# Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations

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## Preface

These explanatory notes are provided to assist in an understanding of legislative proposals relating to income tax.  These explanatory notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

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These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

## Legislative Proposals Relating to Income Tax

## Income Tax Act

### Clause 1

### Application of paragraph 95(2)(*a.1*) – eligible Canadian bank

ITA
95(2.31)

New subsection 95(2.31) of the *Income Tax Act* (the Act) provides an exception from paragraph 95(2)(*a.1*) for certain securities transactions between a Canadian-based bank and certain of its foreign affiliates that are carried out in the course of the bank's business of facilitating trades for arm's length customers. (As discussed below, new subsection 95(3.01) provides a similar exception from paragraph 95(2)(*b*) for services performed in connection with these types of securities transactions.) Subsection 95(2.31) provides that paragraph 95(2)(*a.1*) does not apply to a controlled foreign affiliate (for the purposes of section 17) of an eligible Canadian bank (as defined in subsection 95(2.43)) in respect of a purchase or sale of a property where certain conditions are satisfied.

The first condition, in the preamble to this provision, is that the property cannot be a share of a Canadian-resident corporation – or a debt obligation of the Government of Canada, the government of a province, a municipality in Canada or a corporation resident in Canada – that is owned by the affiliate for more than five days. Thus, any foreign affiliate that holds on to these types of securities for more than a reasonable period of time (i.e., five days) before effecting the trade will not be eligible for this exception.

The second condition, in paragraph 95(2.31)(*a*), is that the property must be the type of property that would, if it were owned by the Canadian parent bank, be a mark-to-market property (as defined in subsection 142.2(1)) of the bank, and the property must have a readily available fair market value. A property's value may be considered readily available, for example, where its value is regularly quoted on a public market, such as a stock exchange.

The third condition, in paragraph 95(2.31)(*b*), is that the purchase or sale must be made by the affiliate

- in the course of a business of trading or dealing in securities that is conducted principally with persons with whom the affiliate deals at arm's length, and
- for the purpose of enabling the acquisition or disposition of the property by an arm's length person who initiated the acquisition or disposition.

The fourth condition, in paragraph 95(2.31)(*c*), is that the business must be principally carried on in the country (other than Canada) under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued.

The fifth condition, in paragraph 95(2.31)(*d*), is that the affiliate must be a foreign bank or a trader or dealer in securities, and the activities of the business must be regulated

- under the laws of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued, and under the laws of each country in which the business is carried on through a permanent establishment in that country,
- under the laws of the country (other than Canada) in which the business is principally carried on, or
- if the affiliate is related to a corporation, under the laws of the country under whose laws that related corporation is governed and any of exists, was (unless that related corporation was continued in any jurisdiction) formed or organized, or was last continued, if those regulating laws are recognized under

the laws of the country in which the business is principally carried on and all those countries are members of the European Union.

The final condition, in paragraph 95(2.31)(*e*), is that the terms and conditions of the purchase or sale of the property must be the same as the terms and conditions that would have been made between persons who deal at arm's length with each other.

**Overview**

ITA
Subsections 95(2.43) to (2.46)

New subsections 95(2.43) to (2.46) of the Act – together with new section 125.21 of the Act and amendments to the definitions "earnings" and "exempt earnings" in subsection 5907(1) of the *Income Tax Regulations*, which are discussed elsewhere in these notes – are intended to alleviate the tax cost to Canadian-based banks of using excess liquidity of their foreign affiliates in their Canadian operations. Subsections 95(2.43) to (2.46) can be summarized as follows:

- Subsection 95(2.43) defines terms that are relevant for these new provisions.
- Subsection 95(2.44) provides a recharacterization rule that, in certain circumstances, allows certain foreign affiliates of a Canadian-based bank to use their excess liquidity to make loans to their Canadian parent bank, or to acquire certain Canadian government debt securities, without the income from such investments being treated as foreign accrual property income ("FAPI").
- Subsections 95(2.45) and (2.46), respectively, generally provide rules to ensure that the use of a foreign affiliate's excess liquidity in the Canadian operations of its Canadian parent bank do not cause the affiliate to have an "investment business" (as defined in subsection 95(1)) or prevent the affiliate's (or another affiliate's) shares from being considered excluded property for the purposes of clause 95(2)(*a*)(ii)(D).

