by the Canadian shareholder, if the loan is made in the ordinary course of the lender’s money lending business (or indebtedness arose in the ordinary course of the creditor’s business), or if the loan or indebtedness is repaid within two years, other than where the repayment is part of a series of loans and repayments. Transitional relief is provided during a five year period for loans or indebtedness made before August 19, 2011 by deeming such loans or indebtedness to have been made on August 19, 2014, if they remain outstanding on that date, which is relevant for the income inclusion provision and the “repayment within two years” exception.

In addition, relief is generally available on a year-by-year basis for amounts which would have been fully exempt from Canadian tax if the loaned amount had been distributed as a dividend to the Canadian taxpayer. Thus, the lender’s exempt surplus, taxable surplus to the extent of the deduction available for associated underlying foreign tax, and previously taxed FAPI (amounts which could have been received tax-free) reduce the income inclusion. Relief is also available for the new hybrid surplus account (repository of certain gains on shares and partnership interests described below) provided the hybrid underlying tax is sufficiently high to fully offset the Canadian tax that would be payable on hybrid surplus distributions (currently, this generally requires hybrid underlying tax to have been paid at a rate of at least 12.5%). The revised rules generally allow the adjusted cost base of directly-held foreign affiliates to also be taken into account for this purpose, unless the relevant loan is made from a foreign affiliate to a non-arm’s length non-resident (such as a foreign parent of the Canadian shareholder or a non-resident subsidiary of the foreign parent that is outside of the Canadian ownership chain). The revised rules also clarify that surplus accounts of foreign affiliates “upstream” or “downstream” in the same chain may be taken into account for this purpose. Relief is also provided for certain loans made in the ordinary course...
of carrying on a life insurance business outside Canada where interest on such loans would otherwise be included in the affiliate’s active business income.

Other revisions collapse certain back-to-back loans for purposes of these rules (preventing multiple income inclusions), and provide transitional relief in respect of certain foreign exchange gains on upstream loans made before August 19, 2011 that are repaid before August 19, 2016 (effectively setting off foreign exchange gains and losses realized by the Canadian taxpayer and the relevant foreign affiliate). The explanatory notes state explicitly that back-to-back loans (and certain similar financial arrangements) with arm’s length parties that have the effect of circumventing the rules would be considered a misuse of these new provisions and an abuse of the Act as a whole for the purposes of Canada’s general anti-avoidance rule.

**Hybrid Surplus:** The Proposals include a “hybrid surplus” regime, which tracks capital gains realized by a foreign affiliate from the disposition of shares of another foreign affiliate (or partnership interests), where such gains are not taxed in Canada on an accrual basis as FAPI. Under current rules, 50% of such a gain is added in computing each of exempt surplus and taxable surplus. The current rules allow a foreign affiliate to distribute the exempt surplus half of the gains free of Canadian tax while deferring Canadian tax on the taxable surplus half by leaving such amounts invested offshore (or by loaning such amounts back to Canada). The Proposals force the exempt and taxable portion of such gains to be distributed together. A Canadian shareholder is entitled to deduct half of the amount of any distribution out of hybrid surplus, plus a grossed-up amount in respect of foreign taxes applicable to the gains included in hybrid surplus. Very generally, if the foreign taxes on gains included in hybrid surplus are at least equal to the Canadian corporate capital gains tax rate (currently 12.5%) then the resulting hybrid surplus may be distributed free of additional Canadian corporate level taxes. The default rules provide that dividends are paid in the following order: exempt surplus, hybrid surplus, and taxable surplus, with any remaining amounts being deemed to be paid out of pre-acquisition surplus. Subject to certain conditions, taxpayers may elect to change the default ordering, by, for example, having dividends paid out of taxable surplus or pre-acquisition surplus before hybrid surplus. Some differences arise in the timing and manner in which hybrid surplus is computed relative to that of exempt and taxable surplus (such as hybrid surplus arising at the time of a particular sale rather than at the end of a taxation year).

The hybrid surplus rules apply after August 19, 2011 for sales within a corporate group (to a “designated person or partnership”), and otherwise will not apply until after 2012.

**Foreign Affiliate Mergers and Liquidations:** The Proposals amend the rules applicable to the merger of foreign affiliates, as well as the liquidation and dissolution of one foreign affiliate into another or into a Canadian-resident shareholder.

