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

Published by
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Minister of Finance

February 2014

Department of Finance Canada
Ministère des Finances Canada

Preface

These explanatory notes are provided to assist in an understanding of legislative proposals relating to the *Income Tax Act* and *Income Tax Regulations*. 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 in Respect of Base Erosion Rules – Canadian Banks

Income Tax Act

Clause 1

Upstream loan from eligible bank affiliate

ITA
90(8)

Subsection 90(8) of the *Income Tax Act* (the Act) provides some important exceptions to subsection 90(6), the main operative rule in the upstream loan rules in subsections 90(6) to (15). Subsection 90(8) is amended by adding new paragraph 90(8)(*d*), which contains a new exception to subsection 90(6) for an "upstream deposit" owing to an "eligible bank affiliate". By virtue of amended subsection 90(15), these terms have the same meaning as in subsection 95(2.43).

The exception in paragraph 90(8)(*d*) is subject to subsection 90(8.1), which – based on the amount of upstream deposits owing to an eligible bank affiliate – deems the affiliate to have made an upstream loan in certain circumstances. For further information, please see the commentary on subsection 90(8.1).

Upstream deposit – eligible bank affiliate

ITA
90(8.1)

For the purposes of section 90 of the Act (including, in particular, the upstream loan rules in subsection 90(6) to 90(15)), new subsection 90(8.1) provides rules that deem an eligible bank affiliate of an eligible Canadian bank to make an upstream loan to the bank when the affiliate's upstream deposits with the bank exceed the difference between the affiliate's excess liquidity and all eligible Canadian indebtedness owing to the affiliate. In combination, subsections 90(8) and (8.1) will result in subsection 90(6) not applying to loans made by an eligible bank affiliate to an eligible Canadian bank if 90% of the amount of all upstream deposits owing to the affiliate by the bank does not exceed the available excess liquidity of the affiliate for the year. This is consistent with the policy of the excess liquidity proposals in new subsections 95(2.43) to (2.45).

Specifically, paragraph 90(8.1)(*a*) provides that if an eligible bank affiliate of an eligible Canadian bank is owed an upstream deposit at any time in a particular taxation year or in the immediately preceding taxation year, the affiliate is deemed to make a loan to the bank immediately before the end of the particular year equal to the amount determined by the formula

$$A - B - C$$

For these purposes,

- A is 90% of the average of all amounts each of which is, in respect of a calendar month that ends in the particular year, the greatest total amount at any time in the month of upstream deposits owing to the affiliate. The use of 90% of upstream deposits in effect provides a buffer that allows upstream deposits owing to the affiliate to exceed its excess liquidity (less eligible Canadian indebtedness owing to the affiliate) in recognition of the fact that the affiliate's excess liquidity might fluctuate for reasons beyond the control of either the bank or the affiliate.
- B is the lesser of
    - the amount, if any, by which the affiliate's excess liquidity for the particular year exceeds the average of all amounts each of which is, in respect of a calendar month that ends in the particular year, the greatest total amount at any time in the month of eligible Canadian

indebtedness owing to the affiliate (in other words, available excess liquidity after deducting the amount used by the affiliate to acquire eligible Canadian indebtedness), and

- the amount determined for variable A, and

- C is the amount, if any, by which the amount determined for variable A for the immediately preceding year exceeds the amount determined for variable B for the immediately preceding year.

The subtraction of the eligible Canadian indebtedness owing to the affiliate from its excess liquidity (*i.e.*, in computing variable B) reflects the policy of facilitating the affiliate's use of its excess liquidity to fund the making of upstream deposits and acquisition of eligible Canadian indebtedness. For this purpose, the affiliate's excess liquidity is essentially applied first to eligible Canadian indebtedness owing to the affiliate, and it is only the remaining amount of excess liquidity, if any, that may be applied to reduce the amount otherwise considered as an upstream loan made by the eligible bank affiliate to the bank in respect of its upstream deposits.

The amount determined by A – B is the affiliate's excess loan amount, and is generally deemed to be an upstream loan made by the affiliate to the bank.

The subtraction of variable C in the formula ensures that subsection 90(8.1) deems an affiliate to make an upstream loan in a particular year only to the extent of the incremental year-over-year increase in the excess loan amount. In other words, where in a particular year the difference between the amount of upstream deposits owing to the eligible bank affiliate (as determined in variable A) and the available excess liquidity of the affiliate (as determined in variable B) increases compared to the prior year, for purposes of the upstream loan rules, the amount of this incremental increase is deemed to be the amount of a new upstream loan made by the affiliate immediately before the end of the particular year.