**Definitions**

ITA
95(2.43)

New subsection 95(2.43) of the Act defines terms that are relevant for the purposes of the rules in new subsections 95(2.44) to (2.46), discussed below, which are applicable in respect of certain foreign affiliates of Canadian-based banks. The definition "eligible Canadian bank" is also relevant for new subsections 95(2.31) and (3.01), and the definitions "upstream deposit", "eligible Canadian bank" and "eligible bank affiliate" are also used in new section 125.21. For further information, please see the commentary on those provisions.

**"eligible bank affiliate"**

An eligible bank affiliate of an eligible Canadian bank (as defined in the same subsection) means a foreign bank (as defined in subsection 95(1)) that is a controlled foreign affiliate (for the purposes of section 17) of the eligible Canadian bank, and that is described in subparagraph (*a*)(i) of the definition "investment business" in subsection 95(1).

**"eligible Canadian bank**"

An eligible Canadian bank is defined as a bank listed in Schedule I to the Bank Act.

**"eligible Canadian indebtedness"**

Eligible Canadian indebtedness of an eligible bank affiliate means bonds, debentures, notes or similar obligations of the Government of Canada, the government of a province or a Canadian municipality that are

owing to the affiliate. Eligible Canadian indebtedness is one of the types of investments in respect of which subsection 95(2.44) provides relief from paragraph 95(2)(*a.3*).

**"excess liquidity**"

Excess liquidity of an eligible bank affiliate for a taxation year of the affiliate is defined as the amount by which the amount described in paragraph (*a*) of the definition exceeds the amount described in paragraph (*b*). The amount described in paragraph (*a*) is the average of all amounts each of which is the amount of the affiliate's relationship deposits for a calendar month ending in the affiliate's taxation year. The amount described in paragraph (*b*) is the average of all amounts each of which is the amount of the affiliate's organic assets for a calendar month ending in the year. For these purposes, the amounts described in both paragraphs (*a*) and (*b*) are to be expressed in the affiliate's calculating currency (as defined in subsection 95(1)). "Relationship deposits" and "organic assets" are defined in the same subsection and are discussed below.

**"ineligible Canadian indebtedness**"

Ineligible Canadian indebtedness of an eligible bank affiliate is defined as indebtedness owing to the affiliate by persons resident in Canada, or in respect of businesses carried on in Canada (i.e., all of the indebtedness to which paragraph 95(2)(*a.3*) can apply), other than "eligible Canadian indebtedness" and "upstream deposits" (both of which are defined in the same subsection).

**"organic assets"**

Organic assets of an eligible bank affiliate of an eligible Canadian bank for a month is defined as the total of all the amounts – in respect of the affiliate – reported as "loans" in the assets section of the consolidated monthly balance sheet filed for the month by the eligible Canadian bank or a related Canadian-resident corporation and accepted by the Superintendent of Financial Institutions, other than loans that are upstream deposits (as defined in the same subsection) of the affiliate.

**"relationship deposits"**

Relationship deposits of an eligible bank affiliate of an eligible Canadian bank for a month is defined as the total of all amounts – in respect of the affiliate – reported as "demand and notice deposits" and "fixed term deposits" in the liabilities section of the consolidated monthly balance sheet filed for the month by the eligible Canadian bank or a related Canadian-resident corporation and accepted by the Superintendent of Financial Institutions. However, any deposits that are of a temporary nature – or are made with the affiliate by a person who, at the end of the month, does not deal at arm's length with the affiliate or is resident in Canada – are not included in the affiliate's relationship deposits. Any deposit made with the affiliate that is not connected to a customer relationship of the affiliate, for example, will be considered to be a deposit of a temporary nature.

**"upstream deposit"**

An upstream deposit of an eligible bank affiliate of an eligible Canadian bank means indebtedness owing by the bank to the affiliate.

**Recharacterization rule — eligible bank affiliate**

ITA
95(2.44)

New subsection 95(2.44) of the Act provides a rule that, in certain circumstances, allows certain foreign affiliates of a Canadian-based bank to use their excess liquidity to make loans to their Canadian parent bank, or to acquire certain Canadian government debt securities, without the income from such investments being included in computing their foreign accrual property income ("FAPI"). In the absence of new subsection 95(2.44), such income would generally be treated as FAPI by virtue of the "base erosion" rule in paragraph 95(2)(*a.3*).