**Foreign affiliate mergers**

Where two foreign affiliates combine in a qualifying “foreign merger,” the current rules generally allow tax-deferred rollover treatment with respect to (a) shares of the predecessor affiliates held by a foreign affiliate shareholder (with a proposed rule generally deeming there to be no disposition of shares of a predecessor affiliate held by another predecessor that are cancelled on the merger), and (b) capital property of a predecessor affiliate where (i) the Canadian taxpayer has an interest (surplus entitlement percentage) of at least 90% in respect of each predecessor affiliate and the resulting merged affiliate, and (ii) no gains or losses are recognized for relevant foreign tax purposes with respect to capital property of the merging affiliates.
The Proposals revise the asset rollover rule to drop the surplus entitlement and non-recognition conditions. The rule will now apply where there is a foreign merger of two or more “predecessor foreign corporations” (PFCs) to form a “new foreign corporation” (NFC), where the NFC is a foreign affiliate of a Canadian-resident taxpayer and one or more PFCs was also a foreign affiliate. Where applicable, the new rule provides for a full rollover of all property of a foreign affiliate PFC (rather than just capital property). The NFC is deemed to be a continuation of and the same corporation as the PFCs for various purposes relating to loss suspension and FAPI computation rules.

The Proposals also add a rule to clarify that a U.S.-style “absorptive” merger (where one merging corporation ceases to exist and the other remains the “survivor”) qualifies as a foreign merger for purposes of the definition “foreign merger,” and consequently the various foreign affiliate merger rules.

The changes to the merger rules generally apply to mergers occurring after August 19, 2011, subject to the ability to elect to have them apply (with certain modifications) to mergers occurring after December 20, 2002. The new absorptive merger rule applies to mergers or combinations that occur after 1994, subject to the ability to elect to have it apply after August 19, 2011.

Liquidations and dissolutions involving a Canadian shareholder

Current rules provide a tax-deferred rollover where shares of a foreign affiliate held by a controlled foreign affiliate of a Canadian shareholder are distributed to a Canadian shareholder on the liquidation and dissolution of the controlled foreign affiliate. The distributed shares are deemed to be disposed of and acquired for proceeds equal to their adjusted cost base, unless the taxpayer elects to receive greater proceeds.

The Proposals remain largely unchanged from the August 2011 draft legislation. They expand the current rules to apply to all property distributed to the Canadian shareholder upon a “qualifying liquidation and dissolution” (QLAD). For other liquidations the rollover rule will only apply to distributed property that is a share of another foreign affiliate that is “excluded property.”

A QLAD generally exists where a 90% ownership threshold is met and the taxpayer elects in accordance with the prescribed rules. The 90% ownership threshold is met where the taxpayer owns 90% or more of the shares of each class throughout the liquidation and dissolution, or where the taxpayer is entitled to receive 90% or more of the net fair market value of the property distributed to shareholders upon the liquidation and has 90% or more of the voting shares of the affiliate.

All property of the liquidating affiliate on a QLAD (or solely “excluded property” foreign affiliate shares on other liquidations) is deemed to be disposed of for proceeds of disposition equal to its relevant cost base (RCB) and to be acquired by the shareholder for the same amount. RCB is essentially the amount that gives rise to no gain or loss from the property, subject to the ability for the taxpayer to elect a higher amount if the affiliate is an “eligible controlled foreign affiliate” (being a controlled foreign affiliate in respect of which the taxpayer’s participating percentage is 90% or more). If a higher amount is elected, any gain realized on the property is treated as FAPI, regardless of whether the property is “excluded property.” All other property on a non-QLAD is disposed of (and acquired by the shareholder) for fair market value. FAPI will arise only if such other property is not excluded property.

The taxpayer’s proceeds of disposition of the shares disposed of on a liquidation and dissolution (QLAD and non-QLAD) is equal to the aggregate cost of the properties distributed, net of any amounts owing assumed or cancelled as a result of the distribution.
In the case of a QLAD, a “suppression election” is available to prevent any gains that may otherwise be realized by the shareholder on the disposition of the shares of the dissolved affiliate, after taking into account any deemed dividend election. The suppression election permits the taxpayer to reduce the proceeds of disposition of any capital property distributed by the dissolving affiliate (thereby reducing the shareholder’s proceeds from the disposition of the dissolving affiliate’s shares). The aggregate reduction cannot exceed the capital gain that would otherwise have been realized on the shares. By making a suppression election the taxpayer can defer the capital gain that would otherwise have been realized on the shares of the dissolving affiliate; such gain would continue to be reflected in the capital assets acquired from the affiliate in respect of which reduced proceeds were claimed. The suppression election is ignored for certain purposes, such as the FAPI computation rules (no FAPI loss may be created) and for surplus computation purposes.