Paragraph 90(8.1)(*a*) also provides that all the amounts referred to in the formula are to be determined in Canadian currency.

Paragraph 90(8.1)(*b*) deems, in certain circumstances, a taxpayer to repay an upstream loan that paragraph 90(8.1)(*a*) had deemed an affiliate to have made to the taxpayer in a prior taxation year. Paragraph 90(8.1)(*b*) applies if the formula in paragraph 90(8.1)(*a*) would (in the absence of section 257) result in a negative amount for the particular year. This would generally apply where, year-over-year, the excess loan amount decreases. Where applicable, paragraph 90(8.1)(*b*)

- deems the taxpayer to repay, immediately before the end of the particular year — in an amount equal to the absolute value of the negative amount calculated using the formula in paragraph 90(8.1)(*a*) for the particular year — loans the affiliate was deemed by paragraph 90(8.1)(*a*) to have made in a prior year and not previously deemed by paragraph 90(8.1)(*b*) to have been repaid. These loans are deemed to have been repaid "in the order in which they arose", *i.e.*, on a "first-in, first-out", or FIFO, basis; and

- deems the repayment to not be part of a series of loans or other transactions and repayments. This ensures that the repayment can qualify for the exception under paragraph 90(8)(*a*) or the deduction under subsection 90(14), as the case may be.

These amendments apply to taxation years of a foreign affiliate that begin after Announcement Date.

Definitions

ITA
90(15)

Subsection 90(15) of the Act defines the terms "specified amount" and "specified debtor", which are used in subsections 90(6) and (9) and, in the case of "specified amount", also in subsections 90(10), (13) and (14).

Subsection 90(15) is amended to add definitions of the following terms: “eligible bank affiliate”; “eligible Canadian bank”; “eligible Canadian indebtedness”; “excess liquidity”; and “upstream deposit”. Each of these terms has the same meaning as in new subsection 95(2.43). These terms are relevant for new subsection 90(8.1).

These amendments apply to taxation years of a foreign affiliate that begin after Announcement Date.

Clause 2

Income from sale of property or from Canadian debt and lease obligations

ITA
95(2)(*a.1*) and (*a.3*)

Paragraph 95(2)(*a.1*) of the Act includes in the income from a business other than an active business (and thus the foreign accrual property income (FAPI)) of a foreign affiliate of a taxpayer resident in Canada, the affiliate’s income from the sale of property (including income derived from services as agent provided in relation to a purchase or sale of property) if certain conditions are met.

Paragraph (2)(*a.1*) is amended in two respects. First, new clause 95(2)(*a.1*)(ii)(C) is introduced so that paragraph 95(2)(*a.1*) does not apply in respect of the sale of an indebtedness, or a lease obligation, of a person resident in Canada or in respect of a business carried on in Canada, that was purchased and sold by the affiliate on its own account. Income earned in respect of the purchase and sale of such property is already addressed in paragraph 95(2)(*a.3*). Therefore, this amendment clarifies that paragraph 95(2)(*a.3*) is the relevant provision to the extent that there is overlap between paragraphs 95(2)(*a.1*) and (*a.3*). Where other provisions of the Act (*e.g.*, subsection 95(2.4)) apply to prevent paragraph 95(2)(*a.3*) from applying in respect of a particular sale of property, this change ensures that paragraph 95(2)(*a.1*) also will not apply in respect of that property. However, this amendment applies only in respect of a sale of property by the affiliate on its own account. Where, for example, the affiliate earns income for acting as agent in respect of the sale of the property, paragraph 95(2)(*a.1*) may still apply.

Second, the portion of paragraph 95(2)(*a.1*) after subparagraph (ii) and before subparagraph (iii) is amended. This portion of the paragraph provides that paragraph 95(2)(*a.1*) does not apply where more than 90% of the affiliate’s gross income from the sale of property is derived from the sale of such property (other than property that specifically meets exclusions from 95(2)(*a.1*)) to arm’s length persons. This rule is amended to clarify that for this purpose, property the income from the sale of which is not included in computing the income from a business other than an active business of the affiliate under paragraph 95(2)(*a.1*) because of new subsection 95(2.31) is similarly excluded.

Paragraph 95(2)(*a.3*) includes in the income from a business other than an active business (and thus the FAPI) of a foreign affiliate of a taxpayer resident in Canada, income of the affiliate derived directly or indirectly from indebtedness and lease obligations (including income of the affiliate for the year from the purchase and sale of indebtedness and lease obligations on its own account, but not including excluded income) of persons resident in Canada or in respect of businesses carried on in Canada.

