

---

# Revised Draft Amendments to the Income Tax Act

---

## Foreign Affiliates

---

Issued by  
The Honourable Paul Martin, P.C., M.P.  
Minister of Finance

January 1995

RESERVE COPY

COPIE DE LA  
RESERVE

Canada

---

# Revised Draft Amendments to the Income Tax Act

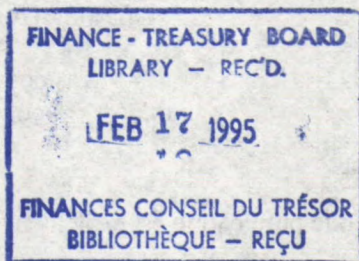
---

## Foreign Affiliates

---

Issued by  
The Honourable Paul Martin, P.C., M.P.  
Minister of Finance

January 1995



Department of Finance  
Canada

Ministère des Finances  
Canada

For additional copies of this document  
please contact:

Distribution Centre  
Department of Finance  
300 Laurier Avenue West  
Ottawa K1A 0G5

Tel: (613) 995-2855  
Fax: (613) 996-0518

Cette publication est également disponible en français.



# Table of Contents

Clause in Draft Amend- ments	Section of the Income Tax Act or Regulations	Topic	Page
--	--	-------	------

## Foreign Affiliates

### Revised Draft Amendments - Income Tax Act

1	20(3)	Borrowed Money . . . . .	1
2	95(1)	Foreign Affiliate - Definition . . . . .	1
	95(1)	Foreign Accrual Property Income - Definition . . . . .	2
	95(1)	Definitions . . . . .	2
	95(2)	Determination of Foreign Accrual Property Income . . . . .	6
	95(6)	Where Rights or Shares are Acquired or Disposed of to Avoid Tax . . . . .	20
3	248(1)	Business . . . . .	20

### Explanatory Notes

1	20(3)	Borrowed Money . . . . .	25
2	95(1)	Foreign Affiliate - Definition . . . . .	25
	95(1)	Foreign Accrual Property Income - Definition . . .	27
	95(1)	Definitions . . . . .	28
	95(2)	Determination of Foreign Accrual Property Income . . . . .	37
	95(6)	Where Rights or Shares are Acquired or Disposed of to Avoid Tax . . . . .	65
3	248(1)	Business . . . . .	68

Clause in the Draft Amend- ments	Section of the Income Tax Act or Regulations	Topic	Page
--	--	-------	------

### Revised Draft Amendments - Income Tax Regulations

1	1402	Insurance Reserves . . . . .	71
2	5903(1), (1.1) & (2)	Deductible Loss . . . . .	71
3	5907(1) (b)(iv)	Exempt Earnings . . . . .	73
	5907(1) (c)(iii)	Exempt Loss . . . . .	77
	5907(1) (f)(iii)	Net Earnings . . . . .	77
	5907(1) (g)(iii)	Net Loss . . . . .	77
	5907(1) (i)(ii)(D)	Taxable Earnings . . . . .	78
	5907(1) (j)(ii)(C)	Taxable Loss . . . . .	78
	5907(1.01), (2.1), (2.7) & (2.8)	Rules for Computing Active Business Earnings . .	78
	5907(11)	Treaty Countries . . . . .	80
4	7900	Prescribed Financial Institutions . . . . .	81

### Explanatory Notes

1	1402	Insurance Reserves . . . . .	85
2	5903(1), (1.1) & (2)	Deductible Loss . . . . .	85

Clause in the Draft Amend- ments	Section of the Income Tax Act or Regulations	Topic	Page
3	5907(1)		
	(b)(iv)	Exempt Earnings .....	86
	5907(1)		
	(c)(iii)	Exempt Loss .....	91
	5907(1)		
	(f)(iii)	Net Earnings .....	91
	5907(1)		
	(g)(iii)	Net Loss .....	92
	5907(1)		
	(i)(ii)(D)	Taxable Earnings .....	92
	5907(1)		
	(j)(ii)(C)	Taxable Loss .....	93
	5907(1.01), (2.1), (2.7) & (2.8)	Rules for Computing Active Business Earnings ..	93
	5907(11)	Treaty Countries .....	95
4	7900	Prescribed Financial Institutions .....	98

---

Revised Draft Amendments  
to the *Income Tax Act*

---

## Borrowed Money

**1.(1) The portion of subsection 20(3) of the Income Tax Act after paragraph (b) is replaced by the following:**

subject to subsection 20.1(6), the borrowed money shall, for the purposes of paragraphs (1)(c),(e) and (e.1), subsections 20.1(1) and (2), section 21 and subparagraph 95(2)(a)(ii) and for the purpose of paragraph 20(1)(k) of the *Income Tax Act*, Chapter 148 of the Revised Statutes of Canada, 1952, be deemed to have been used for the purpose for which the money previously borrowed was used or was deemed by this subsection to have been used, or to acquire the property in respect of which the amount was payable, as the case may be.

**(2) Subsection (1) applies to expenses incurred in taxation years that begin after 1994 except that where there has been a change in the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, subsection (1) applies to taxation years of the foreign affiliate of the taxpayer that end after 1994.**

## Foreign Affiliate - Definition

**2.(1) The definition "foreign affiliate" in subsection 95(1) of the Act is replaced by the following:**

**"foreign affiliate"**

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

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

(b) the total of the equity percentages in the corporation of the taxpayer and of each person related to the taxpayer (where each such equity percentage is determined as if the determinations under paragraph (b) of the definition "equity percentage" in subsection (4) were made without reference to the equity percentage of any person in the taxpayer or in any person related to the taxpayer) is not less than 10%,

except that a corporation is not a foreign affiliate of a non-resident-owned investment corporation;



## Foreign Accrual Property Income - Definition

**(2) The portion of the description of A in the definition "foreign accrual property income" in subsection 95(1) of the Act before paragraph (a) is replaced by the following:**

A is the total of the affiliate's incomes for the year from property and businesses other than active businesses determined as if each amount described in clause (2)(a)(ii)(D) that was paid or payable, directly or indirectly, by the affiliate to another foreign affiliate of either the taxpayer or a person with whom the taxpayer does not deal at arm's length were nil where an amount in respect of the income derived by the other foreign affiliate from that amount that was paid or payable to it by the affiliate was added in computing its income from an active business, other than.

**(3) The description of D in the definition "foreign accrual property income" in subsection 95(1) of the Act is replaced by the following:**

D is the total of the affiliate's losses for the year from property and businesses other than active businesses determined as if there were not included in the affiliate's income any amount described in any of paragraphs (a) to (d) of the description of A and as if each amount described in clause (2)(a)(ii)(D) that was paid or payable, directly or indirectly, by the affiliate to another foreign affiliate of either the taxpayer or a person with whom the taxpayer does not deal at arm's length were nil where an amount in respect of the income derived by the other foreign affiliate from that amount that was paid or payable to it by the affiliate was added in computing its income from an active business,

## Definitions

**(4) Subsection 95(1) of the Act is amended by adding the following definitions in alphabetical order:**

"active business"

"active business" of a foreign affiliate of a taxpayer means any business carried on by the affiliate other than

(a) an investment business carried on by the affiliate, or

(b) a business that is deemed by subsection (2) to be a business other than an active business carried on by the affiliate;

**"foreign bank"**

"foreign bank" means an entity that would be a foreign bank within the meaning assigned by the definition of that expression in section 2 of the Bank Act if

5

(a) that definition were read without reference to the portion thereof after paragraph (g) thereof, and

(b) no entity had been exempt under section 12 of that Act from being a foreign bank;

10

**"income from an active business"**

"income from an active business" of a foreign affiliate of a taxpayer for a taxation year includes, for greater certainty, any income of the affiliate for the year that pertains to or is incident to that business but does not include

15

(a) other income that is its income from property for the year, or

(b) its income for the year from a business that is deemed by subsection (2) to be a business other than an active business carried on by the affiliate;

**"income from property"**

20

"income from property" of a foreign affiliate of a taxpayer for a taxation year includes its income for the year from an investment business and its income for the year from an adventure or concern in the nature of trade, but, for greater certainty, does not include its income for the year that is because of subsection (2) included in its income from an active business or in its income from a business other than an active business;

25

**"investment business"**

"investment business" of a foreign affiliate of a taxpayer means a business carried on by the affiliate in a taxation year (other than a business deemed by subsection (2) to be a business other than an active business carried on by the affiliate) the principal purpose of which is to derive income from property (including interest, dividends, rents, royalties or any similar returns or substitutes therefor), income from the insurance or reinsurance of risks, income from the factoring of accounts receivable, or profits from the

30

35

disposition of investment property, unless it is established by the taxpayer or the affiliate that, throughout the period in the year during which the business was carried on by the affiliate,

(a) the business (other than any business conducted principally with persons with whom the affiliate does not deal at arm's length) is 5

(i) a business carried on by it as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the country in which the business is principally carried on, or

(ii) the development of real estate for sale, the lending of money, the leasing or licensing of property or the insurance or reinsurance of risks, and 10

(b) the affiliate or, where the affiliate carries on the business as a member of a partnership (except where the affiliate is a specified member of the partnership in a fiscal period of the partnership ending in the year), the partnership employs 15

(i) more than 5 employees full time in the active conduct of the business, or

(ii) the equivalent of more than 5 employees full time in the active conduct of the business taking into consideration only the services provided by its employees and the services provided outside Canada to the affiliate or the partnership by the employees of 20

(A) a corporation related to the affiliate (otherwise than because of a right referred to in paragraph 251(5)(b)), or

(B) members of the partnership (other than a member of the partnership that was a specified member of the partnership in a fiscal period of the partnership ending in the year) 25

where the corporation or members referred to in clause (A) or (B) receive compensation from the affiliate or the partnership for the services provided to the affiliate or the partnership by those employees the value of which is not less than the cost to such corporation or members of the compensation paid or accruing to the benefit of those employees that performed the services during the time the services were performed by those employees; 30

**"investment property"**

"investment property" of a foreign affiliate of a taxpayer includes

- (a) a share of a corporation other than a share of another foreign affiliate of the taxpayer that is excluded property of the affiliate,
- (b) an interest in a partnership other than an interest in a partnership that is excluded property of the affiliate, 5
- (c) an interest in a trust other than an interest in a trust that is excluded property of the affiliate,
- (d) indebtedness or annuities,
- (e) commodities or commodities futures purchased or sold, directly or indirectly in any manner whatever, on a commodities or commodities futures exchange (except commodities manufactured, produced, grown, extracted or processed by the affiliate or a person to whom the affiliate is related (otherwise than because of a right referred to in paragraph 251(5)(b)) or commodities futures in respect of such commodities), 10 15
- (f) currency,
- (g) real estate,
- (h) Canadian and foreign resource properties,
- (i) interests in funds or entities other than corporations, partnerships and trusts, and 20
- (j) interests or options in respect of property that is included in paragraphs (a) to (i) of this definition;

**"lease obligation"**

"lease obligation" of a person includes an obligation under an agreement which authorizes the use of or the production or reproduction of property including information or any other thing; 25

**"lending of money"**

"lending of money" by a person (for the purpose of this definition referred to as the "lender") includes 30

(a) the acquisition by the lender of trade accounts receivable (other than trade accounts receivable owing by a person with whom the lender does not deal at arm's length) from another person or the acquisition by the lender of any interest in any such accounts receivable,

5

(b) the acquisition by the lender of loans made by and lending assets (other than loans or lending assets owing by a person with whom the lender does not deal at arm's length) of another person or the acquisition by the lender of any interest in such a loan or lending asset,

10

(c) the acquisition by the lender of a foreign resource property (other than a foreign resource property that is a rental or royalty payable by a person with whom the lender does not deal at arm's length) of another person, and

(d) the sale by the lender of loans or lending assets (other than loans or lending assets owing by a person with whom the lender does not deal at arm's length) or the sale by the lender of any interest in such loans or lending assets;

15

#### **"licensing of property"**

"licensing of property" includes authorizing the use of or the production or reproduction of property including information or any other thing;

20

### **Determination of Foreign Accrual Property Income**

#### **(5) Paragraph 95(2)(a) of the Act is replaced by the following:**

(a) in computing the income from an active business for a taxation year of a particular foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year there shall be included any income of the affiliate for that year from sources in a country other than Canada that would otherwise be income from property of the affiliate for the year to the extent that

25

(i) the income

30

(A) is derived by the particular affiliate from activities that can reasonably be considered to be directly related to the active business activities carried on in a country other than Canada by

(I) any other non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year, or

(II) the taxpayer, where the taxpayer is a life insurance corporation resident in Canada throughout the year, and

5

(B) would be included in computing the amount prescribed to be the earnings or loss from an active business carried on in a country other than Canada of

(I) the non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year, or

10

(II) the taxpayer, where the taxpayer is a life insurance corporation resident in Canada throughout the year

if it were a foreign affiliate of the taxpayer and the income were earned by it,

(ii) the income is derived from amounts that were paid or payable, directly or indirectly, to the particular affiliate or a partnership of which the particular affiliate was a member

15

(A) by

(I) a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year, or

20

(II) a partnership of which a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year is a member and of which that non-resident corporation is not a specified member at any time in a fiscal period of the partnership ending in the year

25

to the extent that those amounts that were paid or payable are for expenditures that would, if the non-resident corporation or the partnership were a foreign affiliate of the taxpayer, be deductible by it in the year or a subsequent year in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada,

30

## (B) by

(I) another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year, or

(II) a partnership of which another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year is a member and of which that other affiliate is not a specified member at any time in a fiscal period of the partnership ending in the year

5

to the extent that those amounts that were paid or payable are for expenditures that were or would be, if the partnership were a foreign affiliate of the taxpayer, deductible in the year or a subsequent taxation year by the other affiliate or the partnership in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada,

10

15

(C) by a partnership of which the particular affiliate is a member and of which the particular affiliate is not a specified member at any time in a fiscal period of the partnership ending in the year to the extent that those amounts that were paid or payable were for expenditures that would be, if the partnership were a foreign affiliate of the taxpayer, deductible in the year or a subsequent year in computing the amounts prescribed to be its earnings or loss from an active business carried on by it outside Canada,

20

25

(D) by another foreign affiliate of the taxpayer (in this clause referred to as the "second affiliate") to which the particular affiliate and the taxpayer are related throughout the year to the extent that the amounts are paid or payable by the second affiliate

30

(I) under a legal obligation to pay interest on borrowed money used for the purpose of earning income from property, or

(II) on an amount payable for property acquired for the purpose of gaining or producing income from property

35

where

(III) the property is excluded property of the second affiliate that is shares of a foreign affiliate (other than the particular affiliate) of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year (in this clause referred to as the "third affiliate"), 5

(IV) the second and third affiliates are resident in and subject to income taxation in the same country, and

(V) the amounts paid or payable are relevant in computing the liability for income taxes in that country of the members of a group of corporations composed of the second affiliate and one or more other foreign affiliates of the taxpayer (the shares of which are excluded property) that are resident and subject to income taxation in that country and in respect of which the taxpayer has a qualifying interest throughout the year, or 10 15

(E) by the taxpayer, where the taxpayer is a life insurance corporation resident in Canada (in this clause referred to as the "insurer"), to the extent that those amounts that were paid or payable were for expenditures that are deductible in the year or a subsequent taxation year by the insurer in computing its income or loss from carrying on its life insurance business outside Canada and are not deductible in the year or a subsequent taxation year in computing its income or loss from carrying on its life insurance business in Canada, 20 25