An election is also available with respect to shares of a Canadian corporation that are taxable Canadian property to the dissolving affiliate: where there is a QLAD, and the shares are not treaty-protected property, the taxpayer and the affiliate may jointly elect for the shares to have been disposed of for proceeds equal to their adjusted cost base.

These rules apply for liquidations and dissolutions beginning after February 27, 2004. A taxpayer may also elect for the rules to apply in a similar manner to property received on a redemption, acquisition or cancellation of shares of a foreign affiliate, on a payment of a dividend by, or on a reduction of the paid-up capital of a foreign affiliate. This is consistent with the Department of Finance promise that taxpayers who had relied on the 2004 Proposals would not be negatively impacted by subsequent amendments.

**Liquidations and dissolutions involving a foreign affiliate shareholder**

Current rules apply to a liquidation and dissolution of one foreign affiliate into another. Where the Canadian shareholder has an interest (surplus entitlement percentage) in the two foreign affiliates of at least 90% and no gain or loss is recognized under the local law in respect of property distributed on the liquidation and dissolution (where the dissolving affiliate and the shareholder are resident in the same country), these rules generally provide a full rollover for all capital property, as well as proceeds equal to cost for the shares of the dissolved affiliate. Where these requirements are not satisfied, the current rules provide for the disposition of other foreign affiliate shares for proceeds equal to RCB.

The Proposals remain largely unchanged from the August 2011 draft legislation. Where a liquidation and dissolution is a “designated liquidation and dissolution” (DLAD), the Proposals deem all property to be disposed of at RCB; if it is a non-DLAD, only excluded property shares of other foreign affiliates are disposed of at RCB, and all other property is disposed of for fair market value proceeds. A DLAD is very similar to a QLAD, except no election is required. The 90% ownership threshold will be satisfied if the taxpayer has a 90% or greater surplus entitlement percentage or if a shareholder that is a foreign affiliate of the taxpayer holds 90% or more of the issued shares of each class of the dissolving affiliate. The 90% net fair market value of distributed property and voting power test, as described above, is also available.

A shareholder’s proceeds from the disposition of the shares of the dissolving affiliate under the Proposals are generally equal to their adjusted cost base on a DLAD (or the aggregate cost of the distributed property to the shareholder where the shares are excluded property and such aggregate cost is less than the adjusted cost base of such shares). If there is not a DLAD, the proceeds are equal to the aggregate cost of the distributed property. Where there is a DLAD, the shareholder is deemed to be a continuation of and the same corporation as the dissolved affiliate for various purposes relating to loss suspension and
FAPI computation rules.

The new liquidation and dissolution rules apply to liquidations and dissolutions beginning after August 19, 2011, subject to the ability to elect for it to apply (with certain modifications) to liquidations and dissolutions beginning after December 20, 2002.

Distributions/Returns of Capital: A distribution from a foreign affiliate may be characterized as a dividend or as a return of capital (which often depends on the character of the distribution for foreign legal purposes). The Proposals generally treat all pro rata distributions on shares of a foreign affiliate as a dividend (unless it arises on the liquidation or dissolution of the affiliate or represents proceeds of disposition from the redemption, acquisition or cancellation of a share).

New rules, which were not in prior draft legislation, allow shareholders (including individuals, partnerships or corporations) to elect to receive certain pro rata distributions as a return of capital. Distributions as a return of capital are generally not included in the recipient’s income, and instead reduce the tax cost of the shares of the distributing corporation. Alternatively, the Proposals allow corporate shareholders to elect to receive distributions out of pre-acquisition surplus (which generally results in a similar basis recovery treatment rather than taxable dividend income). Prior draft legislation would have restricted the pre-acquisition surplus election to distributions to Canadian corporate shareholders. These changes are particularly helpful for distributions from corporations governed by a foreign corporate law which does not provide for returns of capital (which includes the law of many U.S. states). The Canada Revenue Agency generally treated distributions from such corporations as dividends and not returns of capital. Since pre-acquisition surplus dividends are fully deductible by a Canadian corporation from taxable income and reduce the corporate shareholder’s basis of a foreign affiliate’s share, the Proposals permit a shareholder to recover its basis in a foreign affiliate’s share in a manner similar to a return of paid-up capital under the current rules (or a qualifying return of capital under the Proposals). As the pre-acquisition surplus election is not limited to the basis of the foreign affiliate’s shares and may potentially result in a capital gain if such basis becomes negative, the Proposals contain an anti-avoidance rule forcing dividend treatment in respect of any gain that may be recognized as a result of the election where the relevant affiliate group has net surplus available for distribution.