The portion of paragraph 95(2)(*a.3*) after subparagraph (ii) and before subparagraph (iii) is amended. This portion of the paragraph provides that paragraph 95(2)(*a.3*) does not apply where more than 90% of the affiliate’s gross revenue derived directly or indirectly from indebtedness and lease obligations (other than revenue that specifically meets exclusions to 95(2)(*a.3*)) was derived directly or indirectly from indebtedness and lease obligations of non-resident persons with whom the affiliate deals at arm’s length. Like paragraph 95(2)(*a.*1), this provision is amended to clarify that revenue that is not included in computing the income from a business other than an active business of the affiliate under paragraph 95(2)(*a.3*) because of new subsection 95(2.31) is similarly excluded.

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

Application of paragraphs 95(2)(*a.1*) and (*a.3*)

ITA
95(2.31)

New subsection 95(2.31) of the Act provides an exception from the application of paragraphs 95(2)(*a.1*) and (*a.3*) 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 paragraphs 95(2)(*a.1*) and (*a.3*) do 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 activities carried out to earn income from a property where certain conditions are satisfied.

The first condition, in the preamble to this provision, is that the property cannot be a specified property. "Specified property" is defined in subsection 95(2.32) and generally refers to certain types of property that have a Canadian source or nexus and that are owned by the affiliate for more than ten days. For further information, please see the commentary on subsection 95(2.32). Thus, a foreign affiliate that holds these types of securities for more than a reasonable period of time (*i.e.*, ten days) before effecting the trade will not be eligible for this exception.

The second condition, in paragraph 95(2.31)(*a*), is that the affiliate must sell the property, or perform services as an agent in relation to a purchase or sale of the property, and it must be reasonable to conclude that the cost to any person of the property is relevant in computing the income from

- a business carried on by the bank or a person resident in Canada that does not deal at arm's length with the bank, or
- a business carried on in Canada by a non-resident person that does not deal at arm's length with the bank.

The third condition, in paragraph 95(2.31)(*b*), is that the property must have a readily available fair market value and must be a property that either

- is listed on a recognized stock exchange, or
- would be a mark-to-market property (as defined in subsection 142.2(1)) of the bank if it were owned by the bank.

A property's value can be considered readily available where, for example, a bid-ask price is regularly quoted, and the property is actively traded, on a public market, such as a stock exchange, contemporaneously with the transaction in question. However, if there are no publicly available price quotations in respect of a particular security, and the security was not, or was only nominally, traded in the days leading up to the transaction, a valuation report, whether prepared internally or through external sources, would not be sufficient to consider the property to have a readily available fair market value for the purposes of this subsection.

The fourth condition, in paragraph 95(2.31)(*c*), is that the purchase or sale, or services performed by the affiliate as agent in respect of the purchase or sale, must be made by the affiliate

- on terms and conditions that are substantially the same as the terms and conditions of similar purchases or sales of, or services performed in respect of the purchase or sale of, such property by persons dealing at arm's length,
- in the course of a business that regularly includes the trading or dealing in securities principally with persons with whom the affiliate deals at arm's length and that is principally carried on through a permanent establishment outside of Canada, and

- for the purpose of enabling the purchase or sale of the property by an arm's length person.

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.

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

Specified property

ITA
95(2.32)

New subsection 95(2.32) of the Act defines "specified property" of a foreign affiliate for the purposes of subsection 95(2.31) as a property that is owned by the affiliate for more than ten days and that is any of the following:

- a share of a Canadian-resident corporation;
- a property traded on a stock exchange located in Canada and not traded on a stock exchange located in the jurisdiction in which the affiliate is resident;
- a debt obligation
    - of a corporation resident in Canada,
    - of a trust or partnership, units of which are traded on a stock exchange located in Canada, or
    - of, or guaranteed by, the Government of Canada, the government of a province, an agent of a province, a municipality in Canada or a municipal or public body performing a function of government in Canada.

If a property is a specified property of an affiliate, the affiliate's income from the sale of that property, or from services performed by the affiliate in relation to the purchase or sale of that property, does not qualify for the exception from paragraphs 95(2)(*a.1*) and (*a.3*) in subsection 95(2.31). This definition effectively requires an affiliate to dispose of a Canadian source property within ten days of acquiring it in order to qualify for the exception in subsection 95(2.31). This limit is intended to allow sufficient time for ordinary course trades in the relevant Canadian securities.

This amendment applies to taxation years of a foreign affiliate that begin after October 31, 2012.