(iii) the income is derived by the particular affiliate from the factoring of accounts receivable acquired by the particular affiliate or a partnership of which the particular affiliate was a member from a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year to the extent that the accounts receivable arose in the course of an active business carried on in a country other than Canada by the non-resident corporation, or 30

(iv) the income is derived by the particular affiliate from loans or lending assets acquired by the particular affiliate or a partnership of which the particular affiliate was a member from a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year to the extent that the loans or lending assets arose in the course of an active business carried on in a country other than Canada by the non-resident corporation; 35 40



(a.1) in computing the income from a business other than an active business for a taxation year of a foreign affiliate of a taxpayer there shall be included the income of the affiliate for the year from the sale of property (which, for the purposes of this paragraph, includes the income of the affiliate for the year from the performance of services as an agent in relation to a purchase or sale of property) where

5

(i) it is reasonable to conclude that the cost to any person of the property (other than property that was manufactured, produced, grown, extracted or processed in Canada by the taxpayer or a person with whom the taxpayer does not deal at arm's length in the course of carrying on a business in Canada and that was sold to non-resident persons other than the affiliate or sold to the affiliate for sale to non-resident persons) is relevant in computing the income from a business carried on by the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length or is relevant in computing the income from a business carried on in Canada by a non-resident person with whom the taxpayer does not deal at arm's length, and

10

15

(ii) the property was not manufactured, produced, grown, extracted or processed in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the affiliate's business is principally carried on,

20

unless more than 90% of the gross income of the affiliate for the year from the sale of property is derived from the sale of such property (other than a property described in subparagraph (ii) the cost of which to any person is a cost referred to in subparagraph (i)) to persons with whom the affiliate deals at arm's length (which, for this purpose, includes a sale of property to a non-resident corporation with which the affiliate does not deal at arm's length for sale to persons with whom the affiliate deals at arm's length) and, where this paragraph applies to include income of the affiliate from the sale of property in the income of the affiliate from a business other than an active business

25

30

(iii) the sale of such property shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and

35

(iv) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business;

(a.2) in computing the income from a business other than an active business for a taxation year of a foreign affiliate of a taxpayer there shall be included the income of the affiliate for the year from the insurance of a risk (which, for the purposes of this paragraph, includes income of the affiliate for the year from the reinsurance of a risk) where the risk was in respect of 5

(i) a person resident in Canada,

(ii) a property situated in Canada, or

(iii) a business carried on in Canada

unless more than 90% of the gross premium income of the affiliate for the year from the insurance of risks (net of reinsurance ceded) was in respect of the insurance of risks (other than risks in respect of a person, a property or a business described in subparagraphs (i) to (iii)) of persons with whom the affiliate deals at arm's length and, where this paragraph applies to include income of the affiliate from the insurance of risks in the income of the affiliate from a business other than an active business 10 15

(iv) the insurance of those risks shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and 20

(v) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business;

(a.3) in computing the income from a business other than an active business for a taxation year of a foreign affiliate of a taxpayer there shall be included the income of the affiliate for the year derived directly or indirectly from indebtedness (other than a specified deposit with a prescribed financial institution) and lease obligations (which, for the purposes of this paragraph, includes the income of the affiliate for the year from the purchase and sale of indebtedness and lease obligations on its own account) 25 30

(i) of persons resident in Canada, or

(ii) in respect of businesses carried on in Canada

unless more than 90% of the gross income of the affiliate derived directly or indirectly from indebtedness (other than a specified deposit with a prescribed financial institution) and lease obligations was derived directly or indirectly from indebtedness and lease obligations of non-resident persons with whom the affiliate deals at arm's length 35

and, where this paragraph applies to include income of the affiliate for the year in the income of the affiliate from a business other than an active business

(iii) those activities carried out to earn such income shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and

(iv) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business;

(a.4) in computing the income from a business other than an active business for a taxation year of a foreign affiliate of a taxpayer there shall be included (to the extent not included under paragraph (a.3) in such income of the affiliate for the year) that proportion of the income of the affiliate for the year derived directly or indirectly from indebtedness and lease obligations (which, for the purposes of this paragraph, includes the income of the affiliate for the year from the purchase and sale of indebtedness and lease obligations on its own account) in respect of a business carried on outside Canada by a partnership (any portion of the income or loss of which for fiscal periods of the partnership that end in the year is included or would, if the partnership had an income or loss for such fiscal periods, be included directly or indirectly in computing the income or loss of the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length) that

(i) the total of all amounts each of which is the income or loss of the partnership for fiscal periods of the partnership that end in the year that are included directly or indirectly in computing the income or loss of the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length

is of

(ii) the total of all amounts each of which is the income or loss of the partnership for fiscal periods of the partnership ending in the year

unless more than 90% of the gross income of the affiliate derived directly or indirectly from indebtedness and lease obligations was derived directly or indirectly from indebtedness and lease obligations of non-resident persons with whom the affiliate deals at arm's length (other than indebtedness and lease obligations of a partnership described in this paragraph) and where this paragraph applies to include a proportion of the income of the affiliate for the year in the income of the affiliate from a business other than an active business

(iii) those activities carried out to earn such income of the affiliate for the year shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and

(iv) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business

5

and for the purpose of this paragraph, where the income or loss of a partnership for a fiscal period ending in the year is nil, the proportion of the income of the affiliate that is to be included in the income of the affiliate for the year from a business other than an active business shall be determined as if the partnership had income of \$1,000,000 for that fiscal period ending in the year;

10

**(6) Subsection 95(2) of the Act is amended by deleting the word "and" at the end of paragraph (i) and by adding the following paragraphs after paragraph (j):**

15

(k) where, in a particular taxation year, a foreign affiliate of a taxpayer

(i) carries on an investment business outside Canada and, in the preceding taxation year, that business was not an investment business of the affiliate (or the definition "investment business" did not apply in respect of the business in the preceding taxation year), or

20

(ii) is deemed by paragraph (a.1), (a.2), (a.3) or (a.4) to carry on a separate business, other than an active business and, in the preceding taxation year, that paragraph did not apply to deem the affiliate to be carrying on that separate business,

25

for the purpose of computing the income of the affiliate from the investment business or the separate business as the case may be (in this subsection referred to as the "foreign business") for the particular year and each subsequent taxation year in which the foreign business is carried on,

30

(iii) the affiliate shall be deemed

(A) to have begun to carry on the foreign business in Canada at the later of the time the particular year began or the time that it began to carry on the foreign business, and

35

(B) to have carried on the foreign business in Canada throughout that part of the particular year and each such subsequent taxation year in which the foreign business was carried on by it,

(iv) where the foreign business of the affiliate is a business in respect of which, if the foreign business were carried on in Canada, the affiliate would be required by law to report to a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar authority of a province, the affiliate shall be deemed to have been required by law to report to and to have been subject to the supervision of such regulating authority, and

(v) paragraphs 138(11.91)(c) to (f) apply to the affiliate for the particular year in respect of the foreign business as if

(A) the affiliate were the insurer referred to in subsection 138(11.91),

(B) the particular year of the affiliate were the particular year of the insurer referred to in that subsection, and

(C) the foreign business of the affiliate were the business of the insurer referred to in that subsection;

(I) paragraph (a.3) does not apply to a foreign affiliate of a taxpayer in respect of its income derived directly or indirectly from indebtedness to the extent that

(i) the income is derived by the affiliate in the course of a business conducted principally with persons with whom the affiliate deals at arm's length carried on by it as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the business is principally carried on, and

(ii) the income is derived by the affiliate from trading or dealing in the indebtedness (which, for this purpose, 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 the trading or dealing) with persons (in this paragraph referred to as "regular customers") with whom it deals at arm's length that were resident in a country other than Canada in which it 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,

and, for the purpose of this paragraph, an acquisition of indebtedness from the taxpayer shall be deemed to be part of the trading or dealing in indebtedness described in subparagraph (ii) where the indebtedness is acquired by the affiliate and sold to regular customers and the terms and conditions of the acquisition and the sale are substantially the same as the terms and conditions of similar acquisitions and sales made by the affiliate in transactions with persons with whom it deals at arm's length;

(m) in computing the income from property for a taxation year of a foreign affiliate of a taxpayer there shall be included the income of the affiliate for the year from a business (other than an investment business of the affiliate) the principal purpose of which is to derive income from trading or dealing in indebtedness (which for the purpose of this paragraph includes the earning of interest on indebtedness) other than

(i) indebtedness owing by persons with whom the affiliate deals at arm's length that are resident in the country in which the affiliate was formed or continued and exists and is governed and in which the business is principally carried on, or

(ii) accounts receivable owing by persons with whom the affiliate deals at arm's length,

unless

(iii) the business is carried on by the affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the business is principally carried on, and

(iv) the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities resident in Canada, the business activities of which are subject by law to the supervision of a regulating authority such as the Superintendent of Financial Institutions or a similar authority of a province;

(n) for the purposes of paragraph (a.3), "indebtedness" does not include obligations of a person under agreements with non-resident corporations providing for the purchase, sale or exchange of currency where

- (i) the agreements are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, options or rights agreements, or similar agreements, 5
  - (ii) the person is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities resident in Canada, the business activities of which are subject by law to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar authority of a province, 10
  - (iii) the agreements are entered into by the non-resident corporation in the course of a business carried on by it principally with persons with which it deals at arm's length in the country under whose laws the non-resident corporation was formed or continued and exists and is governed and in which the business is principally carried on by it, and 15
  - (iv) the terms and conditions of such agreements are substantially the same as the terms and conditions of similar agreements made by the person with others with whom the person deals at arm's length; 20
- (o) paragraph (a.1) does not apply to a foreign affiliate of a taxpayer in respect of a sale or exchange of property that is currency or a right to purchase, sell or exchange currency where 25
- (i) the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities resident in Canada, the business activities of which are subject by law to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar authority of a province, 30
  - (ii) the sale or exchange was made in the course of a business carried on by the affiliate principally with persons with whom the affiliate deals at arm's length in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the business is principally carried on by it, and 35

(iii) the terms and conditions of the sale or exchange of such property are substantially the same as the terms and conditions of similar sales or exchanges of such property with the taxpayer made by persons with whom the taxpayer was dealing at arm's length;

5

(p) for the purposes of the definition "investment business" in subsection (1), a foreign affiliate of a taxpayer and the taxpayer shall be considered to be dealing with each other at arm's length in respect of the entering into of agreements that provide for the purchase, sale or exchange of currency and the execution of those agreements where

10

(i) the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities resident in Canada, the business activities of which are subject by law to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar authority of a province,

15

(ii) the agreements are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, options or rights agreements or similar agreements,

(iii) the agreements are entered in the course of a business carried on by the affiliate principally with persons with whom the affiliate deals at arm's length in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the business is principally carried on, and

20

(iv) the terms and conditions of such agreements are substantially the same as the terms and conditions of similar agreements made by the taxpayer with persons with whom it deals at arm's length;

25

(q) for the purposes of paragraph (a.3), "specified deposit" means a deposit of a foreign affiliate of a taxpayer resident in Canada with a prescribed financial institution resident in Canada where

30

(i) the income from the deposit is income of the affiliate for the year that would, but for paragraph (a.3), be income from an active business carried on by it in a country other than Canada (other than a business the principal purpose of which is to derive income from property including interest, dividends, rents, royalties or similar returns or substitutes therefore or profits from the disposition of investment property), or

35



(ii) the income from the deposit is income of the affiliate for the year that would, but for paragraph (a.3), be income from an active business carried on by the affiliate principally with persons with whom the affiliate deals at arm's length in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the business is principally carried on by it and the deposit was held by the affiliate in the course of carrying on that part of the business conducted with non-resident persons with whom the affiliate deals at arm's length or that part of the business conducted with a person with whom the affiliate was related where it can be demonstrated that the related person used or held the funds deposited in the course of a business carried on by the related person with non-resident persons with whom the related person and the affiliate deal at arm's length;

5

10

(r) a taxpayer has a qualifying interest in respect of a foreign affiliate of the taxpayer at any time if, at that time, the taxpayer owned

15

(i) not less than 10% of the issued and outstanding shares (having full voting rights under all circumstances) of the affiliate, and

(ii) shares of the affiliate having a fair market value of not less than 10% of the fair market value of all the issued and outstanding shares of the affiliate

20

and for the purpose of this paragraph

(iii) where, at any time, shares of a corporation are owned or are deemed for the purposes of this paragraph to be owned by another corporation (in this paragraph referred to as the "holding corporation"), those shares shall be deemed to be owned at that time by each shareholder of the holding corporation in a proportion equal to the proportion of all such shares that

25

(A) the fair market value of the shares of the holding corporation owned at that time by the shareholder

30

is of

(B) the fair market value of all the issued shares of the holding corporation outstanding at that time,

(iv) where, at any time, shares of a corporation are property of a partnership or are deemed for the purposes of this paragraph to be property of a partnership, those shares shall be deemed to be owned at that time by each member of the partnership in a proportion equal to the proportion of all such shares that

35

(A) the member's share of the income or loss of the partnership for its fiscal period that includes that time

is of

(B) the income or loss of the partnership for its fiscal period that includes that time

5

and for the purpose of this subparagraph, where the income and loss of the partnership for its fiscal period that includes that time are nil, that proportion shall be computed as if the partnership had income for the period in the amount of \$1,000,000, and

(v) where, at any time, a person is a holder of convertible property issued by the affiliate before June 23, 1994 the terms of which confer on the holder the right to exchange the convertible property for shares of the affiliate and the taxpayer elects in its return of income for its first taxation year that ends after 1994 to have the provisions of this subparagraph apply to the taxpayer in respect of all the convertible property issued by the affiliate and outstanding at that time, each holder shall, in respect of the convertible property held by it at that time, be deemed, immediately before that time, to have

10

15

(A) exchanged the convertible property for shares of the affiliate, and

20

(B) acquired shares of the affiliate in accordance with the terms and conditions of the convertible property; and

(s) for the purposes of paragraph (a), a non-resident corporation that was not a foreign affiliate of a taxpayer in respect of which the taxpayer had a qualifying interest throughout a particular taxation year shall be deemed to be a foreign affiliate of a taxpayer in respect of which the taxpayer had a qualifying interest throughout that year where

25

(i) the taxpayer has, in that year, acquired or disposed of shares of that non-resident corporation, and

30

(ii) at the commencement of that year or at the end of that year, the non-resident corporation was a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest.