These changes apply after August 19, 2011, unless an election is made for them to apply after December 20, 2002 (without the new qualifying return of capital election).

Foreign Exchange: The Proposals amend the manner in which foreign exchange gains and losses are calculated, and prevent foreign exchange gains and losses from arising in respect of a corporation’s own share capital. In addition, instead of all currency-related gains and losses for a taxation year being pooled and netted together, the Proposals will treat each foreign currency gain or loss in respect of a foreign currency debt as a separate capital gain or loss from the disposition of property. The latter measure is part of a group of related amendments in the Proposals that are intended to facilitate the carving out of certain income or capital gains and losses, other than active business income, that accrued before a foreign corporation became a foreign affiliate of the relevant taxpayer (or certain other persons). The Proposals remain largely unchanged from the August 2011 draft legislation. These changes apply in respect of taxation years of the foreign affiliate that end after August 19, 2011, subject to an election for these changes to apply in respect of taxation years of the affiliate ending after June 2011.

Prevention of Surplus: The Proposals contain a number of rules aimed at preventing foreign affiliates from inflating or duplicating exempt surplus. These Proposals remain largely unchanged from the August 2011 draft legislation. First, the Proposals contain a rule to recharacterize exempt earnings as taxable
earnings where the transaction giving rise to the earnings is an “avoidance transaction” as defined for the purposes of Canada’s general anti-avoidance rule. The Proposals also require that the maximum amount of any discretionary deductions (such as tax depreciation deductions) notionally be claimed in computing active business earnings where the Canadian rules are relevant (preventing taxpayers from inflating earnings by not claiming discretionary deductions like depreciation in computing Canadian surplus accounts). Under another rule, when a foreign affiliate disposes of any shares of another foreign affiliate (i.e., not only shares of another foreign affiliate that are excluded property), the Proposals require the disposing foreign affiliate to treat some or all of the gain as a deemed dividend, to the extent of underlying surplus of the foreign affiliate whose shares were disposed of. This rule ensures that new surplus will not be created by the disposing foreign affiliate to the extent that there is underlying surplus in the disposed-of foreign affiliate (although this rule may also be helpful in cases where the disposed-of shares are not excluded property). Changes to these rules generally apply after August 19, 2011, subject to an election to have the latter rule apply to dispositions occurring after February 27, 2004. Finally, for dispositions occurring after August 19, 2011, the Proposals amend the rules that prevent surplus from arising on certain intra-group transfers of capital property where rollover treatment is provided under foreign tax law.

**FAPI Losses:** The determination of FAPI currently takes into account passive income (or losses) and other amounts earned on income account, as well as the taxable portion of certain capital gains (and allowable capital losses). An allowable capital loss may therefore be applied to reduce a FAPI income inclusion, and a FAPI loss carryforward can include allowable capital losses that may be used to offset future FAPI income amounts. In an effort to make the FAPI rules more consistent with the rules applicable to Canadian corporations, the Proposals extend the ability to carryover FAPI losses to other tax years, to bring the FAPI loss rules in line with the domestic non-capital loss carryover rules. Also, similar to the domestic rules, the Proposals will “stream” capital losses included in FAPI to capital gains included in FAPI, preventing such capital losses from being used to shelter other FAPI amounts. These Proposals remain largely unchanged from the August 2011 draft legislation.

Although under the domestic rules capital losses may be carried back three years or forward indefinitely, under the Proposals, FAPI capital losses (similar to other FAPI losses), may be carried back three years or forward 20 years. These changes generally apply to taxation years of foreign affiliates ending after August 19, 2011.

**Other Loss Rules:** Various loss suspension rules in the Act apply to certain transfers of property (such as depreciable property, eligible capital property, and certain kinds of capital property) within an affiliated group. Very generally, these rules are intended to prevent taxpayers from recognizing losses on internal transactions that could be used to shelter other income. The Proposals prevent these loss-suspension rules from applying to dispositions by a foreign affiliate of “excluded property”, thereby ensuring that such losses are taken into account in computing surplus accounts. These changes generally apply after August 19, 2011.