Application of paragraph 95(2)(*a.3*)

ITA
95(2.4)

In general terms, paragraph 95(2)(*a.3*) includes in the income from a business other than an active business (and thus the foreign accrual property income (FAPI)) of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate derived directly or indirectly from indebtedness and lease obligations (which includes income of the affiliate for the year from the purchase and sale of indebtedness and lease obligations on its own account, but not excluded income) of persons resident in Canada or in respect of businesses carried on in Canada.

Subsection 95(2.4) provides that paragraph 95(2)(*a.3*) does not apply in respect of income derived by a foreign affiliate of a taxpayer directly or indirectly from indebtedness to the extent that both paragraphs 95(2.4)(*a*) and (*b*) apply. Paragraph 95(2.4)(*b*) requires that the income be derived by the affiliate from trading or dealing in indebtedness (which consists of income from the actual trading or dealing in the indebtedness and interest earned by the affiliate during a short-term holding period on indebtedness acquired by it for the purpose of trading or dealing) with customers with whom the affiliate deals at arm's length. In addition, the customers must be resident in a country other than Canada in which the affiliate and any competitor (which is resident in the country in which the affiliate is resident and regulated in the same manner the affiliate is regulated in the country under whose laws the affiliate was formed or continued and exists and is governed and in which its business is principally carried on) compete and have a substantial market presence.

The French version of subsection 95(2.4) is amended by restructuring its preamble and paragraph 95(2.4)(*a*) so that they are grammatically correct in light of the amendments to paragraph 95(2.4)(*b*).

Paragraph 95(2.4)(*b*) is amended in three respects. First, the customers are no longer required to be resident in the relevant foreign country, but rather can either be resident, or carry on business through a permanent establishment, in the relevant country. Second, the arm's length competitor is no longer required to be resident in the relevant country, but rather can either be resident, or carry on business through a permanent establishment, in the country.

Third, the regulation requirement is made less stringent. The competitor's business activities can now be regulated (in the same manner as the activities of the affiliate's business) under the laws of the relevant country or, where the country is a member of the European Union, any country that is a member of the European Union. Thus, the European Union is to effectively be treated as one country in a manner consistent with the treatment of members of the European Union in paragraph 95(2.4)(*a*).

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

Overview

ITA
95(2.43) to (2.45)

New subsections 95(2.43) to (2.45) of the Act – together with new section 125.21 and amendments to the definitions "earnings" and "exempt earnings" in subsection 5907(1) of the *Income Tax Regulations* – 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 (2.45) can be summarized as follows:

- Subsection 95(2.43) defines terms that are relevant for these new provisions.
- Subsection 95(2.44) provides a rule that, in certain circumstances, allows certain foreign affiliates of a Canadian-based bank (namely, "eligible bank affiliates" of "eligible Canadian banks", as defined in subsection 95(2.43)) 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). As well, subsections 90(8) and (8.1) are related additions made to the upstream loan rules to ensure that, to the extent that an eligible bank affiliate lends amounts to its parent eligible Canadian bank that do not exceed the affiliate's available excess liquidity, such loans generally will not give rise to the application of subsection 90(6), the main operative provision in the upstream loan rules.

- Subsection 95(2.45) generally provides rules to ensure that the use of a foreign affiliate's excess liquidity in the Canadian operations of its Canadian parent bank does 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 excluded property.

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) and (2.45), 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). The definitions "upstream deposit", "eligible Canadian bank" and "eligible bank affiliate" are also used in new section 125.21. The definitions "excess liquidity", "upstream deposit", "eligible Canadian bank", "eligible Canadian indebtedness" and "eligible bank affiliate" are also relevant for the purposes of new subsection 90(8.1). For further information, please see the commentary on those provisions.

"Canadian indebtedness"

Canadian indebtedness, owing to an eligible bank affiliate of an eligible Canadian bank, means indebtedness (other than upstream deposits) owing to the affiliate by persons resident in Canada or in respect of businesses carried on in Canada.

The term is relevant for the purposes of new paragraphs 95(2.45)(*a*) and (*b*). 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 this 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, owing to an eligible bank affiliate, means bonds, debentures, notes or similar obligations, owing to the affiliate, of: the Government of Canada; the government of, or an agent of, a province; a Canadian municipality; or a municipal or public body performing a function of government in Canada. However, it does not include debt securities held by the affiliate in respect of which paragraph 95(2)(*a.3*) does not apply because of the exception in subsection 95(2.31).

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*).