35

## Where Rights or Shares are Acquired or Disposed of to Avoid Tax

### (7) Subsection 95(6) of the Act is replaced by the following:

Where rights or shares issued, acquired or disposed of to avoid tax

#### (6) For the purposes of this subdivision (other than section 90)

(a) where any person or partnership has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares of a corporation and 5

(i) it can reasonably be considered that the principal purpose for the existence of the right is to cause 2 or more corporations to be related for the purpose of paragraph (2)(a), those corporations shall be deemed not to be related for that purpose, or 10

(ii) it can reasonably be considered that the principal purpose for the existence of the right is to permit any person to avoid, reduce, or defer the payment of tax or any other amount that would otherwise be payable under this Act, those shares shall be deemed to be owned by that person or partnership, and 15

(b) where a person or partnership acquires or disposes of shares of a corporation, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition of the shares is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, those shares shall be deemed not to have been acquired or disposed of, as the case may be, and where the shares were unissued by the corporation immediately prior to the acquisition, those shares shall be deemed not to have been issued. 20 25

(8) Subsections (1) to (7) apply to taxation years of foreign affiliates of taxpayers that begin after 1994 except that where there has been a change in the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, subsections (1) to (7) apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. 30

## Business

3.1) The definition "business" in subsection 248(1) of the Act is replaced by the following: 35

**"business"**

"business" includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph 18(2)(c), section 54.2, subsection 95(1) and paragraph 110.6(14)(f), an adventure or concern in the nature of trade but does not include an office or employment;

5

**(2) Subsection (1) applies to taxation years that end after 1994 .**



---

Explanatory Notes to  
Revised Draft Amendments  
– *Income Tax Act*

---

These explanatory notes are provided to assist in an understanding of amendments to the *Income Tax Act* and *Income Tax Application Rules*. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

## **Borrowed Money**

ITA  
20(3)

Subsection 20(3) of the Act provides a rule that applies when a taxpayer uses borrowed money to repay an existing debt. For the purposes of the provisions of the Act set out therein, the borrowed money is treated as having been used for the same purpose as that of the money previously borrowed but repaid. The amendment to this subsection simply makes the provision apply also for the purposes of proposed new subparagraph 95(2)(a)(ii) of the Act. That provision deals with foreign affiliates and the definition of foreign accrual property income which is discussed in the explanatory notes relating to subsection 95(2) of the Act. The amendment is applicable for expenses incurred in taxation years that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendment will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. Thus, where a foreign affiliate of a taxpayer borrows money to repay a loan, the funds are considered to have been used for the same purpose as the use made of the funds that were derived from the repaid loan.

## **Foreign Affiliate - Definition**

ITA  
95(1)

Subsection 95(1) of the Act defines the term "foreign affiliate" of a taxpayer resident in Canada for the purposes of the rules in the Act which deal with the taxation of shareholders of non-resident corporations. Under the current definition, a corporation not resident in Canada will be considered to be a foreign affiliate of a taxpayer resident in Canada if the taxpayer's equity percentage in the corporation as defined in subsection 95(4) of the Act is not less than 10%. Among other things, the term is relevant for the purposes of the rules in section 91 of the Act dealing with the taxation of foreign accrual property income and the rules in section 113 of the Act dealing with the deduction for dividends received from a foreign corporation by a corporation resident in Canada.



The definition is amended applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendment will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. The amendment provides that a corporation not resident in Canada will be considered to be a foreign affiliate of a taxpayer where the taxpayer has an equity percentage in that corporation that is not less than 1% and the total of the equity percentages of the taxpayer and persons related to the taxpayer in that corporation is not less than 10%. For the purpose of the 10% equity percentage test, the equity percentages are to be determined without reference to the equity percentages of any person in the taxpayer or in any persons related to the taxpayer. The amendment ensures that a taxpayer resident in Canada cannot avoid the foreign accrual property income rules by arranging to have shares of a non-resident corporation held by other persons related to the taxpayer.

## **EXAMPLE 1**

### Facts

Corporation A which is resident in Canada owns an 82% interest in the outstanding shares of a foreign corporation.

Corporations B and C which are related to corporation A and are resident in Canada each own a 9% interest in the outstanding shares of the same foreign corporation.

### Results Under Current Definition

Under the existing definition of a foreign affiliate of a taxpayer resident in Canada in subsection 95(1) of the Act, the foreign corporation would be a foreign affiliate of corporation A but not of corporation B or C since the equity percentage of each of those corporations in the foreign corporation is less than 10%.

Since corporation A controls the foreign corporation, the foreign corporation is a controlled foreign affiliate of corporation A. Corporation A would then report as income 82% of the foreign accrual property income of that controlled foreign affiliate.

### Results Under Amended Definition

The amended definition of a foreign affiliate of a taxpayer resident in Canada would treat the foreign corporation as a foreign affiliate of corporations B and C since each have an equity percentage in the foreign corporation that is not less than 1% and the total of the equity percentages of the three related corporations in the foreign corporation is not less than 10%.

Since the foreign corporation is controlled by corporation A which is related to corporations B and C, it is also a controlled foreign affiliate of corporations B and C (see the definition of a "controlled foreign affiliate" in subsection 95(1) of the Act). Therefore, 100% of the foreign accrual property income of the controlled foreign affiliate will be included in the income of the Canadian shareholders - corporation A (82%), corporation B (9%) and corporation C (9%).

### **Foreign Accrual Property Income - Definition**

ITA  
95(1)

Subsection 95(1) of the Act defines "Foreign accrual property income" of a foreign affiliate of a taxpayer.

The description for the letter A and the formula in that definition includes in foreign accrual property income ("FAPI") the affiliate's income for the year from property and businesses other than active businesses with some exceptions. The amendment to the description for the letter A provides that such income is to be determined without reference to those expenses of the foreign affiliate that are referred to in proposed new clause 95(2)(a)(ii)(D) of the Act where an amount in respect of the income derived from those amounts of expense payments was included in computing the income from an active business of another foreign affiliate of the taxpayer or a foreign affiliate of a person with which the taxpayer does not deal at arm's length. Under proposed new subsection 5907(2.8) of the Regulations, such expenses of the affiliate are to be deducted in computing the income or loss of the affiliate from an active business carried on or deemed to have been carried on by it in the country in which it is resident and subject to income taxation. This amendment ensures that

the payment of an expense by one affiliate that is included in the active business income of another affiliate cannot be used to reduce the FAPI of the paying affiliate.

The description for the letter D and the formula in the definition deducts from foreign accrual property income of an affiliate its losses from property and businesses other than active businesses. The amendment to the description for the letter D provides that those losses are also to be determined without reference to those expenses of the affiliate referred to in proposed new clause 95(2)(a)(ii)(D) of the Act where an amount in respect of the income derived from those amounts of expense payments was included in computing the income from an active business of another foreign affiliate of the taxpayer or a foreign affiliate of a person with which the taxpayer does not deal at arm's length.

The amendments are applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendments will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994.

## **Definitions**

### **ITA 95(1)**

The proposed new definitions in subsection 95(1) of the Act are applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the new definitions will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. They define "active business", "foreign bank", "income from an active business", "income from property" and "investment business" as well as other terms relevant in determining the foreign accrual property income of a foreign affiliate.

"Active business" of a foreign affiliate of a taxpayer is defined as any business carried on by the affiliate other than a business that is an investment business of the affiliate or is deemed to be a separate

business other than an active business carried on by the affiliate under subsection 95(2) of the Act.

"Foreign bank" means an entity that would be a foreign bank as that expression is defined in section 2 of the Bank Act if that definition were read without its postamble and no entity had been exempt from being a foreign bank under section 12 of the Bank Act.

"Income from an active business" of a foreign affiliate of a taxpayer for a taxation year includes, for greater certainty, any income of the affiliate for the year that pertains to or is incident to that active business but does not include other income that is income from property of the affiliate for the year and does not include income of the affiliate for the year from a business that is deemed by subsection 95(2) of the Act to be a business other than an active business of the affiliate.

"Income from property" of a foreign affiliate of a taxpayer for a taxation year includes its income for the year from an investment business and its income for the year from an adventure or concern in the nature of trade but, for greater certainty, does not include its income for the year that is treated by subsection 95(2) of the Act as its income from a business.

"Investment business" of a foreign affiliate of a taxpayer means a business carried on by the affiliate in a taxation year (other than a business that is deemed by subsection 95(2) of the Act to be a business other than an active business) the principal purpose of which is to derive income from property (including interest, dividends, rents, royalties or any similar returns or substitutes therefor), income from the insurance or reinsurance of risks, income from the factoring of accounts receivable or profits from the disposition of investment property.

However, an "investment business" will not include a business carried on by a foreign affiliate in a taxation year where it is established that, throughout the period in the year during which the business was carried on, the following conditions are satisfied.

First, it must be established that the business was carried on principally with arm's length persons and was either

- carried on by the affiliate as a foreign bank, trust company, credit union, insurance corporation or a trader or dealer in securities or commodities the activities of which are regulated in the country in which the business is principally carried on, or
- the development of real estate for sale, the lending of money, the leasing or licensing of property or the insurance or reinsurance of risks.

Second, it must be established that the affiliate or, where the affiliate carries on the business as a member of a partnership (other than where the affiliate was a specified member of the partnership in a fiscal period of the partnership ending in the year), the partnership either

- employed more than five employees full time in the active conduct of the business, or
- employed the equivalent of more than 5 employees full-time in the active conduct of the business taking into consideration only the services provided by its employees and the services provided outside Canada by employees of a corporation related to the affiliate or employees of members of the partnership (other than a partner that was a specified member of the partnership in a fiscal period of the partnership ending in the year). This test is satisfied only where such employers received compensation from the affiliate in exchange for the services performed by their employees in an amount that is at least equal to the cost of the employee compensation paid or accruing to the employees while the services were performed by them.

For this purpose, the term "specified member" of a partnership is defined in subsection 248(1) of the Act and refers to limited partners and to certain members who are not actively engaged in the partnership business.

A financial institution regulated as a bank or other regulated financial institution on a consolidated basis by a regulatory authority located in a member state of the European community, other than the member state in which the business of the financial institution is principally carried on, in accordance with the Consolidated Supervision Directive will be considered to be a financial institution whose activities are

regulated in the member state in which the business is principally carried on where the European regulatory law has been incorporated into the local regulatory law of that member state.

The term "investment property" is relevant for the definition "investment business". The investment property of a foreign affiliate of a taxpayer is defined to include

- a share in a corporation and an interest in a partnership or trust other than any such property that is excluded property of the affiliate,
- indebtedness and annuities,
- commodities or commodities futures purchased or sold, directly or indirectly in any manner whatever, on a commodities or commodities futures exchange (except where the commodities were manufactured, produced, grown, extracted or processed by the affiliate or a person to which the affiliate was related, otherwise than by reason of a right referred to in paragraph 251(5)(b) of the Act, or the commodities futures were in respect of such commodities),
- currency,
- real estate,
- Canadian and foreign resource properties,
- interests in funds and entities other than corporations, partnerships and trusts, and
- interests and options in respect of any such property.

"Lease obligation" of a person is defined to include an obligation under an agreement that authorizes the use of or the production or reproduction of property including information or any other thing (such as a software licensing agreement). This definition is relevant for the purposes of the rule for determining income from a business other than an active business in proposed new paragraph 95(2)(a.3) of the Act.

"Lending of money" by a person (the lender) is defined to include

- the acquisition of trade accounts receivable of another person (the borrower) owing by persons that deal at arm's length with the lender or of interests in such trade accounts receivable,
- the acquisition of loans made by and lending assets of another person (the borrower) owing by persons that deal at arm's length with the lender or of interests in such loans or lending assets,
- the acquisition of foreign resource properties of other persons (the borrower) other than resource properties that are rents or royalties payable by persons that do not deal at arm's length with the lender, and
- the sale by the lender of loans or lending assets or an interest in loans or lending assets where the loans or lending assets were owing by persons that deal at arm's length with the lender.

The definition "lending of money" is relevant for the purpose of the definition "investment business".

"Licensing of property" is defined to include authorizing the use of or production or reproduction of property including information or any other thing. This definition is relevant for the purposes of the definition "investment business".

The approach for determining the income of a foreign affiliate of a taxpayer for a year that is its income from an active business, its income from property, its income from a business that is deemed under subsection 95(2) to be a business other than an active business and its foreign accrual property income is as follows.

- Determine if the affiliate carries on income earning activities that are deemed to be a separate business other than an active business carried on by the affiliate under subsection 95(2) of the Act (such as under proposed new paragraphs (a.1) to (a.4) thereof). Income from such separate business including any income from assets at risk in or essential to that business (such as interest from the investment of temporarily surplus funds) is income from a business other than an active business. As such,

the income is excluded from the affiliate's income from property and its income from an active business because of the definitions of those terms in subsection 95(1).

- Determine if the affiliate carries on other income earning activities that constitute separate businesses and apply the investment business definition in subsection 95(1) to each such separate business to determine if an investment business exists. Income from an investment business of the affiliate is included in the income from property of the affiliate. Where a business is not an investment business, it will qualify as an active business. Income from the active business including any income derived from assets at risk in or essential to the active business (such as interest from the investment of temporarily surplus funds) is income of the affiliate from an active business because of the definition of that income in subsection 95(1).
- Determine if the affiliate carries on any income earning activities that do not constitute a separate business. An adventure or concern in the nature of trade would not constitute a separate business and would be included in these types of activities because of the amendment to the definition "business" in subsection 248(1) of the Act. The definition "income from property" in subsection 95(1) includes the income of the affiliate from an investment business and its income from an adventure or concern in the nature of trade in income from property of the affiliate.
- Determine the extent to which paragraph 95(2)(a) applies to treat income from property of the affiliate as active business income of the affiliate. Include such income in the active business income of the affiliate. The balance of the income from property remains as income from property of the affiliate.
- Determine the foreign accrual property income of the affiliate by including the income from property of the affiliate and the income from a business other than an active business of the affiliate as well as the other amounts included under the Act.



**EXAMPLE 2**Facts

A corporation resident in Canada has three foreign affiliates that it controls - FA1, FA2 and FA3.

FA1 and FA2 are resident in and carry on a manufacturing business in a designated treaty country.

FA3 is a financing affiliate that carries on a non-arms length financing business and makes interest-bearing loans to FA1 and FA2 and the interest cost in respect of such loans are deductible in computing the amount prescribed to be the earnings or loss from an active business carried on in the designated treaty country by FA1 and FA2.

The manufacturing income of FA1 is \$1915 which includes \$15 of interest income from the short term investment of funds that are at risk in the manufacturing business (income pertaining to or incident to the active manufacturing business).

FA2 has manufacturing income of \$1500.

FA3 has interest income from loans made to FA1 and FA2 of \$160 and interest income from the investment of funds derived from its operating surpluses of \$60.

Application of definitions

FA1 carries on a manufacturing business that is an active business and has income from an active business of \$1915.

FA2 carries on a manufacturing business that is an active business and has income from an active business of \$1500 because of the definition "active business" and "income from an active business" in subsection 95(1).

FA3 carries on a non-arm's length financing business that is an investment business and includes the \$220 of income from the investment business in its income from property because of the

definitions "investment business" and "income from property" in subsection 95(1).

FA3 will include \$160 of its income from property in its income from an active business under subparagraph 95(2)(a)(ii) (the income FA3 derived from the interest payments made to it by FA1 and FA2) and the remaining \$60 of its income from property will remain as income from property of FA3.

FA3 will have \$60 of income from property (the \$60 of income from the investment of funds derived from operating surpluses) that will be included in its foreign accrual property income.

### **EXAMPLE 3**

#### Facts

A corporation resident in Canada has a number of foreign affiliates which it controls each of which is resident in and carries on a manufacturing business in a designated treaty country. It also has another foreign affiliate which it controls which carries on the non-arm's length insurance business of insuring the risks of the Canadian corporation and its manufacturing affiliates.

The insurance affiliate derives \$1000 of premium income (net premiums minus claims and related expenses etc.) from insuring the Canadian corporation's risks (the "Canadian insurance business") and \$300 of premium income derived from the insurance of the foreign affiliates' risks (the "Foreign insurance business"). As well, the investment of the Canadian business net premiums and capital earns \$50 of interest income while the investment of foreign business net premiums and capital earns \$15 of interest income. There is no income derived from assets not employed in the businesses.

#### Applications of the definitions

The insurance affiliate is deemed to carry on a separate business other than an active business under subsection 95(2) (proposed paragraph (a.2)) of the Act in respect of the insurance of the Canadian risks. The \$1000 of premium income derived from

the insurance of the Canadian risks and the \$50 of interest derived from the investment of the funds at risk in that separate business is included in the affiliate's income from a business other than an active business.