New subsection 95(2.44) applies if two conditions are met. First, the affiliate must be an eligible bank affiliate of an eligible Canadian bank (both as defined in subsection 95(2.43)) throughout the affiliate's relevant taxation year. Second, the affiliate and its parent eligible Canadian bank must file a joint election in respect of the affiliate for the taxation year on or before the bank's filing-due date for the taxation year of the bank in which the affiliate's relevant taxation year ends.

Where these two conditions are met, subsection 95(2.44) provides that the amount determined by the formula set out in that subsection is to be included in the affiliate's income from an active business for the year, and deducted in computing the amount determined for variable A in the definition "foreign accrual property income" in subsection 95(1) for the year. The formula for determining this amount is

$$A - B - C - D$$

Variable A is the affiliate's total income for the year from its upstream deposits and eligible Canadian indebtedness (both as defined in subsection 95(2.43)) that is (by virtue of the application of paragraph 95(2)(*a.3*)) income from a business other than an active business of the affiliate. This income remains included in computing the amount determined for variable A in the definition of FAPI in subsection 95(1), but subsection 95(2.44) provides for a separate deduction, in respect of this income, from the amount determined for variable A equal to the amount determined under subsection 95(2.44).

Variable B is the total of all amounts each of which is an amount by which an income amount included in variable A in respect of an upstream deposit exceeds the amount that would have been the affiliate's income for the year from that deposit if it were computed at an interest rate equal to the lesser of the actual rate of interest on the deposit and the benchmark rate of interest, for the day on which the deposit is made, that is acceptable to the Minister of National Revenue in respect of Canadian dollar denominated bankers' acceptances with a term to maturity of three months.

Thus, where the rate of interest charged on an upstream deposit is greater than the benchmark rate acceptable to the Minister, subsection 95(2.44) will not recharacterize the excess amount of interest income in respect of the upstream deposit as active business income. It is currently expected that the rate acceptable to the Minister for a particular day will be the generally accepted Canadian dealer offered rate (known in the financial industry as "CDOR") for that day, but the rate acceptable to the Minister is subject to change in the event another rate is determined by the Minister to be a more appropriate benchmark.

Variable C is the total income of the affiliate for the year from an upstream deposit or an eligible Canadian indebtedness that can reasonably be considered to either

- have been funded, directly or indirectly, in whole or in part, by property transferred or lent by the eligible Canadian bank (or a Canadian-resident person that was not dealing at arm's length with the bank), where the transfer or loan is part of a series of transactions that includes the making of the deposit or the acquisition of the indebtedness (paragraph (*a*)); or
- have funded, directly or indirectly, in whole or in part, a transfer or loan of property by the eligible Canadian bank (or another person that is resident in Canada and is not dealing at arm's length with the bank) to the affiliate or another foreign affiliate of the bank (or of the other person), where the transfer or loan is made as part of a series of transactions that includes the making of the deposit or the acquisition of the indebtedness (paragraph (*b*)).

Thus, variable C in effect contains anti-avoidance rules. First, it ensures that income from an upstream deposit or an eligible Canadian indebtedness does not qualify for recharacterization as active business income under subsection 95(2.44) if the deposit or the acquisition of indebtedness is funded by the parent bank or a person not dealing at arm's length with the parent bank, rather than from the affiliate's excess liquidity. Second, it ensures the same result where the proceeds of the deposit or the acquisition of indebtedness are used by the parent bank or another person not dealing at arm's length with the parent bank to make a transfer or loan to the affiliate (or

to another foreign affiliate of the bank or of the other person). These rules reflect the policy intent behind subsection 95(2.44), of allowing a foreign affiliate of a Canadian-based bank to use its excess liquidity to make loans to its Canadian parent bank, or to acquire certain Canadian government debt securities (including from its parent bank), without the related income being included in the affiliate's FAPI – where the proceeds of the loans, or from the sales of securities by the parent bank to the affiliate, are used by the parent bank in its Canadian operations.

Variable D is, in general terms, the portion of the income described in variable A (as reduced by the amounts described in variables B and C) that is derived from upstream deposits and eligible Canadian indebtedness of the affiliate that are, in the aggregate, in excess of its excess liquidity for the year. Thus, variable D is a "cap" to the recharacterization rule in subsection 95(2.44), which effectively allows a foreign affiliate of a Canadian-based bank to use only its excess liquidity to make loans to its Canadian parent bank, or to acquire certain Canadian government debt securities, without the income therefrom being included in the affiliate's FAPI.