“eligible currency hedge”

An eligible currency hedge, of an eligible bank affiliate of an eligible Canadian bank, means an agreement that provides for the purchase, sale or exchange of currency and that

- can reasonably be considered to have been made by the affiliate to reduce its risk of fluctuations in the value of currency with respect to eligible Canadian indebtedness and upstream deposits owing to the affiliate; and
- cannot reasonably be considered to have been made by the affiliate to reduce its risk with respect to property other than eligible Canadian indebtedness and upstream deposits owing to the affiliate.

In order for a currency hedging agreement entered into by an affiliate to be an eligible currency hedge, it must hedge currency risk solely from eligible Canadian indebtedness and upstream deposits owing to the affiliate, and not, either in whole or in part, any other currency risk.

“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 12-month period that begins 60 days prior to the start of the affiliate’s taxation year (or, if the affiliate was formed after the beginning of the 12-month period, in respect of a month that ends in the year).

For example, for an affiliate with an October 31 taxation year-end, the relevant 12-month period is from September to the following August – unless the affiliate was formed after September 1, in which case the 12-month period runs from November to October. This two-month lag between the affiliate’s taxation year and its 12-month measurement period allows the affiliate to better project its excess liquidity for the year when using that excess liquidity to make upstream deposits or acquire eligible Canadian indebtedness.

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 same 12-month period.

For these purposes, the amounts described in both paragraphs (*a*) and (*b*) are to be expressed in the affiliate’s calculating currency for the year (as defined in subsection 95(1)) unless the context requires otherwise. “Relationship deposits” and “organic assets” 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 – each of which is

- included in the amounts 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, or
- an amount that is owing to the affiliate by a person that is related to the affiliate but that is not included in the “loans” in the assets section of the consolidated monthly balance sheet.

However, the affiliate’s organic assets do not include eligible Canadian indebtedness or upstream deposits owing to the affiliate.

“qualifying indebtedness”

A foreign affiliate’s income from an upstream deposit or eligible Canadian indebtedness may qualify for treatment as active business income under subsection 95(2.44) only if the upstream deposit or indebtedness is

qualifying indebtedness. Qualifying indebtedness owing to an eligible bank affiliate of an eligible Canadian bank, means an upstream deposit or eligible Canadian indebtedness owing to the affiliate to the extent the deposit, or the affiliate's acquisition of the indebtedness, as the case may be, satisfies two conditions. The first condition, in paragraph (*a*) of the definition, is that it must be reasonable to consider that the deposit or acquisition is funded by

- property transferred or lent by a person other than the bank or a person resident in Canada that was not, at the time of the transfer or loan, dealing at arm's length with the bank;
- a repayment by the bank of all or part of an upstream deposit; or
- the purchase of eligible Canadian indebtedness, from the affiliate, by the bank or a person resident in Canada that was not, at the time of the transfer or loan, dealing at arm's length with the bank.

The second condition, in paragraph (*b*) of the definition, is that the proceeds of the upstream deposit or the proceeds received by the vendor that sold the eligible Canadian indebtedness to the affiliate, as the case may be, must be used for a purpose other than to fund a transfer or loan of property by the bank – or another person resident in Canada that was not, at the time of the transfer or loan, dealing at arm's length with the bank – to the affiliate or another foreign affiliate of the bank or of the other person.

The definition "qualifying indebtedness" ensures that subsection 95(2.44) does not apply to the extent that 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. It also ensures the same result to the extent that 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). This definition reflects the policy intent 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 if 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.

Example 1 - Paragraph (a) of the definition "qualifying indebtedness"

Assumptions

- *An eligible bank affiliate of an eligible Canadian bank makes a loan of $1,000 to the bank (i.e., an upstream deposit) in a manner that satisfies the conditions in paragraph (b) of the definition "qualifying indebtedness".*
- *A week before the affiliate made the upstream deposit, the bank had provided funds to the affiliate (other than as a result of the acquisition of an eligible Canadian indebtedness or as a repayment of an upstream deposit) of $2,000 via a transaction in the affiliate's ordinary course of business. The funds were transferred into the affiliate's general operating account. In the week before the upstream deposit was made, the affiliate also received funds from numerous customers with which the affiliate dealt at arm's length in the amount of $5,000, which were also transferred into the affiliate's general operating account.*
- *The affiliate made the upstream loan out of its general operating account. This account is the one out of which the affiliate makes disbursements in the ordinary course of its business.*

Analysis

Paragraph (a) of the definition "qualifying indebtedness" will be satisfied to the extent that it can reasonably be considered that the upstream deposit is funded by property transferred or lent by a person other than the bank or a person resident in Canada that was not dealing at arm's length with the bank.