The insurance affiliate carries on a non-arm's length insurance business insuring the risks of related affiliates. That business is an investment business and the \$300 of premium income and the \$15 of interest derived from the investment of funds at risk in that business is income from the investment business that is included in its income from property because of the definition "income from property" in subsection 95(1). However, because of the application of subparagraphs 95(2)(a)(i) and (ii), the insurance affiliate will include in computing its active business income, the \$315 of income derived from the business of the insurance of the risks of the related foreign affiliates. The income from property of the affiliate will then be nil.

#### **EXAMPLE 4**

##### **Facts**

A corporation resident in Canada has three foreign affiliates that it controls - FA5, FA6 and FA7.

FA5 and FA6 are resident in and carry on a manufacturing business in a designated treaty country.

FA7 is a financing affiliate that carries on a non-arm's length financing business and makes interest-bearing loans to FA5 and FA6 and the interest cost in respect of such loans are deductible in computing the amount prescribed to be the earnings or loss from an active business carried on in the designated treaty country by FA5 and FA6. FA7 earns \$440 of interest in respect of these loans.

FA7 also receives, as part of that non-arm's length financing business, advances of funds from FA5 and FA6 that are at risk in their manufacturing businesses but are temporarily available for investment. The funds are returned to FA5 and FA6 for use in their manufacturing business as required. FA7 earns \$10 of income on the investments of such funds.

### Application of definitions

FA7 carries on a non-arm's length financing business that is an investment business and the \$450 of income from the investment business is included in its income from property because of the definition "income from property" in subsection 95(1). However, because of the application of subparagraphs 95(2)(a)(i) and (ii), FA7 will include the \$450 in computing its active business income (the \$10 of income derived from the investment of funds at risk in the manufacturing businesses of FA5 and FA6 and the \$440 of income derived from the interest paid to it by FA5 and FA6). The income from property of FA7 will then be nil.

### **Determination of Foreign Accrual Property Income**

ITA

95(2)

Subsection 95(2) of the Act provides rules for determining the income of a foreign affiliate of a taxpayer resident in Canada from a particular source. A foreign affiliate is considered to have three sources of income - income from property, income from a business other than an active business and income from an active business. This sourcing of income is important since the affiliate's income from property and the affiliate's income from a business other than an active business is included in the foreign accrual property income of the affiliate. Where the affiliate is a controlled foreign affiliate, the taxpayer's share of the affiliate's foreign accrual property income must be included in the taxpayer's income for Canadian tax purposes whether or not the income is distributed. The income of a foreign affiliate from an active business is included in the taxpayer's income for Canadian tax purposes only when paid to the shareholder as a dividend.

ITA

95(2)(a)

Existing paragraph 95(2)(a) of the Act includes in the income from an active business of a foreign affiliate of a taxpayer the income of the affiliate from property and the income of the affiliate from a business other than an active business to the extent that

- the income pertains to or is incident to an active business carried on in a country other than Canada by the affiliate or by a non-resident corporation with which the taxpayer does not deal at arm's length, or
- the income is derived from amounts paid or payable to the affiliate or a partnership of which the affiliate is a member by another affiliate of the taxpayer or by a non-resident corporation with which the taxpayer does not deal at arm's length where the amounts paid or payable reduce (or would reduce, if the non-resident corporation were a foreign affiliate of the taxpayer) the amounts prescribed to be the active business earnings of the payer from a business carried on in a country other than Canada.

That paragraph is being replaced applicable to taxation years of foreign affiliates that begin after 1994 except that, where there has been a change to a taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of the affiliate that end after 1994.

The wording of the existing paragraph causes some uncertainty particularly as it relates to the determination of what income of one affiliate pertains to or is incident to the active business carried on by another corporation. The proposed new definitions "income from an active business" and "income from property" of a foreign affiliate in subsection 95(1) of the Act as well as proposed new subparagraph 95(2)(a)(i) deal with this issue. As well, because of the new definition "income from property" in subsection 95(1), only income that would otherwise be income from property needs to be dealt with in paragraph 95(2)(a). Finally, the scope of proposed new subparagraphs 95(2)(a)(i) and (ii) have been altered as discussed below.

Proposed new subparagraph 95(2)(a)(i) defines situations where income for the year that would otherwise be the income from property of a foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year will be treated as active business income for the year of the affiliate.

Income from property for a taxation year of a particular foreign affiliate of a taxpayer in respect of which the taxpayer has a

qualifying interest throughout the year will be considered to be income from an active business of the particular affiliate for the year to the extent that it is derived by it from activities that could reasonably be considered to be directly related to active business activities carried on outside Canada either by any other non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year, or by the taxpayer in those circumstances where the taxpayer is a life insurance corporation resident in Canada throughout the year. The income must be of the type that, if earned by the non-resident corporation or the taxpayer that is the life insurance corporation, would be included in computing the amount prescribed to be its earnings or loss from an active business carried on outside Canada if it were a foreign affiliate of the taxpayer. Rules are provided in proposed new paragraphs 95(2)(r) for determining when a taxpayer has a qualifying interest in a foreign affiliate of the taxpayer. Subparagraph 95(2)(a)(i) is directed at cases where the business activities of a single foreign active business are conducted in more than one related corporation. It also deals with the situation where income of one foreign corporation is derived from assets that are at risk in a foreign active business carried on by a related foreign corporation. Assets will be considered to be at risk in a business where the permanent removal of such assets would have a destabilizing effect on the business.

There must be a link between the foreign active business activities conducted by the related foreign corporation and the activities conducted by the other foreign corporation that produces income from property. The activities resulting in the income from property must be dependent upon and would not have taken place but for the active business activities taking place. The fact that activities are similar is not enough to demonstrate a link.

## **EXAMPLE 5**

### Facts

A corporation resident in Canada has two foreign affiliates which it controls throughout the year - FA1 and FA2.

FA1 carries on the active business of leasing property at arm's length and has 20 employees.

FA2 is a wholly owned subsidiary of FA1 with no employees and was formed by FA1 for business reasons to hold a single high risk lease that was negotiated and executed by the employees of FA1 in the conduct of the business of FA1.

FA2 earns leasing income of \$100 which would otherwise qualify as income from property.

Application of Subparagraph 95(2)(a)(i)

The leasing activity of FA2 is directly linked to the active business activities of FA1 since it was negotiated by the employees of FA1 in the conduct of the business of FA1 and can be considered to be an extension of the business of FA1. The leasing activities of FA2 resulting in the property income are dependent upon the active business activities of FA1 and would not have taken place but for the active business activities of FA1.

If FA1 had earned the leasing income of FA2, the income would be income from the active leasing business of FA1.

The corporation resident in Canada, FA1 and FA2 are related throughout the year.

The \$100 of FA2's income derived from the leasing activities is included in its income from an active business rather than its income from property.

FA2 has no property income and \$100 of active business income.

**EXAMPLE 6**

Facts

A corporation resident in Canada has two foreign affiliates which it controls throughout the year - FA3 and FA4.

FA3 carries on the active business of developing real estate for sale and has 30 employees.

FA4 is a wholly owned subsidiary of FA3 and is used by FA3 to develop and sell a real estate property that but for the risk involved would have been developed and sold by FA3. The activities of FA4 are managed by employees of FA3. FA4 carries on no other activities and earns a profit of \$200 on the sale of the property.

Application of Subparagraph 95(2)(a)(i)

The development and sale of the real estate property by FA4 is an activity that is directly linked to the active business activities of FA3 and can be considered to be an extension of the active business of FA3.

If FA3 had earned the income of FA4, the income would be income from the active business of FA3.

The corporation resident in Canada, FA3 and FA4 are related throughout the year.

The \$200 of income derived by FA4 from the development and sale of the real estate property is included in its income from an active business rather than its income from property.

FA4 has no property income and \$200 of active business income.

**EXAMPLE 7**

Facts

A corporation resident in Canada has three foreign affiliates which it controls throughout the year - FA5, FA6 and FA7.

FA5 and FA6 carry on active manufacturing businesses in foreign countries and advance funds that are at risk in their active businesses but are also available for temporary investment to FA7 for investment. The funds are returned to FA5 and FA6 for use in their active businesses as required.



FA7 earns \$100 of income from investing the funds of FA5 and FA6. As well, it earns \$200 of income from investing funds derived from its surplus. FA7 has fewer than 5 employees and carries on an investment business as defined in subsection 95(1).

Application of Subparagraph 95(2)(a)(i)

The activities involving the investment of the funds provided by FA5 and FA6 are directly linked to the active business activities of FA5 and FA6 since FA7 is performing a treasury function in respect of funds at risk in the businesses of FA5 and FA6.

If FA5 and FA6 had earned the \$100 of income that was derived by FA7 from the investment of these funds, the income would be income from their active businesses since the funds were at risk in their businesses.

The corporation resident in Canada, FA5, FA6 and FA7 are related throughout the year.

The \$100 of income from property of FA7 derived from the investment of funds provided by FA5 and FA6 would be included in its income from an active business. The remaining \$200 of property income of FA7 would remain income from property.

Proposed new subparagraph 95(2)(a)(ii) of the Act is similar to existing subparagraph 95(2)(a)(ii) of the Act. However, the scope of the provision has been altered in two ways. First, the scope has been expanded to accommodate the use of holding corporations by certain groups of foreign affiliates of a taxpayer. Second, its application has been restricted to income from property derived from certain transactions involving members of groups of related non-resident corporations or groups of foreign affiliates of the taxpayer in respect of which the taxpayer has a qualifying interest as defined in proposed new paragraph 95(2)(r) of the Act.

Income that would otherwise be income from property for a taxation year of a foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest will be included in its income from an active business for the year to the extent that the income is derived

from amounts paid or payable, directly or indirectly, to the affiliate or a partnership of which it is a member

- under clause (A), by a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year or by a partnership of which such a non-resident corporation is a member (other than where it is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that would, if the non-resident corporation or the partnership were a foreign affiliate of the taxpayer, be deductible in the year or a subsequent taxation year by it in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada,
- under clause (B), by another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year or by a partnership of which such other foreign affiliate of the taxpayer is a member (other than where the other affiliate is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that are or would be, if the partnership were a foreign affiliate of the taxpayer, deductible in the year or a subsequent taxation year by the other affiliate or the partnership in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada,
- under clause (C), by a partnership where the particular affiliate is a member of the partnership (other than where it is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that would be, if the partnership were a foreign affiliate of the taxpayer, deductible in the year or a subsequent taxation year in computing the amounts prescribed

to be its earnings or loss from an active business carried on by it outside Canada, or

- under clause (D), by another foreign affiliate of the taxpayer that is related to the particular affiliate and the taxpayer throughout the year (second affiliate) pursuant to a legal obligation to pay interest on borrowed money used to acquire, or on an amount payable for the acquisition of, property, where
  - the property is excluded property of the second affiliate that is shares of another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year (third affiliate),
  - the second affiliate and third affiliate are resident and subject to income taxation in the same country, and
  - the amounts paid or payable are relevant in computing the liability for taxes of the members of a corporate group composed of the second affiliate and one or more other foreign affiliates of the taxpayer which are resident and subject to income taxation in the same country as the second affiliate and in respect of which the taxpayer has a qualifying interest throughout the year.
- under clause (E), by the taxpayer, where the taxpayer is a life insurance corporation resident in Canada, to the extent that those amounts paid or payable are for expenditures that are deductible in the year or a subsequent taxation year by the insurer in computing its income or loss from carrying on its insurance business outside Canada and not in Canada.

## EXAMPLE 8

### Facts

A foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year loaned funds to another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year.

The interest on the loan would otherwise qualify as income from property of the lending affiliate.

The interest expense of the borrowing affiliate is deductible in computing the amount prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada.

Application of Subparagraph 95(2)(a)(ii)

Proposed new clause 95(2)(a)(ii)(B) of the Act would include the income of the lending affiliate derived from the interest paid by the borrowing affiliate in the active business income of the lending affiliate. The active business earnings or loss of the group of affiliates is then unaffected by the inter-affiliate interest payments.

Where foreign income tax rules such as the rules dealing with earnings stripping in the United States defer an expense deduction, subparagraph 95(2)(a)(ii) still applies since the interest is considered to be deductible in computing the amount prescribed to be the borrower's earnings or loss from an active business carried on outside Canada.

Proposed new subsection 5907(2.7) of the *Income Tax Regulations* provides that the interest paid or payable by the borrower is to be deducted in computing the active business earnings or loss of the borrower in the year of the borrower that includes the earlier of the day on which the interest is paid or the day on which the interest becomes payable.

Proposed subclause 5907(1)(b)(iv)(B)(V) of the *Income Tax Regulations* includes the income that is deemed to be active business income of the affiliate in computing the lender's exempt earnings or loss to the extent that the interest paid or payable are deductible in computing the borrowing affiliate's exempt earnings or loss.

**EXAMPLE 9****Facts**

A foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year carries on an active business as a member of a partnership.

The affiliate makes a loan to the partnership and the interest on the loan is deductible in computing the amount that would be, if the partnership were a foreign affiliate of the taxpayer, its earnings or loss from an active business carried on by it.

The income of the affiliate derived from the interest on the loan would otherwise be income from property of the affiliate.

**Application of Subparagraph 95(2)(a)(ii)**

Proposed new clause 95(2)(a)(ii)(C) would treat the income of the affiliate as active business income of the affiliate to the extent that the interest paid or payable to the affiliate would be, if the partnership were a foreign affiliate of the taxpayer, deductible in computing the amount prescribed to be its earnings or loss from an active business carried on in a country other than Canada.

Proposed new subsection 5907(2.7) of the *Income Tax Regulations* requires the affiliate to deduct the interest paid to the affiliate in computing its active business earnings or loss from the partnership in the year of the partnership that includes the earlier of the day on which the interest is paid and the day on which the interest becomes payable.

Where the affiliate is resident in a designated treaty country, proposed subclause 5907(1)(b)(iv)(B)(VII) of the *Income Tax Regulations* includes the income deemed to be active business income of the affiliate in computing the lenders exempt earnings or loss to the extent that the interest paid or payable by the partnership would be, if the partnership were a foreign affiliate of a corporation, deductible in computing its exempt earnings or loss.

## EXAMPLE 10

### Facts

A foreign affiliate of a taxpayer (the "first affiliate") in respect of which the taxpayer has a qualifying interest throughout the year loaned funds to another foreign affiliate of the taxpayer (the "second affiliate") to which the particular affiliate and the taxpayer are related throughout the year.

The second affiliate used the funds to purchase excluded property that is shares of yet another affiliate of the taxpayer (the "third affiliate") in respect of which the taxpayer has a qualifying interest throughout the year.

The interest paid to the first affiliate by the second affiliate would otherwise be income from property of the first affiliate.

The second affiliate did not carry on an active business and did not deduct the interest in computing the amount prescribed to be its earnings or loss from that active business carried on outside Canada.

The second and third affiliates are resident and subject to income taxation in the same country.

The interest paid or payable by the second affiliate to the first affiliate is relevant in computing the liability for income taxes of the members of a group of corporations composed of the second affiliate and one or more other affiliates of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year that are resident and subject to income taxation in the same country as the second affiliate.

Tax consolidation is used by the group of foreign affiliates of the taxpayer.