The Proposals also restrict the application of share-for-share exchange rules that allow a tax-deferred rollover where a Canadian resident or a foreign affiliate exchanges shares of a foreign affiliate for consideration that includes shares of another foreign affiliate. Under the Proposals, such an exchange of foreign affiliate shares with an accrued loss will no longer occur on a rollover basis and may result in a suspended loss to a Canadian transferor, or a reduction to hybrid surplus of a foreign affiliate transferor.

In addition, the Proposals significantly modify the loss denial rules that may apply where a Canadian
resident disposes of shares of a foreign affiliate, or where a foreign affiliate disposes of shares of another foreign affiliate that are not “excluded property”, in respect of which “exempt dividends” have previously been paid. The Proposals generally allow recognition of the portion of such a loss that relates to foreign currency fluctuations, but only to the extent of a corresponding foreign currency gain arising from either
(a) settlement of arm’s length foreign currency debt incurred in connection with the acquisition of the transferred shares, or
(b) certain currency hedging transactions entered into in connection with the acquisition of the transferred shares. In other words, where there is concurrent realization of a loss on a disposition of foreign affiliate shares and a related gain on the acquisition debt or acquisition hedging arrangements, the resulting loss on the foreign affiliate shares will generally not be denied. These changes generally apply after February 27, 2004, unless an election is made for them to apply after 1994 with certain transitional rules.

Consolidated Groups: Very generally, a taxpayer is permitted a deduction in computing income in respect of any “foreign accrual tax” (FAT) that is attributable to an amount of FAPI that is included in computing the taxpayer’s income. In the context of consolidated group taxation rules within a particular foreign jurisdiction, where a particular foreign affiliate makes a compensatory payment in respect of the use of a loss of another corporation within the group, the payment is deemed to be FAT. This applies to the extent that the compensatory payment can reasonably be regarded as being in respect of an income or profits tax that would otherwise be payable in respect of a FAPI amount for a taxation year of the taxpayer, had the particular affiliate’s income been determined without regard to the use of such loss. FAT may also arise where the compensatory payment relates to a tax payment by another corporation on behalf of the group. Compensatory payments made in respect of a loss of another corporation are limited by the Proposals to payments that can reasonably be considered to be in respect of a loss that is a FAPL of a controlled foreign affiliate of a person or partnership that is, at the end of the taxation year, a relevant person or partnership in respect of the taxpayer. Thus a payment for the use of an active business loss may not generate FAT. An amount denied under this new rule can in qualifying circumstances be reinstated as FAT applicable to the FAPI amount in the taxation year of the particular affiliate in which the loss that caused the denial, and all other losses of any consolidated group members in that same taxation year, could otherwise have been applied to reduce active business income of the group, provided that such year ends within five taxation years of the taxation year of the taxpayer in which the FAPI is realized. Other rules apply to limit the ability to create FAT related to FAPI capital losses that would not otherwise be deductible under the new FAPI capital loss streaming rules. These changes generally apply to foreign affiliate taxation years that end after August 19, 2011.

Foreign tax credit generator rules: The Proposals include the rules relating to “artificial foreign tax credit generator” schemes. As applicable to foreign affiliates, these rules may deny FAT (relating to FAPI) or underlying foreign tax (relating to taxable surplus) where an equity investment in a particular foreign affiliate has a hybrid nature, such that a “relevant” foreign tax law views there to be a lower equity investment than the investment that exists under Canadian tax law. The Proposals limit the “relevant” foreign tax law to the income tax law applicable to the particular foreign affiliate, to another foreign affiliate that owns equity in the particular affiliate, or to another foreign affiliate in which the particular affiliate owns equity. Thus, generally speaking, the Proposals should limit the impact of the foreign tax credit generator rules to the particular foreign affiliate “chain” in which the hybrid investment exists. The purpose of these rules, and the circumstances in which they may apply, are discussed in greater detail in a further Osler Update.

