Reforming the Taxation of Foreign Affiliate Share Dispositions: Capital Gains and Surplus Balances

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In its final report released in December 2008, the Advisory Panel on Canada’s System of International Taxation (the “Panel”) recommended broadening Canada’s existing exemption system to cover all foreign-source active business income earned by foreign affiliates. The Panel further recommended that the exemption extend to capital gains and losses realized from dispositions of foreign affiliate shares deriving all or substantially all of their value from active business assets (i.e., where the shares qualify as excluded property).

This article explores the main arguments in favour of the comprehensive “participation exemption” style system recommended by the Panel for the treatment of capital gains. It also considers the principal issues that would need to be addressed or reconciled under the Canadian foreign affiliate rules if this proposal were to be adopted.

A comprehensive exemption for capital gains from dispositions of excluded property foreign affiliate shares would be a terrific result if it can be made to work. It would fundamentally simplify the Canadian foreign affiliate rules, facilitating less costly compliance by taxpayers and easier administration of the system by the Canada Revenue Agency and the Department of Finance. It would also undoubtedly promote the competitiveness of Canadian-based multinationals operating in foreign markets.

Most of the key issues arise only if the exemption is extended to capital gains and losses realized by a Canadian parent corporation from dispositions of directly owned, top-tier foreign affiliate shares, as distinct from a full exemption for lower-tier foreign affiliate share dispositions. Accordingly, it is possible that the Department of Finance may choose, or be directed by its political masters, to expand the exemption system but to retain capital gains taxation of top-tier foreign affiliate share dispositions.

Based on this premise, the article concludes with some suggestions for one possible way the exempt surplus rules might be modified and expanded to implement a broader, and simplified, exemption system for foreign-source active business income. Regardless of the direction of tax reform chosen, meaningful consultation with tax practitioners and the business community on the specifics of any proposals is strongly encouraged.

Arguments Supporting Full Capital Gains Exemption

The Panel’s main arguments for a comprehensive exemption system extending to capital gains realized from all excluded property foreign affiliate share dispositions are briefly summarized below.

Simplification of the Foreign Affiliate Rules

There are two aspects of the recommended exemption for capital gains, each with its own distinct simplification possibilities. First, there is the case of lower-tier foreign affiliate share dispositions, where the vendor is another foreign affiliate of the Canadian parent corporation. In this situation, where the shares meet the excluded property test, the taxable capital gain is not included in foreign accrual property income (“FAPI”) and thus is not taxed currently in the hands of the Canadian parent corporation, but the current system does add the taxable capital gain to the vendor foreign affiliate’s taxable surplus. In this way the gain remains within the Canadian system, because it will be subject to Canadian tax (with relief for underlying foreign tax) if and when the taxable surplus is ultimately distributed to the Canadian parent as a dividend. The recommendation to exempt excluded property lower-tier foreign affiliate share dispositions from Canadian tax, when coupled with the other recommendation to extend exemption treatment to all foreign-source active business income regardless of whether the source is within a designated treaty country or a country with which Canada has a tax information and exchange agreement (“TIEA”), would effectively permit the elimination of taxable surplus accounts.

Second, there is the case of top-tier foreign affiliate shares directly owned by the Canadian parent. The Panel’s recommendation to exempt a capital gain or loss realized by the Canadian parent where the top-tier foreign affiliate shares meet the excluded property test could potentially lead to elimination of both exempt surplus and taxable surplus balances. This is because in such a system, all foreign affiliate dividends, and all excluded property foreign affiliate share dispositions, would be fully exempt from Canadian tax, so there would be no further need to keep track of any surplus balances. Thus, a comprehensive exemption system could allow significant simplification of the existing foreign affiliate rules, including elimination of
the section 93 election mechanism and streamlining of the foreign affiliate share reorganization rules.

Capital Gain is Substitute for Active Business Income

Where a foreign affiliate share derives all or substantially all of its value from active business assets, capital appreciation on the share may arguably be attributable to an increase in the present value of the affiliate's future earnings from its active business. In this view, a capital gain on an excluded property share is a proxy or substitute for the active business earnings that would be exempt when earned under an expanded exemption system. So if Canada would not tax the earnings when earned in the future, Canada should similarly not tax the gain when realized.

In a similar vein, an asset sale is an alternative to an excluded property share sale. If the foreign affiliate were to sell its active business assets (which would constitute all or substantially all of its property if the shares are excluded property), an expanded exemption system would exempt the gains from tax, and the sale proceeds could then be distributed to the parent as an exempt dividend. A sale of the foreign affiliate shares gets the vendor to the same place from an economic perspective, and so should be accorded the same fully exempt tax treatment.