### Application of Subparagraph 95(2)(a)(ii)

Proposed new clause 95(2)(a)(ii)(D) will treat the income of the first affiliate derived from the interest paid to it by the second affiliate as active business income.

Proposed new subsection 5907(2.8) of the *Income Tax Regulations* requires the second affiliate to deduct the interest paid to the first affiliate in computing its active business earnings or loss from an active business in the year that includes the earlier of the day on which the interest is paid and the day on which the interest becomes payable and will deem the second affiliate to be carrying on an active business in the country in which it is resident if it does not do so.

Where the first affiliate is resident in a designated treaty country, proposed subclause 5907(1)(b)(iv)(B)(VIII) of the *Income Tax Regulations* includes the income deemed to be active business income in computing its exempt earnings or loss provided that conditions set out therein are satisfied.

Proposed new subparagraph 95(2)(a)(iii) of the Act includes in the income from an active business for a taxation year of a particular foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year its income for the year derived from the factoring of accounts receivable acquired by it or by a partnership of which it was a member from a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year. The accounts receivable must have arisen in the course of an active business carried on outside Canada by the non-resident corporation.

Proposed new subparagraph 95(2)(a)(iv) of the Act includes in the income from an active business for a taxation year of a particular foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year its income for the year derived from loans or lending assets acquired by the particular affiliate or a partnership of which it was a member from a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year. The loans and lending assets must have arisen in the course of an active business carried on outside Canada by the non-resident corporation.

## ITA

## 95(2)(a.1)

Proposed new paragraph 95(2)(a.1) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. It includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the sale of property (including the income derived from services as agent provided in relation to a purchase or sale of property) where

- the cost of the property (other than property manufactured produced, grown, extracted or processed in Canada by the taxpayer or a person with which the taxpayer does not deal at arm's length in the course of carrying on a business in Canada that was subsequently sold to non-resident persons other than the affiliate or to the affiliate for sale to non-resident persons) is relevant in computing the income from a business carried on by the taxpayer or persons resident in Canada that do not deal at arm's length with the taxpayer or a business carried on in Canada by non-resident persons that do not deal at arm's length with the taxpayer, and
- the property was not manufactured, produced, grown, extracted or processed in the country under whose laws the affiliate was formed or organized and in which the affiliate's business was principally carried on.

The rule does not apply where more than 90% of the gross income of the affiliate from the sale of property is derived from sales of property (other than property the cost of which falls within the rules described above) to persons that deal at arm's length with the affiliate, which, for this purpose, includes a sale of property to a related non-resident corporation for sale by it to arm's length persons. Where the rule applies to the foreign affiliate of the taxpayer, the sale of such property is deemed to be a separate business other than an active business of the affiliate. Any income that pertains or is incident to that business is also deemed to be income of the affiliate from a business other than an active business of the affiliate.



This new rule will discourage the establishment of a foreign subsidiary by a corporation for the purpose of purchasing goods (and the provision of services as an agent in relation to a purchase or sale of goods) for resale or use in a business carried on in Canada either by the corporation itself or by any person with whom the corporation does not deal at arm's length.

## **EXAMPLE 11**

### Facts

Canco is a corporation resident in Canada that carries on a manufacturing business in Canada.

Canco purchases raw materials for its manufacturing business from suppliers in foreign country "X".

Canco is able to negotiate a bargain purchase price for its raw materials which is less than the price paid by its competitors.

Canco establishes a wholly-owned purchasing and sales subsidiary (F) in a foreign country "Y" with favourable tax rates for the purpose of purchasing the raw materials and selling them to Canco at a profit.

F makes a profit for the year from the purchase of the raw materials from the foreign supplier and the sale of the raw materials to Canco of \$1,000,000.

### Application of paragraph 95(2)(a.1)

The sale of the raw materials by F to Canco is deemed to be a separate business other than an active business of F.

The \$1,000,000 of income of F derived from the separate business is income from a business other than an active business of F and is included in the foreign accrual property income of F. Canco must include the foreign accrual property income of F in its income.

ITA

95(2)(a.2)

Proposed new paragraph 95(2)(a.2) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. It includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the insurance of risks (including income from the reinsurance of risk) where the risks insured were in respect of

- a person resident in Canada
- property situated in Canada, or
- a business carried on in Canada.

The rule does not apply where more than 90% of the gross premium income of the affiliate from the insurance (net of reinsurance ceded) of risks was derived from the insurance of other risks of persons with whom the affiliate deals at arm's length. Where the rule applies to the foreign affiliate of the taxpayer, the insurance of those risks is deemed to be a separate business other than an active business of the affiliate. The income derived from the investment of the insurance premiums and the surplus required to provide for those risks that are being insured is income from that separate business. Income derived from the investment of assets derived from that business that are not employed or at risk in that business is income from property.

The purpose of this new rule is to protect the Canadian tax base from erosion through the use of foreign affiliates by Canadian corporations to insure risks in Canada.

## EXAMPLE 12

### Facts

Canco is a corporation resident in Canada that carries on the business of a financial institution.

Canco sells insurance to or arranges for insurance for its customers as part of its business carried on in Canada.

Canco incorporates a wholly-owned subsidiary F in a foreign country with favourable tax rates for the purposes of insuring risks in respect of its Canadian customers.

Canco directs the insurance premiums and business to F.

F has income of \$1,000,000 from the insurance of risks of persons resident in Canada.

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

The insurance of the risks of persons resident in Canada by F is deemed to be a separate business other than an active business of F.

The \$1,000,000 of income of F derived from the separate business is income from a business other than an active business of F and is included in the foreign accrual property income of F. Canco must include the foreign accrual property income of F in its income.

ITA  
95(2)(a.3)

Proposed new paragraph 95(2)(a.3) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. It includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate derived directly or indirectly from indebtedness (other than specified deposits with a prescribed financial institution) or lease obligations (including any income of the affiliate derived from the purchase or sale of indebtedness and lease obligations on its own account) of persons resident in Canada or in respect of businesses carried on in Canada. The word "indirectly" is intended to refer to transactions designed to avoid the rule, for example, back-to-back arrangements where risks

and rewards of a particular Canadian indebtedness or lease obligation rest with the foreign affiliate. Lease obligation is defined in a proposed new definition in subsection 95(1) of the Act to include an obligation under a license. "Specified deposit" is defined in proposed new paragraph 95(2)(q) of the Act. Prescribed financial institutions are set out in section 7900 of the *Income Tax Regulations*.

The rule does not apply where more than 90% of the gross income of the foreign affiliate for the year that was derived directly or indirectly from indebtedness and lease obligations was derived directly or indirectly from indebtedness or lease obligations of non-resident persons with whom the affiliate was dealing at arm's length. Where the rule applies to the foreign affiliate of the taxpayer, those activities are deemed to constitute a separate business other than an active business of the affiliate. Any income incident to or pertaining to that business is deemed to be income of the affiliate from a business other than an active business of the affiliate.

The purpose of this new rule is to protect the Canadian tax base from erosion, for example, through the use of foreign affiliates by Canadian corporations in the financing and leasing and licensing business to acquire debt and lease obligations of persons resident in Canada.

### EXAMPLE 13

#### Facts

Canco is a corporation resident in Canada that carries on the business of a financial institution.

Canco makes loans to or arranges for loans for its customers as part of its business carried on in Canada.

Canco incorporates a wholly owned subsidiary F in a foreign country with favourable tax rates for the purposes of making loans to or purchasing loans made to its Canadian customers.

Canco directs the lending business and sells loans to F.

F has income of \$1,000,000 derived from loans made to persons resident in Canada.

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

The lending of money to or the acquisition of loans of persons resident in Canada by F is deemed to be a separate business other than an active business of F.

The \$1,000,000 of income of F derived from the separate business is income from a business other than an active business of F and is included in the foreign accrual property income of F. Canco must include the foreign accrual property income of F in its income.

ITA

95(2)(a.4)

Proposed new paragraph 95(2)(a.4) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. It includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, a portion of the income of the affiliate for a year derived directly or indirectly from indebtedness or lease obligations (including any income of the affiliate derived from the purchase or sale of indebtedness and lease obligations on its own account) in respect of businesses carried on outside Canada by a partnership where the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length (the non-arm's length persons) includes any income or loss of the partnership in computing its income or loss either directly or indirectly. It does not apply to income of the affiliate included in the affiliate's income from a business other than an active business under paragraph (a.3).

It applies to that proportion of such income of the affiliate that the total of the taxpayer's and the non-arm's length persons' shares of the income or loss of the partnership is of the total income or loss of the partnership for fiscal periods of the partnership ending in the year. Where the partnership does not have an income or loss for a fiscal period, it is assumed to have income of \$1,000,000 for the purpose of calculating the proportion of the affiliate's income derived directly or indirectly from indebtedness or lease obligations in respect of

businesses carried on outside Canada by the partnership that is to be included in the affiliate's income from a business other than an active business.

The rule does not apply where more than 90% of the gross income of the foreign affiliate for the year was derived directly or indirectly from indebtedness or lease obligations of non-resident persons with whom the affiliate was dealing at arm's length (other than indebtedness and lease obligations of partnerships described in this proposed new paragraph). Where the rule applies to the foreign affiliate of the taxpayer, those activities are deemed to constitute a separate business other than an active business of the affiliate. Any income incident to or pertaining to that business is deemed to be income of the affiliate from that separate business.

This rule protects the Canadian tax base where a foreign affiliate of a taxpayer loans funds to a partnership (such as a limited partnership) and non-arm's length persons resident in Canada share in the partnership income or loss. The income of the affiliate derived from the indebtedness and lease obligations of the partnership is to be included in the income of the affiliate from a business other than an active business and foreign accrual property income to the extent of the non-arm's length persons' proportionate shares of the partnership's income or loss. In this way, any Canadian tax base erosion through the use of affiliate loans to a partnership is eliminated.

#### **EXAMPLE 14**

##### Facts

Canco is a member of a partnership that carries on a business in a foreign country. Canco has a 90% share of the partnership income or loss. The only other partner is X, a wholly-owned foreign affiliate of Canco.

Canco incorporates a wholly-owned subsidiary (F) in a foreign country with favourable tax rates to serve as a financing affiliate and invests \$10,000,000 in its capital.

F loans at 10% interest the \$10,000,000 to the partnership for use in its business. F derives income of \$1,000,000 from the loan.

The partnership incurs a loss of \$700,000 in the conduct of its active business which is carried on in a designated treaty country. Canco's share of the loss is \$630,000 and X's share of the loss is \$70,000.

Application of paragraph 95(2)(a.4)

F must include \$900,000 of its income derived from the loan to the partnership in its income from a business other than an active business and its foreign accrual property income. The remaining \$100,000 of income of F derived from the loan to the partnership is income from property to which the rule in clause 95(2)(a)(ii)(B) would apply.

Canco would report a foreign business loss of \$630,000 as its share of the partnership loss of \$700,000. Canco has, in effect, realized, directly or indirectly, a profit of \$370,000 with respect to the activities of the partnership -- that is \$1,000,000 of income derived by its financing affiliate setoff by \$630,000 of the partnership loss. Only \$100,000 (that portion of F's income to which the rule in clause 95(2)(a)(ii)(B) applies) is recognized as income from an active business, the remaining \$900,000 would be included in F's foreign accrual property income.

ITA  
95(2)(k)

Proposed new paragraph 95(2)(k) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

The proposed new paragraph provides a start-up rule that is to apply to a foreign affiliate of a taxpayer in respect of a business (foreign business) that is to be considered to be an investment business as defined in subsection 95(1) of the Act or a separate business other than an active business under proposed paragraphs 95(2)(a.1), (a.2),

(a.3) or (a.4) of the Act. It provides rules for computing the income of the affiliate from the foreign business for the first and subsequent taxation years in which such business is considered to be carried on.

For the purposes of computing the income of the affiliate from the foreign business for the first taxation year and each subsequent taxation year in which the foreign business is carried on, the following rules are provided.

- The affiliate is deemed to have commenced to carry on the foreign business in Canada at the later of the commencement of the first taxation year and the time it commenced to carry on the business and to have carried on the foreign business in Canada throughout that part of the first year or any subsequent taxation year in which the affiliate carried on the foreign business.
- Where the foreign business is a business in respect of which the affiliate would, if the foreign business were carried on in Canada, be required by law to report to a regulating authority such as the Superintendent of Financial Institutions or a similar authority of a province, the affiliate shall be deemed to have been subject to the supervision of such regulating authority.
- Paragraphs 138(11.91)(c) to (f) of the Act are to apply to the affiliate in respect of the foreign business as if the affiliate were the insurer referred to in subsection 138(11.91), the first year were the particular year referred to therein and the foreign business were the business of the insurer referred to therein.

The purpose of these rules is to ensure that the income of the affiliate from the foreign business is calculated appropriately using Canadian tax rules. For example, in the first year the affiliate is assumed to have claimed maximum reserves in the immediately preceding year. As well, there is a deemed disposition and reacquisition of property used or held in the foreign business immediately before the commencement of the first taxation year. Other rules exist in subsection 138(11.91). These fresh start rules are to apply to all affiliates and are designed to ensure that income or losses accruing in prior periods do not enter into the income calculations for the foreign business in the first or subsequent taxation years. The rule deeming



the affiliate to be subject to the supervision of a regulating authority is to permit the affiliate to claim certain insurance reserves.

## EXAMPLE 15

### Facts

F is a wholly owned foreign affiliate of Canco which is deemed to carry on a separate business other than an active business under paragraph 95(2)(a.2). The separate business is the insurance of Canadian risks.

F has accrued gains on property used or held in the business of \$1,000,000 and was entitled to claim reserves of \$2,000,000 as at the end of its taxation year ending on December 31, 1994.

The first taxation year of F in respect of which paragraph 95(2)(k) applies to the separate business is the year ended December 31, 1995.

### Application of Paragraph 95(2)(k)

F is deemed to have a taxation year ending December 31, 1994 and to have claimed maximum reserves for that year of \$2,000,000. As well, F is deemed to have disposed of and reacquired the property used or held in the foreign business at its fair market value as at December 31, 1994 recognizing the accrued gain of \$1,000,000 in its 1994 taxation year.

For its 1995 taxation year, F calculates its income from the foreign business using Canadian income tax rules, as if it had claimed maximum reserves in the immediately preceding taxation year and as if the cost of the property used or held in the foreign business was its fair market value as at December 31, 1994.

### ITA

#### 95(2)(l)

Proposed new paragraph 95(2)(l) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and

after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

This proposed new paragraph provides a rule for the purposes of proposed new paragraph 95(2)(a.3) of the Act. It provides that paragraph 95(2)(a.3) will not apply in respect of income derived by a foreign affiliate of a taxpayer directly or indirectly from indebtedness to the extent that

- such income was derived by the affiliate in the course of a business carried on by it as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the activities of which are regulated in the jurisdiction in which it was formed or continued and exists and is governed and in which the business was principally carried on, and
- such income was derived from the trading or dealing in such indebtedness with persons resident in a country other than Canada in which the affiliate and its similarly regulated competitors compete and have a substantial market presence (foreign business).

For this purpose, income from trading and dealing includes interest income from indebtedness acquired for trading and dealing. As well, the acquisition of indebtedness by the affiliate from the taxpayer for trading and dealing in the affiliate's foreign business is considered to be a foreign business transaction where the terms and conditions of the acquisition and sale are arm's length terms and conditions.