The variable D amount is determined by the formula

$$E \times F/G$$

where

- variable E is the amount, if any, by which the amount determined for variable A exceeds the total of the amounts determined for variables B and C;
- variable F is the amount, if any, by which (i) the average of the amounts each of which is the greatest total amount of the affiliate's upstream deposits and eligible Canadian indebtedness at any time in a calendar month ending in the affiliate's tax year, exceeds (ii) the affiliate's excess liquidity for the year; and
- variable G is the amount determined under subparagraph (i) of the description of F.

**Investment business — eligible bank affiliate**

ITA
95(2.45)

New subsection 95(2.45) of the Act provides a deeming rule for the purposes of the definition "investment business" in subsection 95(1). In general terms, the significance of a business of a foreign affiliate of a taxpayer being an investment business is that the affiliate's income from that business will be treated as income from property, and thus will be included in computing its FAPI. A foreign affiliate's business will be an investment business, even if it otherwise satisfies the exception contained in paragraphs (*a*) to (*c*) of that definition, if the business is conducted principally with persons with whom the affiliate does not deal at arm's length.

The deeming rule in subsection 95(2.45) is generally intended to ensure that, where the conditions in that subsection are met, the making of upstream deposits by a foreign affiliate to, and the acquisition by the affiliate of both eligible Canadian indebtedness and ineligible Canadian indebtedness from, its Canadian parent bank do not cause the affiliate to be considered to conduct its business principally with non-arm's length persons and thus cause the affiliate to have an investment business. To achieve this result, subsection 95(2.45) deems an eligible Canadian bank and an eligible bank affiliate of the bank to deal with each other at arm's length in respect of the making of such deposits, and the acquisition of such indebtedness, by the affiliate in the course of a business carried on by the affiliate in a taxation year if the affiliate's excess liquidity for the year is equal to at least 90% of the average of all amounts each of which is the greatest total amount of the affiliate's upstream deposits, eligible Canadian indebtedness and ineligible Canadian indebtedness at any time in a calendar month ending in the affiliate's taxation year. This 90% threshold is intended to provide some flexibility, but the underlying principle is that subsection 95(2.45) applies where only excess liquidity is being used to make the relevant investments.

Ineligible Canadian indebtedness does not qualify for recharacterization under subsection 95(2.44) but is eligible for relief under subsections 95(2.45), as well as subsection 95(2.46), which is discussed below.

**Rule for clause 95(2)(*a*)(ii)(D) — eligible bank affiliate**

ITA
95(2.46)

New subsection 95(2.46) of the Act provides that, in determining whether shares of a foreign affiliate of an eligible Canadian bank are excluded property of another foreign affiliate of the bank – for the purposes of determining whether shares of a "third affiliate" referred to in subclause 95(2)(*a*)(ii)(D)(III) are excluded property of a "second affiliate" referred to in that subclause – upstream deposits, eligible Canadian indebtedness and ineligible Canadian indebtedness of an eligible bank affiliate are not to be taken into account (i.e., they are not to be considered property of the affiliate for the purposes of that determination), provided the 90% test in that provision is satisfied. This 90% test is the same as the one used in subsection 95(2.45), discussed above.

**Definitions**

ITA
95(2.5)

**"specified deposit"**

Subsection 95(2.5) of the Act sets out definitions that apply for the purposes of paragraph 95(2)(*a.3*).

The definition "specified deposit" in subsection 95(2.5) is relevant for the definitions "excluded income" and "excluded revenue" in subsection 95(2.5), which provide exceptions from the "base erosion" rule in paragraph 95(2)(*a.3*) for, among other things, income and revenue, respectively, derived from a specified deposit with a prescribed financial institution.

The definition "specified deposit" is amended in two ways. First, it is amended to clarify that it only applies in respect of bank deposits of foreign affiliates that are made with foreign branches of Canadian deposit-taking financial institutions. This better reflects the policy intent of treating deposits with those foreign branches in the same manner as deposits with foreign financial institutions. Second, the definition is amended by effectively eliminating its existing paragraph (*b*). As such, the specified deposit exception is not available in respect of a business whose principal purpose is to derive income from property or profits from the disposition of investment property.