Modest Tax Revenue Loss

Many Canadian-based multinationals hold their foreign affiliate share investments through holding companies resident in low-tax jurisdictions. These holding structures permit the exit from a foreign affiliate investment to occur as a lower-tier foreign affiliate share sale, rather than as a sale by the Canadian parent directly. Taxable surplus can arise from such lower-tier share dispositions, but the practical reality is that this taxable surplus is generally not distributed to the Canadian parent as a dividend in circumstances where it would generate Canadian tax. Instead, it may be loaned up to the Canadian parent, or redeployed outside Canada. Since very little tax revenue is generated under the current system from taxing capital gains from foreign affiliate share dispositions, extending exemption treatment to such share dispositions would result in only modest tax revenue loss.

Issues with a Comprehensive Exemption for Capital Gains

The Panel acknowledged in its Report a number of conceptual and technical issues that would need to be overcome, addressed or accepted if Canada were to adopt the recommendation for a comprehensive exemption for capital gains from dispositions of top-tier and lower-tier foreign affiliate shares meeting the excluded property test.

Domestic Gains Taxable, Foreign Gains Exempt

One of the most challenging aspects of a comprehensive capital gains exemption is that Canadian companies would remain fully taxable on their sales of Canadian subsidiaries, but would be exempt from tax on sales of their directly owned foreign subsidiaries (meeting the excluded property test). This would be a departure from the principle in subsection 2(1) of the Income Tax Act (Canada) (the "Act") that a Canadian-resident taxpayer is subject to tax on all of its directly earned income from any source.

Reconciling this may require acceptance that the benefits to Canada of a comprehensive exemption system for foreign-source active business income (for example, simplification of our foreign affiliate system and thereby promoting the competitiveness of Canadian-based multinationals) justify a broader exemption than is strictly necessary to avoid double taxation of that income.

A related political question is whether a broader capital gains exemption for excluded property foreign affiliate share dispositions could be successfully explained and justified to the wider Canadian public. This possible tax reform could be vulnerable to objections on the basis that it would favour foreign investments over domestic ones.

Source of Capital Gain

As noted above, one of the conceptual arguments in support of a broader capital gains exemption for excluded property foreign affiliate share dispositions is that the capital gain may be viewed as a proxy for foreign-source active business income. But in the case of a top-tier foreign affiliate share sale, is the gain better understood as Canadian-source, because the Canadian company directly owns the share? And is the capital gain properly characterized as investment or property income, rather than as a proxy for active business income?

Inconsistency with Tax Treaties

Canada's wide network of tax treaties generally reflects the longstanding principle that where a company resident in one country sells shares of a company resident in another (source) country, the jurisdiction to tax the capital gain is allocated to the residence country. The general exception is where the shares derive their value principally from immovable property situated in the source country, in which case the jurisdiction to tax the capital gain is allocated to the source country.

Thus, where a Canadian corporation sells directly owned, excluded property shares of a top-tier foreign affiliate resident in a country with which Canada has a tax
treaty, then, in most circumstances (where the shares do not derive their value from real estate or resource property in the source country, for instance), only Canada may tax the capital gain. The effect of Canada’s adoption of a broadened capital gains exemption would be that neither country would tax the capital gain. The source country where the foreign affiliate is resident would be precluded from taxing the gain under the tax treaty, and Canada would not tax the capital gain under its domestic rules.

This illustrates that an exemption for capital gains realized from dispositions of top-tier excluded property foreign affiliate shares may in many cases be more generous than is required to achieve the objective of avoiding double taxation of the capital gain. A comprehensive capital gains exemption that extends to top-tier foreign affiliate shares would need to be justified on other grounds, such as simplicity and competitiveness.

**FAPI Earned in Non-Controlled Foreign Affiliates**

Under Canada’s existing anti-deferral rules for foreign-source property income, where a controlled foreign affiliate of a Canadian company earns FAPI, the appropriate participating percentage of the FAPI is attributed to, and taxed in the hands of, the Canadian parent corporation. However, where the interest is non-controlling and does not meet the controlled foreign affiliate threshold, the FAPI is not attributed to the Canadian parent, but instead is added to the foreign affiliate’s taxable surplus in respect of the Canadian parent. This FAPI will ultimately be subject to Canadian tax when the FAPI (taxable surplus) is distributed to the Canadian company, or when the shares of the foreign affiliate are sold and the accumulated FAPI contributes to a capital gain, which is subject to tax.