ITA

95(2)(m)

Proposed new paragraph 95(2)(m) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

This proposed new paragraph includes certain business income of a foreign affiliate of a taxpayer in its income from property. It applies

to the affiliate in respect of its income from a business (other than an investment business) the principal purpose of which is to derive income from the trading or dealing in indebtedness (which, for this purpose, includes interest on indebtedness). This rule does not apply with respect to indebtedness of arm's length persons resident in the country in which the affiliate was formed or continued and is governed and exists and in which its business is principally carried on nor with respect to accounts receivable owing by arm's length persons.

The rule does not apply where the taxpayer is a regulated financial institution in Canada and the business is carried on by its foreign affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the activities of which are regulated in the jurisdiction in which it was formed or continued and exists and in which the business was principally carried on. A regulated financial institution is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority.

ITA

95(2)(n)

Proposed new paragraph 95(2)(n) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

This proposed new paragraph provides a rule for the purposes of proposed new paragraph 95(2)(a.3) of the Act. It provides that indebtedness shall not include any obligations of a taxpayer under agreements with non-resident corporations providing for the purchase, sale or exchange of currency where:

- the agreements are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements or options or rights agreements or similar agreements,

- the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority,
- the agreements are entered into by the non-resident corporation in the course of a business carried on principally with arm's length persons in the country in which the non-resident corporation was formed or continued and exists and is governed and in which the business is principally carried on by it, and
- the terms and conditions of the agreements are arm's length terms and conditions.

This rule will permit foreign affiliates of Canadian taxpayers to deal with the foreign branches of Canadian financial institutions with respect to the currency needs of their foreign businesses. Such currency transactions of the affiliates will be afforded the same tax treatment given similar transactions conducted with foreign financial institutions.

#### ITA

#### 95(2)(o)

Proposed new paragraph 95(2)(o) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

This proposed new paragraph provides a rule for the purposes of proposed new paragraph 95(2)(a.1). It provides that paragraph 95(2)(a.1) will not apply to a foreign affiliate of a taxpayer in the respect of a sale or exchange of currency or a right to sell or exchange currency where

- the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the

Superintendent of Financial Institutions or a similar provincial authority,

- the sale or exchange was made by the foreign affiliate in the course of a business carried on principally with arm's length persons in the country in which the affiliate was formed or continued and exists and is governed and in which the business is principally carried on by it, and
- the terms and conditions of the sale or exchange are arm's length terms and conditions.

This rule will permit foreign affiliates of Canadian taxpayers to deal with the foreign branches of Canadian financial institutions with respect to the currency needs of their foreign businesses. Such currency transactions of the affiliates will be afforded the same tax treatment given similar transactions conducted with foreign financial institutions.

ITA

95(2)(p)

Proposed new paragraph 95(2)(p) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

This proposed new paragraph provides a rule for the purposes of the proposed new definition "investment business" in subsection 95(1). It provides that a foreign affiliate of a taxpayer and the taxpayer will be considered to be dealing with each other at arm's length in respect of the entering into and the execution of agreements providing for a purchase or sale or exchange of currency where

- the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority,

- the agreements are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, options or rights agreements or similar agreements,
- the agreements are entered into by the foreign affiliate in the course of a business carried on principally with arm's length persons in the country in which the affiliate was formed or continued and exists and is governed and in which the business is principally carried on by it, and
- the terms and conditions of the sale or exchange are arm's length terms and conditions.

This rule will permit foreign affiliates of Canadian taxpayers to deal with the foreign branches of Canadian financial institutions with respect to the currency needs of their foreign businesses. Such currency transactions of the affiliates will be afforded the same tax treatment given similar transactions conducted with foreign financial institutions.

ITA  
95(2)(q)

Proposed new paragraph 95(2)(q) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

It defines "specified deposit" for the purposes of proposed new paragraph 95(2)(a.3) of the Act. A specified deposit is a deposit of a foreign affiliate of a taxpayer with a prescribed financial institution (prescribed in section 7900 of the Income Tax Regulations) where

- the income of the affiliate from the deposit is income that would, but for paragraph 95(2)(a.3), be income from an active business other than a business the principal purpose of which is to derive income from property including interest, dividends, rents, royalties or similar returns or substitutes therefore or profits from the disposition of investment property, or

- the income is derived from a deposit of funds derived in the ordinary course of carrying on business activities with arm's length persons in the course of a business that, but for paragraph 95(2)(a.3), would be an active business conducted principally with arm's length persons.

The purpose of this rule is to treat bank deposits of foreign affiliates with foreign branches of Canadian deposit taking financial institutions the same as deposits with foreign financial institutions.

ITA

95(2)(r)

Proposed new paragraph 95(2)(r) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

The proposed new paragraph defines when a taxpayer has a qualifying interest in a foreign affiliate of the taxpayer and is relevant for the purposes of the amended paragraph 95(2)(a) of the Act. A taxpayer will have a qualifying interest in a foreign affiliate of a taxpayer at any time the taxpayer owned

- not less than 10% of the issued and outstanding shares having full voting rights under all circumstances of the affiliate, and
- shares of the affiliate having a fair market value of not less than 10% of the fair market value of all the issued and outstanding shares of the affiliate.

It also provides special rules for the purposes of this ownership test.

- Shares of one corporation held by another corporation are deemed to be held by the shareholders of the holding corporation in a proportion determined by reference to the shareholder's percentage fair market value interest in the corporation.
- Shares of a corporation held by a partnership are deemed to be held by the partners in a proportion based on the partners'

percentage share of the income or loss of the partnership. The partnership is assumed for this purpose to have \$1,000,000 of income where it has no income or loss.

- A taxpayer that holds convertible property issued by the affiliate and outstanding at June 23, 1994 can elect to treat all such property as having been converted into shares as provided for under the terms and conditions of the convertible property.

ITA

95(2)(s)

Proposed new paragraph 95(2)(s) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994.

The proposed new paragraph provides a rule for the purposes of paragraph 95(2)(a) of the Act. It provides that a non-resident corporation that was not a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest throughout a particular year shall be deemed to be a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest throughout that year where

- the taxpayer has, in that year, acquired or disposed of shares of that non-resident corporation, and
- at the commencement of that year or at the end of that year, the non-resident corporation was a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest.

### **Where Rights or Shares are Acquired or Disposed of to Avoid Tax**

ITA

95(6)

Subsection 95(6) of the Act is an anti-avoidance rule designed to prevent the avoidance of tax through the use of rights to acquire



shares or the issuance of shares. It applies for the purposes of subdivision i of the Act.

The subsection has been amended in a number of ways and is consequential to the amendments to paragraph 95(2)(a) of the Act and the general concern with respect to tax avoidance. The amended subsection applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the amended subsection will apply to taxation years of such foreign affiliate that end after 1994.

The amendment to the preamble of subsection 95(6) provides that the rule does not apply for the purposes of section 90 of the Act. Section 90 simply includes in the income of a taxpayer resident in Canada a dividend received by the taxpayer on a share of a non-resident corporation owned by the taxpayer.

Paragraph 95(6)(a) has been amended in a number of ways. First, the "one of the main reasons test" is replaced by a "principal purpose" test consistent with the test in proposed new paragraph (b). Second, it has been made to apply to persons and partnerships. Finally, it has been made to apply where the principal purpose for the existence of any right is to make two or more corporations related for the purposes of paragraph 95(2)(a) or to avoid, defer or reduce any amounts payable under the Act. In the first case, the corporations are deemed not to be related for the purposes of paragraph 95(2)(a) and, in any other case, the shares that could be acquired under the right are deemed to be owned.

Paragraph 95(6)(b) has been rewritten and applies to an acquisition or disposition of shares where the principal purpose for such acquisition or disposition was the avoidance, reduction or deferral of amounts payable under the Act. If the principal purpose exists, the shares are deemed not to have been acquired or disposed of and previously unissued shares are deemed not to have been issued.

## EXAMPLE 16

### Facts

Canco is a corporation resident in Canada that has a wholly owned foreign subsidiary (FC) which carries on an active business in a designated treaty country. Only one class of shares of FC are outstanding.

XCo is another corporation resident in Canada that is not related to Canco that is to lend money to FC for use in its foreign business. XCo forms a wholly-owned subsidiary (FX) in a designated treaty country for the purpose of making the loan to FC. FX does not carry on a business.

To take advantage of the rules in paragraph 95(2)(a) of the Act (which would permit FX to include its income from property derived from the loan in its active business income), XCo acquires a 11% interest in the outstanding shares of FC from Canco which are to be sold back to Canco when the loan is repaid. Canco has a right of first refusal at an agreed price in the event that XCo is to sell the shares.

FX includes the income derived from the loan in its active business income under subparagraph 95(2)(a)(ii) of the Act.

### Application of subsection 95(6) of the Act

The shares of FC acquired by XCo shall be deemed not to have been disposed of by Canco or acquired by XCo since the principal purpose for the acquisition was the avoidance of Canadian tax on the foreign accrual property income of FX derived from the loan to FC.

The income of FX derived from the loan to FC will be property income of FX and will be included in its foreign accrual property income (FAPI). XCo will include the FAPI in its income for Canadian income tax purposes.

**Business**

ITA

248(1)

Subsection 248(1) of the Act provides definitions for the purposes of the Act. The definition of "business" includes an adventure or concern in the nature of trade except for certain purposes. That definition is being amended to ensure that it does not include an adventure or concern in the nature of trade for the purposes of the proposed new definitions in subsection 95(1) of the Act. Any income of a foreign affiliate arising from an adventure or concern in the nature of trade is included in the affiliate's "income from property" as that expression is defined.

The amendment is applicable to taxation years that end after 1994.

---

Revised Draft Amendments  
to the *Income Tax Regulations*

---



## Insurance Reserves

**1. Section 1402 of the *Income Tax Regulations* is replaced by the following:**

1402. (1) For the purposes of sections 1400 and 1401, any amounts determined under those sections shall be determined on a net of reinsurance ceded basis. 5

(2) For the purposes of sections 1400 and 1401, where an insurer is a foreign affiliate of a taxpayer resident in Canada and the amounts to be determined under those sections are in respect of a business that is

(a) an investment business of the affiliate, as defined in subsection 95(1) of the Act, or 10

(b) a separate business, other than an active business, of the affiliate that the affiliate is deemed, under paragraph 95(2)(a.2) of the Act, to carry on,

the amounts determined under those sections in respect of the business shall not exceed an amount that is reasonable having regard to all the circumstances and shall be determined as if the business were carried on in Canada and the affiliate were subject to the supervision of the Superintendent of Financial Institutions. 15

## Deductible Loss 20

**2. Subsections 5903(1) and (2) of the Regulations are replaced by the following:**

5903. (1) For the purpose of the description of F in the definition "foreign accrual property income" in subsection 95(1) of the Act, the amount prescribed to be the deductible loss of a foreign affiliate of a taxpayer for a taxation year and the 5 immediately preceding taxation years (each of which preceding taxation years is referred to in this subsection as a "preceding year") is the amount, if any, by which 25

(a) the total of all amounts each of which is the amount, if any, for each of the preceding years of the affiliate during which it was a controlled foreign affiliate of the taxpayer or of a person described in any of subparagraphs 95(2)(f)(iv) to (vii) of the Act, by which 30

(i) the total of the amounts determined for D and E in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of the affiliate for that preceding year 35

exceeds

(ii) the total of the amounts determined for A, B and C in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of the affiliate for that preceding year

exceeds the total of

5

(b) the total of all amounts each of which is an amount determined for F in the definition "foreign accrual property income" in subsection 95(1) of the Act for the purpose of computing amounts to be included in the income of the taxpayer or a person described in any of subparagraphs 95(2)(f)(iv) to (vii) of the Act under subsection 91(1) of the Act in respect of any preceding year of the affiliate, to the extent that the amount relates to a loss of the affiliate described in the description of D or E in the definition "foreign accrual property income" in subsection 95(1) of the Act for any preceding year, and

10

15

(c) where a payment has been received by the foreign affiliate and the payment can reasonably be considered to relate to a payment described in subsection 5907(1.3) made by another foreign affiliate of the taxpayer in respect of a loss, or any portion of a loss, of the affiliate described in the description of D or E in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of any preceding year of the affiliate, the amount of that loss or portion.

20

(1.1) For the purpose of paragraph (1)(b), it shall be assumed that no amount is included in F in the definition "foreign accrual property income" in subsection 95(1) of the Act for any year in respect of a loss until the maximum amount of a loss for preceding taxation years has been deducted or included.

25

(2) For the purposes of subsection (1), each amount referred to in paragraph (1)(c) in respect of a controlled foreign affiliate of a taxpayer resident in Canada that is not otherwise determined in Canadian currency shall be converted to Canadian currency at the rate of exchange prevailing on the last day of the affiliate's taxation year in respect of which the amount determined under subsection (1) is being used to determine the foreign affiliate's foreign accrual property income (as defined in subsection 95(1) of the Act).

30

35

## Exempt Earnings

### 3. (1) Subparagraph 5907(1)(b)(iv) of the Regulations is replaced by the following:

(iv) for the 1976 or any subsequent taxation year, where the affiliate is resident in a designated treaty country, each amount that is 5

(A) the affiliate's net earnings for the year from an active business carried on by it in Canada or a designated treaty country, or

(B) the earnings of the affiliate for the year from an active business to the extent that they derive from 10

(I) amounts by which the income of the affiliate from an active business for the year is increased because of subparagraph 95(2)(a)(i) of the Act that are derived by the affiliate from activities that could reasonably be considered to be directly related to business activities carried on by a non-resident corporation to which the affiliate and the corporation are related throughout the year in the course an active business carried on by the non-resident corporation the income from which would, if the non-resident corporation were a foreign affiliate of a corporation, be included in computing its exempt earnings or exempt loss, 15 20

(II) amounts by which the income of the affiliate from an active business for the year is increased because of subparagraph 95(2)(a)(i) of the Act that are derived by the affiliate from activities that could reasonably be considered to be directly related to business activities carried on by the corporation, where the corporation is a life insurance corporation resident in Canada throughout the year and the affiliate is a foreign affiliate in respect of which the corporation has a qualifying interest throughout the year, in the course of an active business carried on by the corporation the income from which would, if the corporation were a foreign affiliate of a corporation, be included in computing its exempt earnings or exempt loss, 25 30 35

(III) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(A) of the Act that are derived from amounts paid or payable to it by a non-resident corporation to which the affiliate and the corporation are related throughout the year, to the extent that the amounts paid or 40



payable by the non-resident corporation are for expenditures that, if the non-resident corporation were a foreign affiliate of a corporation, would be deductible by the non-resident corporation in the year or a subsequent year in computing its exempt earnings or exempt loss,

5

(IV) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(A) of the Act that are derived from amounts paid or payable to it by a partnership where a non-resident corporation to which the affiliate and the corporation are related throughout the year is a member of the partnership (other than where the non-resident corporation is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that the amounts paid or payable by the partnership are for expenditures that, if the partnership were a foreign affiliate of a corporation, would be deductible by the partnership in the year or a subsequent year in computing its exempt earnings or exempt loss,

10

15

(V) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(B) of the Act that are derived from amounts paid or payable to it by another foreign affiliate of the corporation in respect of which the corporation has a qualifying interest throughout the year, to the extent that the amounts paid or payable by the other foreign affiliate are for expenditures that would be deductible by it in the year or a subsequent year in computing its exempt earnings or exempt loss,

20

25

(VI) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(B) of the Act that are derived from amounts paid or payable to it by a partnership where another foreign affiliate of the corporation in respect of which the corporation has a qualifying interest throughout the year is a member of the partnership (other than where the other foreign affiliate is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that the amounts paid or payable by the partnership are for expenditures that, if the partnership were a foreign affiliate of a corporation, would be deductible by the partnership in the year or a subsequent year in computing its exempt earnings or exempt loss,