In this example, there is no clear tracing of the use of funds received by the eligible bank affiliate, and it may be reasonable to conclude that the $1,000 upstream deposit was funded by some of the $2,000 provided a week before by the bank. However, absent other factors connecting the $2,000 transfer by the bank to the making of the upstream deposit, it is also reasonable to consider that the affiliate fully funded the upstream deposit with part of the $5,000 received from the affiliate's arm's length customers. Therefore, the conditions in paragraph (a) of the definition "qualifying indebtedness" would be satisfied. The fact that an upstream deposit cannot clearly be traced to funds from a source other than the bank or a person resident in Canada with which the bank does not deal at arm's length does not preclude satisfying this test.

Example 2 – Paragraph (b) of the definition "qualifying indebtedness"

Assumptions

- *An eligible bank affiliate of an eligible Canadian bank makes a loan of $1,000 to the bank (i.e., an upstream deposit) in a manner that satisfies the conditions in paragraph (a) of the definition "qualifying indebtedness".*
- *The bank uses $600 of these funds in its Canadian banking business and lends the remaining $400 to a wholly-owned foreign affiliate.*

Analysis

Paragraph (b) of the definition "qualifying indebtedness" will be satisfied to the extent that it can reasonably be considered that the proceeds of the upstream deposit are used for a purpose other than to fund a transfer or loan of property by the bank to the affiliate or another foreign affiliate of the bank. In this example, it would be reasonable to consider that paragraph (b) is satisfied to the extent of the $600 amount – $400 of the $1,000 would not satisfy this condition. The use of the phrase "to the extent that" does not require that the whole amount of the upstream deposit satisfy the condition. Therefore, $600 of the $1,000 amount of the upstream deposit would be considered a "qualifying indebtedness".

"relationship deposits"

Relationship deposits of an eligible bank affiliate of an eligible Canadian bank for a month are 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.

"total specified indebtedness"

Total specified indebtedness, owing to an eligible bank affiliate of an eligible Canadian bank for a year, means the average of all amounts each of which is, in respect of a month that ends in the year, the greatest total amount at any time in the month that is the total of all amounts each of which is

- the amount of an upstream deposit owing to the affiliate;
- the amount of an eligible Canadian indebtedness owing to the affiliate; or
- the positive or negative fair market value of an eligible currency hedge of the affiliate.

The negative fair market value of an eligible currency hedge refers to a currency hedge that is in a loss position. The positive or negative fair market value of an eligible currency hedge of the affiliate would generally be

expected to offset a corresponding foreign exchange loss or gain on the hedged upstream deposit or eligible Canadian indebtedness.

Total specified indebtedness is relevant in computing the proportion of the affiliate's income from upstream deposits and eligible Canadian indebtedness that is treated as active business income under subsection 95(2.44); this amount is generally reduced to the extent that the affiliate's total specified indebtedness exceeds its excess liquidity for the year. This definition is similarly relevant in determining whether an affiliate qualifies for the exception in subsection 95(2.45) from the definition "investment business" in subsection 95(1). For further information, please see the commentary on subsections 95(2.44) and (2.45).

"upstream deposit"

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

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

FAPI adjustment – 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 eligible Canadian bank must file an 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, paragraph 95(2.44)(*a*) provides that there is to be deducted in computing the amount determined for variable A in the definition "foreign accrual property income" in subsection 95(1) for the year, the lesser of the amount determined (without reference to paragraph 95(2.44)(*a*)) for variable A in that definition in respect of the affiliate for the year, and the amount determined by the formula

A – B – C – D

Variable A is the total of all amounts each of which

- is the affiliate's income for the year from a qualifying indebtedness or from an eligible currency hedge (as each of those terms is defined in subsection 95(2.43)); and
- would, in the absence of subsection 95(2.44), be included in computing the affiliate's income from a business other than an active business (by virtue of the application of paragraph 95(2)(*a.3*)).

The relief under this subsection is limited to income from qualifying indebtedness in order to ensure that only upstream deposits and eligible Canadian indebtedness the funding for which satisfies the requirements of the definition "qualifying indebtedness" in subsection 95(2.43) obtain such relief. For further information, please see the commentary on that definition.

Variable B is the total of all amounts each of which is the affiliate's loss for the year from a property that

- is a qualifying indebtedness owing to, or eligible currency hedge of, the affiliate; and

- would, in the absence of subsection 95(2.44), be deducted in computing the income of the affiliate from a business other than an active business.