If Canada were to adopt a comprehensive exemption for capital gains realized upon dispositions of top-tier and lower-tier foreign affiliate shares, this fallback method of taxing FAPI accumulated in non-controlled foreign affiliates would be relinquished. It would accordingly be possible for this FAPI to escape Canadian taxation. This would not be consistent with the underlying principle that all property income earned directly or indirectly by Canadian taxpayers should be subject to accrual taxation on a current basis, a principle reaffirmed and endorsed by the Panel in its recommendation regarding the FAPI, FIE and NRT anti-deferral regimes.

To address FAPI earned in non-controlled foreign affiliates in a comprehensive exemption system, the FAPI rules could be tightened so that they would apply to mere foreign affiliates, rather than controlled foreign affiliates as is now the case. However, this would apply accrual taxation to Canadian investors with minority interests in foreign corporations who may not be able to control or influence the activities giving rise to the FAPI and the distribution of the FAPI earnings to the shareholders, and who may not be able to access the information needed to comply with the FAPI rules. Another alternative would be to expand the scope of the proposed FIE rules to capture FAPI earned in non-controlled foreign affiliates, but this too is unlikely to be optimal in light of objections to the complexity of the existing FIE proposals.

**Technical Issues – Excluded Property and Surplus Stripping**

The Panel has an interesting discussion in Appendix B of its Report concerning a number of technical issues posed by an expanded exemption system applying to capital gains from foreign affiliate share dispositions. Since the benefits of the exemption would apply only to foreign affiliate shares satisfying the excluded property test, there would be increased pressure on the excluded property definition. A number of modifications may be warranted.

For instance, the excluded property definition would need to apply to top-tier foreign affiliate shares directly owned by a Canadian taxpayer. Consideration could be given to permitting a determination based on a consolidated approach that views the assets of a foreign affiliate group on a look-through basis. The current test applies at a particular point in time, whereas many other countries with participation exemptions impose a minimum holding period requirement. In addition, anti-avoidance rules might be required to prevent manipulation of the asset holdings of a foreign affiliate intended to qualify the shares as excluded property immediately before a sale.

Another technical issue is how the current surplus stripping rules in subsection 55(2) of the Act would apply in a comprehensive exemption system. A shareholder of a Canadian corporation needing to compute its safe income is directed by paragraph 55(5)(d) to compute safe income by reference to the surplus balances of the corporation’s foreign affiliates. If the need for maintaining surplus balances is successfully eliminated under a comprehensive exemption system, some alternative proxy would need to be found for safe income purposes.

Moreover, although in a comprehensive exemption system it might be possible to eliminate the section 93 mechanism, issues of surplus stripping could still arise where a taxpayer sells non-excluded property shares of a foreign affiliate. It might not be appropriate for the FAPI gain to be reduced by exempt dividends exceeding some measure of the safe income of the foreign affiliate.

The point is that even with the elimination of all exempt and taxable surplus balances, a proxy for these surpluses would still likely be required to determine safe income for domestic purposes and to police foreign affiliate dividend stripping transactions. When coupled with modifications to the excluded property definition that would likely be required, it is apparent that the simplicity benefits of moving to a full capital gains exemption for foreign affiliate share dispositions may not be as great as they initially appear.

**Surplus Balances**

If the Department of Finance chooses or is directed to adopt the Panel’s recommendation for a comprehensive exemption for capital gains realized from excluded property foreign affiliate share dispositions, both top-tier and lower-tier, then, as noted above, it should be possible to modify the foreign affiliate rules to eliminate the need for surplus balances altogether. This would represent a fundamental change to Canada’s foreign affiliate system and would permit substantial corollary simplification.
On the other hand, if the Department of Finance chooses or is directed to retain Canadian taxation of top-tier dispositions of foreign affiliate shares directly owned by a Canadian corporation, more modest but nonetheless significant simplification of the foreign affiliate rules would be possible. This alternative could avoid the need to tighten the FAPI rules to apply to mere foreign affiliates, since FAPI earned in non-controlled foreign affiliates would remain within the Canadian tax system through potential taxation of the Canadian corporation's capital gain on the top-tier foreign affiliate shares upon final exit from the investment. It would still be necessary to maintain an exempt surplus balance for each foreign affiliate of the Canadian corporation, but taxable surplus balances and corresponding underlying foreign tax balances would no longer be required.