30

35

40

(VII) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(C) of the Act that are derived from amounts paid or payable to it by a partnership where the affiliate is a member of the partnership (other than where the affiliate is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that the amounts paid or payable by the partnership are for expenditures that, if the partnership were a foreign affiliate of a corporation, would be deductible by the partnership in the year or a subsequent year in computing its exempt earnings or exempt loss,

(VIII) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(D) of the Act that are derived from amounts paid or payable to it by another foreign affiliate of the corporation (in this subclause referred to as the "second affiliate") to which the affiliate and the corporation are related throughout the year, to the extent that the amounts paid or payable

1. are on account of interest on borrowed money used for the purpose of earning income from property or interest on an amount payable for property, where

(1) the property is shares of a foreign affiliate of the corporation (in this clause referred to as the "third affiliate") in respect of which the corporation has a qualifying interest throughout the year and that are excluded property, and

(2) the second affiliate, the third affiliate and each other affiliate relevant for the purposes of determining whether the shares of the third affiliate are excluded property are resident and subject to income taxation in a designated treaty country, and

2. are relevant in computing the liability for income taxes, in the designated treaty country in which the second and third affiliate are resident, of the members of a group of corporations composed of the second affiliate and one or more other foreign affiliates of the corporation (the shares of which are excluded property) that are resident in that country and in respect of which the corporation has a qualifying interest throughout the year

and, for the purposes of this subclause,

3. the definition "excluded property" in subsection 95(1) of the Act shall be read without reference to amounts receivable referred to in paragraph (c) of that definition where the interest on the amounts is not, or would not if interest were payable on the amounts, be deductible by the debtor in computing its exempt earnings or exempt loss, and 5

4. the shares of a foreign affiliate (in this subclause referred to as the "non-qualifying affiliate") which is not resident and subject to income taxation in a designated treaty country shall not be considered relevant for the purposes of determining whether shares of the third affiliate are excluded property unless the shares of the third affiliate would not have been excluded property if the shares of all such non-qualifying affiliates were not excluded property, 10 15

(IX) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(a)(ii)(E) of the Act that are derived from amounts paid or payable to it by a life insurance corporation resident in Canada, of which the affiliate is a foreign affiliate in respect of which the corporation has a qualifying interest throughout the year, to the extent that, if the life insurance corporation were a foreign affiliate of a corporation, the amounts paid or payable by the life insurance corporation are for expenditures that would be deductible by it in the year or in a subsequent year in computing its exempt earnings or exempt loss, 20 25

(X) amounts by which the income of the affiliate from an active business for the year is increased because of paragraph 95(2)(a)(iii) of the Act that are derived from the factoring of accounts receivable acquired by the affiliate, or by a partnership of which the affiliate was a member, from a non-resident corporation to which the affiliate and the corporation are related throughout the year, to the extent that the accounts receivable arose in the course of an active business carried on by the non-resident corporation any income from which would be included in the exempt earnings of the non-resident corporation if it were a foreign affiliate of a corporation, or 30 35 40

(XI) amounts by which the income of the affiliate from an active business for the year is increased because of paragraph 95(2)(a)(iv) of the Act that are derived from loans or lending assets acquired by the affiliate, or by a partnership of which the affiliate was a member, from a non-resident corporation to which the affiliate and the corporation are related throughout the year, to the extent that the loans or lending assets arose in the course of an active business carried on by the non-resident corporation any income from which would be included in the exempt earnings of the non-resident corporation if it were a foreign affiliate of a corporation, or

### **Exempt Loss**

**(2) Subparagraph 5907(1)(c)(iii) of the Regulations is replaced by the following:**

(iii) for the 1976 or any subsequent taxation year where the affiliate is resident in a designated treaty country, each amount that is the affiliate's net loss for the year from an active business carried on by it in Canada or in a designated treaty country, or

### **Net Earnings**

**(3) That portion of subparagraph 5907(1)(f)(iii) of the Regulations before clause (A) is replaced by the following:**

(iii) from dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada) is the amount, if any, by which

### **Net Loss**

**(4) That portion of subparagraph 5907(1)(g)(iii) of the Regulations before clause (A) is replaced by the following:**

(iii) from dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada) is the amount, if any, by which

## **Taxable Earnings**

**(5) Clause 5907(1)(i)(ii)(D) of the Regulations is replaced by the following:**

(D) the affiliate's net earnings for the year from dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada), or

5

## **Taxable Loss**

**(6) Clause 5907(1)(j)(ii)(C) of the Regulations is replaced by the following:**

10

(C) the affiliate's net loss for the year from dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada), or

15

## **Rules for Computing Active Business Earnings**

**(7) Section 5907 of the Regulations is amended by adding the following after subsection (1):**

(1.01) In subparagraph 5907(1)(b)(iv), the determination of whether a corporation

20

(a) has a "qualifying interest" in respect of a foreign affiliate throughout a taxation year, or

(b) is related to another corporation throughout a taxation year

shall be made as it would for the purposes of paragraph 95(2)(a) of the Act.

25

**(8) That portion of subsection 5907(2.1) of the Regulations before paragraph (a) is replaced by the following:**

(2.1) In computing the earnings of a foreign affiliate of a corporation resident in Canada for a taxation year of the affiliate from an active business carried on by it in Canada or in a designated treaty country, where the affiliate is resident in a designated treaty country and the corporation, together with all other corporations resident in Canada with which the corporation does not deal at arm's length and in respect of which the affiliate is a foreign affiliate, have so elected in respect of the

30

35

business for the taxation year or any preceding taxation year of the affiliate, the following rules apply:

**(9) Section 5907 of the Regulations is amended by adding the following after subsection (2.6):**

(2.7) Notwithstanding any other provision of this Part, where

5

(a) an amount is included in computing the income or loss from an active business of a particular foreign affiliate of a taxpayer for a particular taxation year under subparagraph 95(2)(a)(i) or (ii) of the Act, and

(b) the amount included is in respect of an amount paid or payable (other than an amount paid or payable that is described in clause 95(2)(a)(ii)(D) of the Act) by another non-resident corporation described in subparagraph 95(2)(a)(i) or (ii) of the Act,

10

in computing the earnings or loss from the active business of the non-resident corporation for a taxation year the amounts paid or payable by it (in respect of which an amount was included in the income or loss from an active business of the particular affiliate for the particular year) shall, except where the amounts paid or payable have been deducted by it under paragraph (2)(j) in computing its earnings or loss from an active business, be deducted by it in computing its earnings or loss from the active business for its taxation year that includes the earlier of the day on which the amount was paid and the day on which the amount became payable and not in any other taxation year.

15

20

(2.8) Notwithstanding any other provision of this Part, where

(a) an amount is included in computing the income from an active business of a particular foreign affiliate (in this subsection referred to as the "first affiliate") of a taxpayer or a person related to the taxpayer for a particular taxation year under clause 95(2)(a)(ii)(D) of the Act, and

25

(b) the amount included was in respect of an amount of interest paid or payable by another non-resident corporation (in this subsection referred to as the "second affiliate") to which the particular affiliate and the taxpayer are related

30

the second affiliate shall

(c) deduct that amount of interest in computing its income or loss, from an active business carried on by it in a country in which it is resident and subject to income taxation, for its taxation year that includes the earlier of the day on which the amount was paid by it and the day on which the amount became payable by it,

5

(d) be deemed to have carried on an active business in a country in which it was resident and subject to income taxation for each taxation year referred to in paragraph (c) in which such an active business was not otherwise carried on by it, and

(e) not deduct, in computing its income for a taxation year from any source, an amount in respect of an amount paid or payable by it that is referred to in paragraph (c) except as is required under that paragraph.

10

### **Treaty Countries and Residence in Treaty Countries**

**(10) Subsection 5907(11) of the Regulations is replaced by the following:**

15

(11) For the purposes of this Part, a country is a "designated treaty country" for a taxation year of a foreign affiliate of a corporation where Canada and that country have entered into a comprehensive agreement or convention for the elimination of double taxation on income that has entered into force and has effect for that taxation year of the affiliate but, for greater certainty, that country does not include any territory, possession, department, dependency or area of that country to which that agreement or convention does not apply.

20

(11.1) For the purposes of subsection (11), where a comprehensive agreement or convention between Canada and another country for the elimination of double taxation on income has entered into force, that convention or agreement shall be deemed to have entered into force and have effect in respect of a taxation year of a foreign affiliate of a corporation any day of which is in the period that begins on the day on which the agreement or convention was signed and that ends on the last day of the last taxation year of the affiliate for which the agreement or convention is effective.

25

30

(11.2) For the purposes of this Part, a foreign affiliate of a corporation shall, at any time, be deemed not to be resident in a country with which Canada has entered into a comprehensive agreement or convention for the elimination of double taxation on income unless

35

(a) the affiliate is, at that time, a resident of that country for the purposes of the agreement or convention;

(b) the affiliate would, at that time, be a resident of that country for the purposes of the agreement or convention if the affiliate were treated, for the purposes of income taxation in that country, as a body corporate; 5

(c) where the agreement or convention entered into force before 1995, the affiliate would, at that time, be a resident of that country for the purposes of the agreement or convention but for a provision in the agreement or convention that has not been amended after 1994 and that provides that the agreement or convention does not apply to the affiliate; or 10

(d) the affiliate would, at that time, be a resident of that country, as provided by paragraph (a), (b) or (c) if the agreement or convention had entered into force. 15

### **Prescribed Financial Institutions**

**4. That portion of section 7900 of the Regulations preceding paragraph (a) thereof is replaced by the following:**

7900. For the purposes of section 33.1, paragraph 95(2)(a.3), clause 212(1)(b)(iii)(D) and subparagraph 212(1)(b)(xi) of the Act, "prescribed financial institution" means 20

**5. Sections 1, 2 and 4 and subsections 3(1), (7) and (9) apply to taxation years of a foreign affiliate of a taxpayer that begin after 1994, except that**

(a) where there has been a change in the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, sections 1, 2 and 4 and subsections 3(1), (7) and (9) apply to taxation years of the affiliate that end after 1994; and 25

(b) in applying subparagraph 5907(1)(b)(iv) of the Regulations, as enacted by subsection 3(1), for taxation years of a foreign affiliate of a taxpayer that begin before 1996 and in respect of which subsections 3(2) to (6), (8) and (10) do not apply, the references to "designated treaty country" shall be read as "country listed in subsection (11)". 30



6. Subsections 3(2) to (6), (8) and (10) apply to taxation years of a foreign affiliate of a corporation that begin after 1995, except that, where the corporation notifies the Minister of National Revenue in its return of income for its first taxation year that begins after 1994 or for a taxation year in which a dividend was paid by the foreign affiliate of its election to have subsections 5907(11), (11.1) and (11.2) of the Regulations, as enacted by subsection 3(10), apply to a taxation year of the foreign affiliate of the corporation that begins before 1996,

5

(a) subsections 3(2) to (6), (8) and (10) apply to that taxation year that begins before 1996 and each subsequent taxation year of the foreign affiliate of the corporation; and

10

(b) any reference in section 5900 of the Regulations to "country listed in subsection (11)" shall be read as "designated treaty country" for that taxation year that begins before 1996 and each subsequent taxation year of the foreign affiliate of the corporation.

15

---

Explanatory Notes to  
Revised Draft Amendments  
– *Income Tax Regulations*

---

These explanatory notes are provided to assist in an understanding of amendments to the *Income Tax Act* and *Income Tax Application Rules*. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

## **Insurance Reserves**

ITR

1402

Section 1402 of the Regulations provides special rules for the purposes of determining reserves of insurance corporations. That section has been amended applicable to taxation years of foreign affiliates commencing after 1994 unless there has been a change to the taxation year of the foreign affiliate in 1994 and after February 22, 1994, in which case, it will apply to taxation years of such affiliate that ends after 1994.

The current section 1402 becomes subsection (1) and a proposed new subsection (2) of that section is being added. The proposed new subsection permits a foreign affiliate of a taxpayer that carries on an investment business as defined in the new definition in subsection 95(1) of the Act or a separate business deemed to be a business other than an active business of the affiliate under paragraph 95(2)(a.2) of the Act to claim insurance reserves of a reasonable amount in computing its income from such businesses. Such income is included in the affiliate's foreign accrual property income.

## **Deductible Loss**

ITR

5903(1), (1.1) and (2)

Subsection 95(1) of the Act defines foreign accrual property income of a foreign affiliate of a taxpayer. Foreign accrual property income is reduced by the amount of the prescribed "deductible losses" of the affiliate as determined under the rules in section 5903 of the Regulations. The deductible loss includes the losses of the affiliate for each of the five immediately preceding taxation years.

Subsections 5903(1) and (2) of the Regulations are being replaced by proposed new subsections 5903(1), (1.1) and (2) for taxation years of foreign affiliates that begin after 1994 unless there has been a change to the taxation year of the foreign affiliate in 1994 and after February 22, 1994, in which case, the proposed new subsections will apply to taxation years of such affiliate that end after 1994.

The proposed new subsections ensure that losses will be included in a deductible loss of a foreign affiliate of a taxpayer only where the affiliate is a controlled foreign affiliate of the taxpayer during the year the loss was incurred. As well, they provide that active business losses will not form part of a deductible loss of a foreign affiliate and will therefore no longer be available to reduce foreign accrual property income.

## **Exempt Earnings**

### **ITR**

#### **5907(1)(b)(iv)**

Paragraph 5907(1)(b) of the *Income Tax Regulations* defines exempt earnings of a foreign affiliate of a corporation for a taxation year. Subparagraph 5907(1)(b)(iv) includes in the exempt earnings of such a foreign affiliate resident in a country listed in subsection 5907(11) of the Regulations the net active business earnings of the affiliate from an active business carried on by it in countries listed in subsection 5907(11) of the Regulations and amounts deemed to be active business earnings of the affiliate under paragraph 95(2)(a) of the Act in certain circumstances.

The amendments to subparagraph 5907(1)(b)(iv) are consequential to the proposed amendments to paragraph 95(2)(a) of the Act and subsection 5907(11) of the Regulations and are applicable to taxation years of a foreign affiliate of a corporation that begin after 1994. However, where the affiliate has changed its year end in 1994 and after February 22, 1994, the amendments will apply to taxation years of the affiliate ending after 1994. As well, in applying the amended subparagraph 5907(1)(b)(iv) of the Regulations for taxation years that begin before 1996 and in respect of which the taxpayer has not elected to have proposed new subsections 5907(11), (11.1) and (11.2) of the Regulations apply, the reference in that subparagraph to "designated treaty country" shall be read as "country listed in subsection (11)".

The references in the subparagraph to "a country listed in subsection 5907(11)" are replaced by references to "a designated treaty country" as a consequence of the amendment to subsection 5907(11). The amendment to subsection 5907(11) removes the notion of countries being listed in that subsection and

now sets out when a country is considered to be a designated treaty country for a taxation year of a foreign affiliate of a corporation.

The proposed new subclause 5907(1)(b)(iv)(B)(I) includes in the exempt earnings of a foreign affiliate of a corporation the amounts determined under proposed new subparagraph 95(2)(a)(i) of the Act to be income from an active business of the affiliate. This will be the case where the activities of the affiliate referred to in that subparagraph that gave rise to the income are directly related to the active business activities carried on by any other non-resident corporation to which the affiliate and the corporation are related throughout the year in the course of carrying on an active business the income from which would, if it were a foreign affiliate of a corporation, be included in computing the exempt earnings or the exempt loss of the non-resident corporation.