Variable C is the total of all amounts each of which is the amount, if any, by which an amount included in computing variable A in respect of an upstream deposit exceeds – or an amount included in computing variable B is less than – the amount that would be the affiliate's income or loss, as the case may be, for the year from the deposit if the interest received or receivable by the affiliate in respect of the deposit were computed at an interest rate equal to the applicable benchmark interest rate. The applicable rate depends on the currency in which a particular upstream deposit is denominated as well as the affiliate's particular circumstances:

- If the deposit is denominated in a qualifying currency (as defined in subsection 261(1)) that is also the affiliate's calculating currency, then the applicable benchmark is the average, for the affiliate's taxation year, of a daily inter-bank offered rate – acceptable to the Minister of National Revenue – for loans denominated in that currency with a term to maturity of three months. It is currently expected that the inter-bank offered rate acceptable to the Minister for these purposes will be the London Inter-bank Offered Rate (LIBOR) for a three-month deposit denominated in the relevant currency. Thus, the applicable benchmark rate is the average of the daily quotations of this LIBOR for the year.
- In any other case, the applicable benchmark interest rate is the average, for the year, of a daily rate – acceptable to the Minister of National Revenue – for Canadian dollar denominated bankers' acceptances with a term to maturity of three months. It is currently expected that the three-month rate acceptable to the Minister for Canadian dollar denominated bankers' acceptances will be the generally accepted Canadian dealer offered rate (CDOR).

The benchmark interest rates acceptable to the Minister are subject to change in the event another rate is determined by the Minister to be a more appropriate benchmark.

In effect, variable C provides that, 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 treat the excess amount of interest income in respect of the upstream deposit as active business income.

Variable D is, in general terms, the portion of the income described in variable A (as reduced by the amounts determined for variables B and C) that is derived from upstream deposits and eligible Canadian indebtedness of the affiliate that are, in aggregate (and taking into consideration the value of any related hedging agreements), in excess of its excess liquidity for the year. Thus, variable D is a "cap", 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 the total specified indebtedness owing to the affiliate for the year exceeds the affiliate's excess liquidity for the year; and
- variable G is the total specified indebtedness owing to the affiliate for the year.

For further information on the terms "excess liquidity" and "total specified indebtedness", please see the commentary on those definitions under subsection 95(2.43).

Paragraph 95(2.44)(*b*) provides that there is to be included in the affiliate's income from an active business for the year an amount equal to the proportion of the amount computed under the formula in subparagraph 95(2.44)(*a*)(ii) (computed as if each amount referred to in that formula were determined using the affiliate's calculating currency) that the amount that is required to be deducted under paragraph 95(2.44)(*a*) for the year is of the amount described in subparagraph 95(2.44)(*a*)(ii).

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

Example

Assumptions

- *In respect of a taxation year, an eligible bank affiliate earned income of C$8,000 that is recharacterized under paragraph 95(2)(a.3) as income from a business other than an active business. This income is comprised of:*
    - *C$10,000 of income from qualifying indebtedness (less expenses reasonably allocable thereto), and*
    - *a C$2,000 loss from indebtedness that was not qualifying indebtedness*.
- *The amounts determined for variables B, C and D in the formula in subparagraph 95(2.44)(a)(ii) are each nil, and for all relevant purposes, the relevant exchange rate for the affiliate's foreign calculating currency (FC) is FC$ 0.90:C$1.00.*
- *The affiliate had no other income that was included in the determination of FAPI for the year.*

Analysis

Under paragraph 95(2.44)(a), there is to be deducted, in computing the amount determined for A in the definition of FAPI, the lesser of (i) the amount determined for variable A in the FAPI definition read without reference to subsection 95(2.44), and (ii) the amount determined by the formula in subparagraph 95(2.44)(a)(ii). The amount determined by the formula is the income from qualifying indebtedness, being C$10,000. The amount otherwise included in variable A of the FAPI definition would be the affiliate's C$8,000 income from the business, other than an active business. As such, paragraph 95(2.44)(a) determines the amount deductible in determining variable A of the definition of FAPI to be C$8,000. (A deduction made by virtue of paragraph 95(2.44)(a) cannot make variable A of the definition of FAPI become negative.)

Pursuant to paragraph 95(2.44)(b), there is to be included, in determining the amount that is the affiliate's income from an active business, an amount equal to the proportion of the amount determined by the formula in subparagraph 95(2.44)(a)(ii)(i.e., FC$9,000, determined in the affiliate's calculating currency) that the amount determined to be deducted under paragraph 95(2.44)(a) (i.e., C$8,000) is of the amount determined under subparagraph 95(2.44)(a)(ii) (i.e., C$10,000). As such, the amount to be added to the income from an active business of the affiliate is FC$7,200 (i.e., FC$9,000 x C$8,000/C$10,000).