**Application of paragraph 95(2)(*b*) — eligible Canadian bank**

ITA
95(3.01)

New subsection 95(3.01) of the Act provides an exception from the "base erosion" rule in paragraph 95(2)(*b*) for services performed in connection with certain securities transactions between a Canadian-based bank and certain of its foreign affiliates. As discussed above, subsection 95(2.31) provides a similar exception from the "base erosion" rule in paragraph 95(2)(*a.1*) for these types of securities transactions. The conditions that must be satisfied in order for subsection 95(3.01) to apply are similar to those in subsection 95(2.31), and readers are referred to the discussion above under that subsection for more information.

These amendments apply to taxation years of a foreign affiliate that begin after October 31, 2012.

**Clause 2**

**Part XIII tax — eligible bank affiliate**

ITA
125.21

New section 125.21 of the Act generally allows a Canadian parent bank a non-refundable credit, applicable against its tax payable under Part I of the Act, for certain amounts of non-resident withholding tax paid in respect of interest on an upstream deposit made by a foreign affiliate of the bank. More specifically, section 125.21 permits a corporation that is an eligible Canadian bank (as defined in subsection 95(2.43)) throughout a taxation year to deduct, in computing its tax payable for the year under Part I, the total of all amounts each of which is the amount by which an amount described in paragraph 125.21(*a*) exceeds an amount described in paragraph 125.21(*b*). An amount described in paragraph 125.21(*a*) is an amount of non-resident withholding tax paid under paragraph 212(1)(*b*) in respect of interest paid or credited in the year by the bank in respect of an upstream deposit (as defined in subsection 95(2.43)) of a corporation that is, throughout the year, an eligible bank affiliate (as defined in subsection 95(2.43)) of the bank.

An amount described in paragraph 125.21(*b*) is the total of all amounts each of which is a portion of the non-resident withholding tax amount described in paragraph 125.21(*a*) that is available to the eligible bank affiliate, or any other person or partnership at any time, as a credit, reduction or deduction against an amount otherwise payable to the government of a country other than Canada (or a political subdivision thereof), taking into consideration all of the provisions of that country's (or political subdivision's) laws, any tax treaty of that country with Canada and any other agreements entered into by that country (or political subdivision).

This amendment applies to taxation years that begin after October 31, 2012.

## Income Tax Regulations

**Clause 3**

**Definitions**

ITR
5907(1)

**"earnings"**

The definition "earnings" in subsection 5907(1) of the *Income Tax Regulations* (the Regulations) is relevant for the purposes of computing the surpluses and deficits of a foreign affiliate. Paragraph (*b*) of the definition "earnings" ensures that "earnings" will reflect the total of all amounts by which the affiliate's income for the year from an active business is increased because of the recharacterization rules in paragraph 95(2)(*a*) of the Act.

Paragraph (*b*) of the definition "earnings" is amended to ensure that earnings will also reflect all income amounts required by the new recharacterization rule in subsection 95(2.44) of the Act to be included in computing a foreign affiliate's income from an active business. For further information, please see the commentary on that subsection.

**"exempt earnings"**

The definition "exempt earnings" in subsection 5907(1) of the Regulations is relevant for the purposes of computing the exempt surplus and exempt deficit of a foreign affiliate. Paragraph (*d*) of the definition "exempt earnings" includes in a foreign affiliate's "exempt earnings" for a taxation year certain income of the affiliate for the year if the affiliate is resident in a designated treaty country. If the affiliate meets this residence

requirement (as well as the conditions in the relevant clause of subparagraph (*d*)(ii)), subparagraph (*d*)(ii) includes in computing the affiliate's "exempt earnings" income of the affiliate that would otherwise be its income from property but is recharacterized under paragraph 95(2)(*a*) of the Act to be income from an active business.

Consequential on the addition of the new recharacterization rule in new subsection 95(2.44) of the Act, subparagraph (*d*)(ii) of the definition "exempt earnings" is amended by adding a new clause (J) to ensure that "exempt earnings" will also include all income amounts required by new subsection 95(2.44) to be included in computing a foreign affiliate's income from an active business, provided that the income amount would, but for paragraph 95(2)(*a.3*), be income from an active business carried on by the affiliate in a designated treaty country. For further information, please see the commentary on subsection 95(2.44).

These amendments apply to taxation years of a foreign affiliate that begin after October 31, 2012.