The proposed new subclause 5907(1)(b)(iv)(B)(II) includes in the exempt earnings of a foreign affiliate of a corporation the amounts determined under proposed new subparagraph 95(2)(a)(i) of the Act to be income from an active business of the affiliate. This will be the case where the activities of the affiliate referred to in that subparagraph that gave rise to the income are directly related to the active business activities carried on by the corporation, where the corporation is a life insurer resident in Canada throughout the year that has a qualifying interest in the affiliate throughout the year, in the course of carrying on an active business the income from which would, if it were a foreign affiliate of a corporation, be included in computing the exempt earnings or the exempt loss of the corporation that is a life insurer resident in Canada throughout the year.

Proposed new subclause 5907(1)(b)(iv)(B)(III) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by a non-resident corporation to which the affiliate and the corporation are related throughout the year that is deemed by proposed new clause 95(2)(a)(ii)(A) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the related non-resident corporation if it were a foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(IV) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by a partnership of which a non-resident corporation to which the affiliate and the corporation are related throughout the year was a member (other than a specified member at any time in a fiscal period of a partnership ending in the year) that is deemed by proposed new clause 95(2)(a)(ii)(A) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the partnership if it were a foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(V) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by another foreign affiliate of the corporation in respect of which the corporation has a qualifying interest throughout the year that is deemed by proposed new clause 95(2)(a)(ii)(B) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the other foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(VI) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by a partnership of which another foreign affiliate of the corporation in respect of which the corporation has a qualifying interest throughout the year was a member (other than a specified member at any time in a fiscal period of a partnership ending in the year) that is deemed by proposed new clause 95(2)(a)(ii)(B) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the partnership if it were a foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(VII) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by a partnership of which the affiliate was a member (other than a specified member at any time in a fiscal period of a partnership

ending in the year) that is deemed by proposed new clause 95(2)(a)(ii)(C) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the partnership if it were a foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(VIII) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to it by another foreign affiliate of the corporation related to it and the corporation throughout the year (second affiliate) that is deemed by proposed new clause 95(2)(a)(ii)(D) of the Act to be the income from an active business of the affiliate. The income must be derived from amounts paid or payable in respect of interest on borrowed money used to earn income from property or on an amount payable for property and the property must consist of shares of another foreign affiliate of the corporation in respect of which the corporation has a qualifying interest throughout the year (third affiliate) that are excluded property of the second affiliate. The second and third affiliate must be resident and subject to income taxation in a designated treaty country (see proposed new subsection 5907(11)) or a country listed in subsection 5907(11) of the Regulations. As well, the amounts paid or payable must be relevant in determining the liability for income taxes in the designated or listed treaty country of a group of corporations composed of the second affiliate and one or more other foreign affiliates of the corporation resident in that country and in respect of which the corporation has a qualifying interest throughout the year.

For the purposes of making these determinations, certain assumptions are made. First, the definition "excluded property" in subsection 95(1) is to be read without reference to amounts receivable referred to in paragraph (c) thereof where, if interest was payable thereon, the interest would not be deductible by the debtor in calculating its exempt earnings or loss. Second, shares of an affiliate not resident and subject to income taxation in a designated treaty country (a non-qualifying affiliate) are to be ignored in determining if the shares of the third affiliate are excluded property unless the shares of the third affiliate would not be excluded property on the assumption that all shares of all non-qualifying affiliates were not excluded property.



Proposed new subclause 5907(1)(b)(iv)(B)(IX) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by the corporation, where the corporation is a life insurance corporation resident in Canada throughout the year that has a qualifying interest in the affiliate throughout the year that is deemed by proposed new clause 95(2)(a)(ii)(E) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the life insurance corporation if it were a foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(X) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income that was included in computing its income from an active business under subparagraph 95(2)(a)(iii) of the Act and was derived by it or a partnership of which it was a member from the factoring of accounts receivable acquired from a non-resident corporation to which the affiliate was related throughout the year. The factored accounts receivable must have arisen in the course of an active business carried on by the related non-resident corporation the income from which would be included in its exempt earnings if it were a foreign affiliate of a corporation.

Proposed new subclause 5907(1)(b)(iv)(B)(XI) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income that was included in computing its income from an active business under subparagraph 95(2)(a)(iv) of the Act and was derived by it or a partnership of which it was a member from the loans or lending assets acquired from a non-resident corporation to which the affiliate was related throughout the year. The loans or lending assets must have arisen in the course of an active business carried on by the related non-resident corporation the income from which would be included in its exempt earnings if it were a foreign affiliate of a corporation.

## **Exempt Loss**

ITR

5907(1)(c)(iii)

Subparagraph 5907(1)(c)(iii) includes in the exempt loss of a foreign affiliate of a corporation for a taxation year (for the 1976 and subsequent taxation years of a foreign affiliate of a corporation resident in a country listed in subsection 5907(11) of the Regulations), any net loss for the year of the affiliate from an active business carried on by it in a country listed in subsection 5907(11) of the Regulations. The amendments to the subparagraph simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

## **Net Earnings**

ITR

5907(1)(f)(iii)

Subparagraph 5907(1)(f)(iii) of the Regulations includes in the net earnings of a foreign affiliate of a corporation for a taxation year from the disposition of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country not listed in subsection 5907(11), the amount by which the taxable capital gain from the disposition that accrued after November 12, 1991 exceeds related income taxes paid to that country. The amendments to the subparagraph simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

**Net Loss**

ITR

5907(1)(g)(iii)

Subparagraph 5907(1)(g)(iii) of the Regulations includes in the net loss of a foreign affiliate of a corporation for a taxation year from the disposition of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country not listed in subsection 5907(11), the amount by which the allowable capital loss from the disposition that accrued after November 12, 1991 exceeds the related income tax refund made by that country. The amendments to the subparagraph simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

**Taxable Earnings**

ITR

5907(1)(i)(ii)(D)

Clause 5907(1)(i)(ii)(D) of the Regulations includes in the taxable earnings of a foreign affiliate of a corporation for a taxation year the net earnings of the affiliate for the year from the disposition of property held principally for the purpose of earning income from an active business carried on in a country not listed in subsection 5907(11) of the Regulations. The amendments to the clause simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

## **Taxable Loss**

ITR

5907(1)(j)(ii)(C).

Clause 5907(1)(j)(ii)(C) of the Regulations includes in the taxable loss of a foreign affiliate of a corporation for a taxation year the net loss of the affiliate for the year from the disposition of property held principally for the purpose of earning income from an active business carried on in a country not listed in subsection 5907(11) of the Regulations. The amendments to the clause simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

## **Rules for Computing Active Business Earnings**

ITR

5907(1.01)

Proposed new subsection 5907(1.01) provides rules for the purpose of subparagraph 5907(1)(b)(iv) of the Regulations. For the purpose of that subparagraph, in determining whether a corporation has a qualifying interest in respect of a foreign affiliate throughout a taxation year or is related to another corporation throughout the year the same tests apply as those for the purposes of paragraph 95(2)(a) of the Act.

ITR

5907(2.1)

Subsection 5907(2.1) of the Regulations provides rules for the purpose of computing active business earnings of a foreign affiliate of a corporation carried on in a country listed in subsection 5907(11) of the Regulations. The amendments to the subsection simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

ITR  
5907(2.7)

Under proposed new subparagraphs 95(2)(a)(i) and (ii) of the Act, the income of a particular foreign affiliate of a taxpayer derived from amounts paid or payable to it by another foreign corporation to which the affiliate is related could be included in the active business income of the particular affiliate if the appropriate conditions are met. There could be a timing difference between the income reporting of the affiliate and the expense reporting of the non-resident corporation where, in the taxing jurisdiction in which the non-resident corporation is a resident, the payer corporation is restricted with respect to the amounts it may deduct for income tax purposes in computing its income from an active business for a year in respect of the amounts paid or payable. To eliminate the timing difference, proposed new subsection 5907(2.7) of the Regulations provides that the amounts paid or payable are to be deducted by the payer in computing active business earnings or loss in the year that includes the earlier of the day on which the amounts are paid or the day on which the amounts become payable unless the amounts have already been deducted under paragraph 5907(2)(j).

The proposed new subsection is applicable for taxation years of foreign affiliates that begin after 1994 unless there has been a change to the taxation year of the foreign affiliate in 1994 and after February 22, 1994, in which case, it will apply to taxation years of such affiliate that end after 1994.

ITR  
5907(2.8)

Under proposed new clause 95(2)(a)(ii)(D) of the Act, the income of a foreign affiliate of a corporation (first affiliate) that is derived from amounts paid or payable to it by another foreign affiliate of the corporation or a related corporation to which the first affiliate and the corporation are related (second affiliate) is included in the active business income of the first affiliate.

The amounts paid or payable by the second affiliate must be in respect of interest on borrowed money used for the purpose of earning income from property or on an amount payable for property where the property consists of shares of another foreign affiliate of

the corporation in respect of which the corporation has a qualifying interest throughout the year (third affiliate) that are excluded property of the second affiliate within the meaning assigned by section 95 of the Act. As well, the amounts of interest paid or payable must be relevant in computing the tax liability of the members of a group of corporations comprised of second affiliate and one or more other affiliates of the corporation in the country in which the second affiliate is resident and subject to income taxation.

In such circumstances, proposed new subsection 5907(2.8) of the Regulations provides that the second affiliate must deduct such interest in computing its earnings or loss from an active business carried on in the country in which it was resident and subject to income taxation. It also provides that the second affiliate shall be deemed to be carrying on such an active business in the country in which it was resident and subject to income taxation where no such business was carried on.

The proposed new subsection is applicable for taxation years of foreign affiliates that begin after 1994 unless there has been a change to the taxation year of the foreign affiliate in 1994 and after February 22, 1994, in which case, it will apply to taxation years of such affiliate that end after 1994.

### **Treaty Countries and Residence in Treaty Countries**

#### **ITR**

5907(11), (11.1) and (11.2)

Subsection 5907(11) of the *Income Tax Regulations* lists countries for various purposes including the definitions of "exempt earnings" and "exempt loss" of a foreign affiliate. Exempt earnings and exempt losses of a foreign affiliate of a corporation resident in Canada are used in calculating the exempt surplus that can be paid to the corporation resident in Canada as a dividend, the full amount of which is deductible under section 113 of the Act in computing the corporation's taxable income for Canadian tax purposes. Exempt earnings and losses of an affiliate resident in a country listed in subsection 5907(11) of the Regulations for a taxation year are the earnings and losses of the affiliate derived from active businesses carried on by the affiliate in that year in the residence country or any other listed country.

This deduction in respect of dividends from foreign affiliates paid to a corporation resident in Canada out of exempt surplus of the affiliate is a simple means for eliminating double taxation on foreign business income earned by the foreign affiliate. It was intended to apply where the foreign affiliate was resident in and the business income was earned in a country with which Canada had a ratified comprehensive international tax treaty. Some countries with which negotiations were undertaken were listed in anticipation of a treaty being ratified. Some treaties were never ratified or concluded. As well, some countries with which Canada has entered into a ratified treaty have not yet been listed.

The repeal of subsection 5907(11) and its replacement with proposed new subsections 5907(11), (11.1) and (11.2) accomplishes a number of objectives.

First, countries will no longer be listed in subsection 5907(11) of the Regulations. That subsection will provide that, for the purposes of Part LIX of the Regulations, a country will be considered to be a designated treaty country for a taxation year of a foreign affiliate of a corporation only where a comprehensive agreement or convention for the elimination of double taxation on income between Canada and that country has entered into force and has effect. Therefore, a country will automatically be included as a designated treaty country at such time as the comprehensive tax treaty takes effect. References in Part LIX of the Regulations to "a country listed in subsection 5907(11)" will be changed to references to "a designated treaty country".

In addition, new subsection 5907(11.1) provides that, once an agreement or convention actually enters into force, it will be considered to have entered into force and have effect for a taxation year of an affiliate any day of which is in the period that begins on the day on which the Canadian and foreign governments signed the treaty and ends on the last day of the last taxation year of the affiliate for which the agreement or convention has effect. Consequently, this subsection accommodates the repatriation of active business earnings derived from investments made in foreign affiliates resident in a designated treaty country that took place after the signing but prior to the ratification of the treaty.

The changes to Regulation 5907(11) will have no effect with respect to foreign affiliates in those countries with which Canada has a comprehensive tax treaty. However, for affiliates in those countries that are listed in the existing subsection and with which such a treaty has not entered into force, their earnings for taxation years that begin after 1995 will no longer qualify as exempt earnings. As a result, any dividends paid out of the earnings for such years will cease to be exempt from tax in the hands of the Canadian corporate shareholders.

Proposed new subsection 5907(11.2) provides rules for determining when a foreign affiliate of a corporation is to be considered to be resident in a particular designated treaty country. The determination of residency is important for the purposes of the rules dealing with the calculation of exempt surplus. Net earnings from an active business is included in the exempt surplus of a foreign affiliate of a corporation only where the affiliate is resident in a designated treaty country and the business is carried on in a designated treaty country.

Under this proposed new subsection, an affiliate will be considered to be a resident of such a country only where it is a resident of that country for the purposes of Canadian income tax rules and for the purposes of the ratified agreement or convention with that country (paragraph (a)) or would be so resident if the affiliate were treated as a corporation under the tax laws of the country in which it is formed or organized (paragraph (b)). The rule in paragraph (b) would treat as foreign affiliates, corporations such as limited liability companies in certain U.S. States which are treated as corporations for Canadian tax purposes but are treated as partnerships for U.S. tax purposes. Where an affiliate is a resident of a country with which Canada has a ratified treaty or convention that entered into force before 1995 but that treaty or convention does not apply in respect of the affiliate, it is intended that the affiliate be considered to be a resident of that country for the purposes of that treaty if it would be so resident under the treaty if the treaty did apply to the affiliate and this clarification is provided in paragraph (c).

The proposed new subsections 5907(11), (11.1) and (11.2) and the consequential amendments to subparagraphs 5907(1)(c)(iii), (f)(iii) and (g)(iii) and clauses 5907(1)(i)(ii)(D) and (j)(ii)(C) are to apply to the taxation years of a foreign affiliate of a corporation that begin after 1995. However, where the corporation resident in Canada notifies the Minister of National Revenue, in its return of income for



its first taxation year that begins after 1994 or for a taxation year in which a dividend was paid by the foreign affiliate, of its desire to have the subsections apply in respect of an earlier taxation year, the proposed new provisions will be effective for that earlier taxation year and each subsequent taxation year of the foreign affiliate. In such case, the references in section 5900 to "country listed in subsection (11)" shall be read as "designated treaty country" for that earlier taxation year and each subsequent year of the foreign affiliate.

### **Prescribed Financial Institutions**

ITR

7900

Section 7900 prescribes financial institutions for certain purposes of the Act. A financial institution will be a prescribed financial institution where it is a corporation that is a member of the Canadian Payments Association or it is a credit union that is a shareholder or member of a body corporate that is a member of the Canadian Payments Association. Section 7900 is being amended to make it applicable for the purposes of proposed new paragraph 95(2)(a.3) of the Act. The amendment is applicable to taxation years of foreign affiliates that begin after 1994 unless there has been a change to the taxation year of the foreign affiliate in 1994 and after February 22, 1994, in which case, it will apply to taxation years of such affiliate that end after 1994.