Investment business and excluded property

ITA
95(2.45)

New subsection 95(2.45) of the Act provides two deeming rules that apply when an election is made under subsection 95(2.44) by an eligible Canadian bank in respect of an eligible bank affiliate of the bank for a taxation year of the affiliate. First, paragraph 95(2.45)(*a*) 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 paragraph 95(2.45)(*a*) generally ensures that, where the applicable conditions are met, the making of upstream deposits by a foreign affiliate to, and the acquisition by the affiliate of Canadian indebtedness from, its Canadian parent bank, or a person resident in Canada that does not deal at arm's length with the bank, do not cause the affiliate to be considered to conduct its business principally with non-arm's length persons and thus to have an investment business. To achieve this result, paragraph 95(2.45)(*a*) 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 loans or 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 affiliate's total specified indebtedness for the year (as defined in subsection 95(2.43)). The underlying principle is that paragraph 95(2.45)(*a*) applies where excess liquidity is being used to make the relevant investments. The 90% threshold is intended to provide some flexibility in recognition of the fact that the affiliate's excess liquidity might fluctuate for reasons beyond the control of either the bank or the affiliate.

Paragraph 95(2.45)(*b*) contains a separate rule that deems the following for the purposes of paragraph (*b*) of the definition "excluded property" in subsection 95(1):

- The fair market value of each upstream deposit and Canadian indebtedness owing to, and eligible currency hedge of, the affiliate (all as defined in subsection 95(2.43) is deemed to be nil. As a result of this rule, the excluded or non-excluded property status of particular deposits, debts and hedges is not taken into account for the purpose of determining whether shares of the affiliate are excluded property of another foreign affiliate of the bank. As a consequence, the additional deeming rules in subparagraphs 95(2.45)(*b*)(ii) and (iii) will operate to determine the relevance of these properties for the purpose of determining whether shares of the affiliate are excluded property.
- The lesser of the following two amounts is deemed to be the fair market value of a property of the affiliate that is excluded property at a given time:
    - the amount that is the total fair market value, at that time, of the upstream deposits and Canadian indebtedness owing to, and eligible currency hedges of, the affiliate; and
    - the amount, if any, by which
        - the amount by which the affiliate's relationship deposits for the calendar month that is two months prior to the particular time (or if the affiliate was formed less than two months prior to the particular time, for the calendar month that includes the particular time)

          exceeds
        - the amount of the affiliate's organic assets for the calendar month that is two months prior to the particular time (or if the affiliate was formed less than two months prior to the particular time, for the calendar month that includes the particular time).
- The amount, if any, by which the amount in clause 95(2.45)(*b*)(ii)(A) (*i.e.*, the total of the upstream deposits and Canadian indebtedness owing to, and eligible currency hedges of, the affiliate) exceeds the amount deemed by subparagraph 95(2.45)(*b*)(ii) to be the fair market value of a property of the affiliate that is excluded property, is deemed to be the fair market value of a property of the eligible bank affiliate that is not excluded property.

Very generally, for the purposes of paragraph (*b*) of the definition "excluded property" in subsection 95(1), subparagraph 95(2.45)(*b*)(ii) deems an excluded property to exist with a fair market value equal to the aggregate value of the upstream deposits and Canadian indebtedness owing to, and eligible currency hedges of, the affiliate to the extent this does not exceed the affiliate's excess liquidity. This is consistent with the policy of generally permitting eligible Canadian banks to access the excess liquidity of their eligible bank affiliates without adverse tax consequences. Where the aggregate value of the upstream deposits and Canadian indebtedness owing to, and eligible currency hedges of, the affiliate exceeds its excess liquidity, however, subparagraph 95(2.45)(*b*)(iii) deems such excess to be the fair market value of a separate non-excluded property of the eligible bank affiliate.

Paragraph 95(2.45)(*b*) is relevant only for purposes of paragraph (*b*) of the definition of "excluded property" (in subsection 95(1)). As such, this deeming rule is relevant, for example, 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. This provision is not relevant in determining whether a particular property is an excluded property in the hands of the eligible bank affiliate itself, nor is it determinative of the tax treatment of dispositions of such property by the eligible bank affiliate.

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

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 applies only 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 eliminating 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.

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

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" rules in paragraphs 95(2)(*a.1*) and (*a.3*) 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). For further information, please see the commentary on subsection 95(2.31).

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

Clause 3

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)) owing to 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 in respect of taxation years that begin after October 31, 2012.

Income Tax Regulations

Clause 4

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 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.

New subsection 95(2.44) of the Act treats income that would otherwise be foreign accrual property income as income from an active business, in certain circumstances. As a consequence, 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.