“Fill-the-hole” rules: Where a foreign affiliate with an exempt deficit (i.e., negative exempt surplus) 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 Proposals include “fill-the-hole” rules that prevent such blocking deficits in upper-tier affiliates from being avoided through certain transfers of a direct or indirect interest in another foreign affiliate with positive exempt surplus. Other rules apply to make corresponding adjustments to the surplus accounts of, and the tax cost of the shares of, lower-tier affiliates. Where applicable, the fill-the-hole rules apply to acquisitions of foreign affiliate shares occurring after December 18, 2009 to:

- reduce the exempt deficit of the deficit affiliate;
- reduce the exempt surplus of the acquired affiliate; and
- 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).

**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 acquirer. Where an acquisition of control of a Canadian corporation that owns shares of a foreign affiliate occurs, the Proposals reduce such affiliate’s exempt surplus to the extent that the aggregate “good” tax attributes in respect of the shares (“tax-free surplus balance” and tax cost of the shares) of the affiliate exceed the fair market value of the shares at the time of the acquisition of control. This rule applies whether or not any bump is claimed on the shares.

The Proposals also reduce the amount by which foreign affiliate shares could otherwise be increased in a “bump” transaction. If the tax cost of the shares plus the Canadian corporation’s share of the affiliate’s tax-free surplus balance (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.

**Surplus account computation rules:** The Proposals revise the rules that may recharacterize a gain arising on sale of shares of a foreign affiliate as a deemed dividend from that affiliate to either another foreign affiliate or its Canadian corporate shareholder. The Proposals also 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:** The Proposals clarify the appropriate operation of the relevant provisions where foreign affiliates are held through a partnership. While these changes better align the rules applicable to foreign affiliates held by partnerships with the general rules applicable to foreign affiliates held by corporations, various differences remain.

**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 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 changes in the Proposals. In addition, the Proposals propose amendments to the Regulations required by certain previously-enacted amendments to the Act.

**Safe Income:** New rules to compute the “safe income” of a foreign affiliate, which is relevant in applying
the domestic rules for tax-free spinoff transactions. Under the Proposals, safe income of a foreign affiliate will generally be equal to the lesser of the amount that the affiliate could distribute as a dividend free of Canadian taxes (its “tax-free surplus balance”), and the fair market value of the shares of the foreign affiliate. Some transitional relief is provided for arm’s length transactions which were agreed to in writing prior to August 19, 2011.

**Fresh Start Rules:** Significant amendments have been made to the “fresh start” rules that apply where a foreign affiliate carries on business that earns active business income in one year and FAPI in the next. Very generally, these rules apply a deemed disposition of the affiliate’s assets at the end of its active business year – subject to the potential application of the new anti-avoidance rule discussed above for tax-motivated creations of exempt surplus. These changes apply to foreign affiliate taxation years that begin after December 20, 2002, unless an election is made for them to apply to foreign affiliate taxation years that begin after 1994, with certain transition rules.

**Other Measures:** The Proposals contain various other technical tax changes that will impact on a variety of investments in foreign affiliates. These other changes include:

- The introduction of a common “permanent establishment” definition for all of the foreign affiliate provisions in the Act and the Regulations.
- A proposal to eliminate the prohibition against using the Canadian dollar as the calculating currency for surplus account balances. This proposal is beneficial, for example, 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 2002) to treat certain foreign oil and gas levies as income or profits tax for the purpose of the surplus account Regulations.
- Various amendments have been made to the rules that apply where a foreign affiliate immigrates to Canada. These changes apply to taxation years that begin after 2006.
- Other rules apply for computing policy reserves in a foreign affiliate’s insurance business, computing surplus entitlement percentages and FAPI participating percentages for corporate groups that include circular shareholdings.

Navigating Canada’s foreign affiliate rules is often difficult. The myriad of recent changes makes it more difficult. Many of the Proposals apply to the current taxation year of foreign affiliates, or retroactively (either automatically or on an elective basis); it is therefore important to review current and past transactions in order to determine the impact of the Proposals and the advisability of making any of the elections provided for. Osler’s international tax practitioners deal with the foreign affiliate rules every day, and are among the nation’s foremost experts. If you have any questions about how these rules may affect you, please contact any member of our [National Tax Department](mailto:national-tax-department@osler.com).

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1 Although not part of the Proposals, other amendments contained in Bill C-45 (which received First Reading in Parliament on October 18, 2012) apply to “foreign affiliate dumping.” Where applicable, those rules could deem a Canadian resident corporation to pay a dividend to a controlling non-resident shareholder (or reduce the paid-up capital of the Canadian corporation’s shares) where the Canadian corporation makes certain direct or indirect investments in a foreign affiliate.

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