The balance of this article attempts to illustrate some of the simplification possibilities in this latter scenario, by focusing on the components of a modified exempt surplus account.

**Exempt Surplus and Capital Surplus**

In this possible system, taxpayers would compute a single exempt surplus (or deficit) balance for each foreign affiliate, where exempt surplus represents amounts that may be distributed up the chain to the Canadian parent on a fully exempt basis. All other amounts would by default belong to a residual category analogous to pre-acquisition surplus under the current system. This might more appropriately be referred to as capital surplus, because distributions that by default are made from capital surplus would be treated as capital distributions, reducing the shareholder's adjusted cost base of its shares of the foreign affiliate.

Dividends paid by a foreign affiliate would be considered paid first out of exempt surplus, to the extent of any positive exempt surplus balance. Dividends in excess of exempt surplus, including all dividends paid where the foreign affiliate has an exempt deficit, would be considered paid out of capital surplus.

Top-tier distributions from capital surplus could trigger a capital gain for the Canadian parent corporation under subsection 40(3) if its adjusted cost base in the top-tier foreign affiliate shares were reduced to a negative amount. Thus, retained capital gains taxation of top-tier foreign affiliate shares would operate as a fallback method of capturing within the Canadian tax system, on a deferred basis, amounts that are not expressly conferred exempt treatment by inclusion in exempt surplus.

**Components of Exempt Surplus**

The exempt surplus balance could include the following income items that would benefit from full exemption treatment:

- Net earnings from active businesses carried on by the foreign affiliate in any country (not restricted to sources within designated treaty countries or TIEAs);
- Net property income recharacterized as active business income under paragraph 95(2)(a) (regardless of residence of payor or payee affiliates in a designated treaty country);
- Dividends (net of foreign withholding tax) received from other foreign affiliates paid out of exempt surplus (exempt surplus would be reduced by dividends paid out of exempt surplus);
- Gains (net of foreign tax) realized from arm's length dispositions of excluded property (non-arm's length dispositions would not create exempt surplus); and
- Net earnings from FAPI, to the extent the FAPI (net of foreign accrual tax) has been taxed in the hands of the Canadian parent corporation under section 91.

Items not specifically included in exempt surplus would by default constitute residual capital surplus, and would accordingly be subject to potential Canadian tax under the retained capital gains tax on dispositions of top-tier foreign affiliate shares, including subsection 40(3) deemed dispositions. Thus capital surplus would include among other items the following:

- Gains realized on non-arm's length dispositions of excluded property. The implication is that internal asset disposals would not have surplus consequences. This would avoid the need for surplus suspension rules such as those proposed in February 2004.
- FAPI earned in non-controlled foreign affiliates. It would be necessary to compute FAPI only for controlled foreign affiliates. FAPI would not be relevant for non-controlled foreign affiliates and would simply form part of capital surplus by default.

Many other variations are possible, but this at least illustrates that simplification of the current foreign affiliate rules is possible by moving to a single exempt surplus account, and retaining capital gains taxation of top-tier foreign affiliate share dispositions as a fallback method of taxing items not specifically captured as exempt surplus.

**Notes:**

1 This is an abbreviated summary of the possible modified exempt surplus system described in more detail in the author's submission to the Advisory Panel dated July 15, 2008, available on the Panel's Web site at www possono.gc.ca/53bmmms/31%20-%20Fume%20Geoffrey.pdf.

**The Foreign Affiliate as a Partner**

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**Introduction**

Canadian investors that invest in businesses outside of Canada often invest in foreign partnerships. It is not surprising that many Canadian tax advisors may assume that the treatment of investments in a partnership by a foreign affiliate under the Income Tax Act (the "Act") is the same as the treatment of an investment in a partnership by a Canadian taxpayer. This article demonstrates that this assumption is not necessarily true. In particular, this article discusses a number of tax issues that can arise when a foreign affiliate of a Canadian corporation is a member of a partnership that carries on a business in a foreign country.

While much has been written about the Canadian tax consequences of the ownership of shares of a foreign corporation by a partnership and the status of such foreign corporation as a foreign affiliate under the provisions of section 93.1, less has been written about the Canadian tax consequences of a foreign affiliate being a partner of a partnership carrying on a foreign business, which will be the focus of this article. In an article of this length it is not possible to provide a comprehensive analysis of all of the Canadian tax implications of a foreign affiliate's participation in a partnership. However, the points discussed in this article will serve as a caution to taxpayers to carefully