The New 95 (2)(f.1) Carve-Out Rule - Election Deadline Approaching

Geoffrey S. Turner
gturner@dwpv.com
The New 95(2)(f.1) Carve-Out Rule – Election Deadline Approaching

A prior version of this article was prepared for the December 2009 issue of the CCH International Tax Newsletter before Finance released its foreign affiliate legislative proposals on December 18, 2009. This version of the article has been updated to reflect these proposals, and includes some brief observations with respect to the aspects of these proposals affecting the tax cost bump of foreign affiliate shares and the new acquisition of control surplus adjustments.

The foreign affiliate income computation and calculating currency rules were recently modified with the enactment on March 12, 2009 of paragraphs 95(2)(f) to (f.15) of the Income Tax Act (Canada) (the “Act”), generally applicable to taxation years of a foreign affiliate beginning after October 2, 2007. These provisions include a new “carve-out rule” in paragraph 95(2)(f.1) that can exclude certain accrued capital gains or capital losses or FAPI (foreign accrual property income) amounts, where these amounts accrued in a foreign affiliate of a “designated acquired corporation” before an acquisition of control.

In the Bill C-10 implementing legislation, Finance included a very flexible election allowing taxpayers to elect to apply these new rules retroactively to taxation years of a foreign affiliate beginning after one of three dates to be selected by the taxpayer – being December 31, 1994, December 20, 2002, or February 27, 2004. The deadline for this election is the later of March 12, 2010, or the taxpayer’s filing-due date for its taxation year that includes the March 12, 2009 in force date for these provisions (June 30, 2010 for calendar year taxpayers).
Consequently, Canadian taxpayers that at any time since 1994 have acquired control of a Canadian target corporation with foreign affiliates should be considering whether to make this election. For example, if at the time of the acquisition of control there was accrued FAPI in the target foreign affiliate group, or accrued capital gains on non-excluded property, the FAPI resulting from these accrued amounts may now potentially be eliminated by electing retroactive application of the paragraph 95(2)(f:1) carve-out rule.

Because the election, if made, will subject all of a taxpayer’s foreign affiliates to retroactive application of the entire package of the foreign affiliate income computation and calculating currency rules in paragraphs 95(2)(f) to (f:15), including new subsection 95(2.6) and the new corollary definitions in subsection 95(1), this article will first provide a very brief overview of these provisions. But the main focus is on the new carve-out rule and the concept of a designated acquired corporation, and the notion that the election operates similarly to a foreign affiliate tax cost bump and could be relevant in many typical M&A transactions over the past 15 years.

**Canadian Rules and Canadian Dollars for FAPI; Foreign Rules Otherwise**

The basic principle embodied in paragraph 95(2)(f) is that a foreign affiliate is deemed to be resident in Canada for the specific purposes of computing its gains or losses from dispositions of capital property, and for computing the key FAPI amounts enumerated in item A of the FAPI definition in subsection 95(1), comprising income from property, income from a business other than an active business, and income from a non-qualifying business. Some exceptions are listed in paragraph 95(2)(f:11), which does not apply certain provisions of the Act to the foreign affiliate as a deemed resident of Canada. For instance, the Act is applied to the foreign affiliate without regard to FAPI attribution in section 91, the thin capitalization rules in subsection 18(4), and the interest imputation rules for low-interest loans in subsection 17(1). These provisions only make sense in computing income of true Canadian-resident corporations, not foreign affiliates. Moreover, paragraph 95(2)(f:14) makes explicit the requirement to use Canadian currency to compute these item A FAPI amounts, and capital gains or losses from non-excluded property that give rise to FAPI.

The effect is generally to require the use of Canadian tax rules in the Act in determining FAPI, and Canadian dollars (or the elected functional currency if the Canadian parent corporation has made an election under subsection 261(3)). This is in contrast to active business income amounts earned by a foreign affiliate, which pursuant to the definition of “earnings” in Regulation 5907(1) are computed under the relevant foreign tax law (subject to possible Regulation 5907(2) adjustments), giving rise to surplus and deficit balances maintained in the relevant foreign currency pursuant to Regulation 5907(6).

New paragraph 95(2)(f:12) formalizes this longstanding distinction by requiring a foreign affiliate to use its “calculating currency” to determine its active business income, its deemed active business income under paragraph 95(2)(a), and its capital gain or capital loss from a disposition of excluded property. “Calculating currency” is now defined in subsection 95(1) to mean the currency of the country in which the foreign affiliate is resident, or any currency demonstrated to be reasonable in the circumstances.

Paragraph 95(2)(f:13) deals with the less common hybrid situation where a foreign affiliate disposes of excluded property that generates FAPI (for instance, a paragraph 95(2)(c) disposition of excluded property foreign affiliate shares in respect of which the taxpayer elects a relevant cost base that triggers a capital gain included in FAPI). In this case, the gain on the excluded property is first computed in the calculating currency and is then con-
verted to Canadian dollars using the Bank of Canada noon exchange rate on the date of disposition.

**The Paragraph 95(2)(f.1) Carve-Out Rule**

The new carve-out rule replaces the prior rule, correcting several anomalies and inconsistencies and, significantly, adding a new enhanced carve-out with respect to designated acquired corporations. Specifically, paragraph 95(2)(f.1) provides that, in computing a foreign affiliate’s gain or loss from a disposition of capital property, or its item A FAPI amounts (being, as noted above, income from property, income from a business other than an active business, or income from a non-qualifying business), there is not to be included any portion of the amount that can reasonably be considered to have accrued while no person (or partnership) that held the property or carried on the business was a “specified person or partnership” in respect of the taxpayer.

Another way to express this carve-out rule is to include only the portion of a foreign affiliate’s capital gain or loss or FAPI amount that accrued while the property was held or the business was carried on by a specified person or partnership. The effect is best illustrated in the context of a foreign affiliate’s holding of capital property. So, for example, where a foreign affiliate of a Canadian taxpayer disposes of a capital property (assume a non-excluded property) and realizes a taxable capital gain (which is included in FAPI), one must consider each person who held the property while the gain accrued, and determine if each such person qualifies as a specified person or partnership in respect of the Canadian taxpayer. If the property holder does not qualify as a specified person or partnership, then the gain that reasonably accrued during that person’s holding period must be excluded, or carved out. In this example where the taxable capital gain is included in FAPI, a broader carve-out is beneficial to the taxpayer – the narrower the category of specified person or partnership, the better.

**Specified Person or Partnership Broadly Defined**

“Specified person or partnership” in respect of a taxpayer is newly defined in subsection 95(1). It includes the taxpayer itself, or a person (other than a “designated acquired corporation”) that includes (i) a foreign affiliate of the taxpayer; (ii) a person resident in Canada (other than a designated acquired corporation) who does not deal at arm’s length with the taxpayer, or a foreign affiliate of such a person; and (iii) a “specified predecessor corporation” of the taxpayer (other than a designated acquired corporation), or a foreign affiliate of such a person. The drafting is, in fact, even broader than this, taking into account holdings through partnerships and tracing back holdings through successive amalgamations and windings-up, as noted below. But the key point to observe is the narrowing of this definition that excludes designated acquired corporations and foreign affiliates of such designated acquired corporations.

“Specified predecessor corporation” is also newly defined in subsection 95(1). This refers to a predecessor to a corporation formed under a subsection 87(1) amalgamation, or an “antecedent corporation”. An “antecedent corporation” is defined broadly in subsection 95(1) to include a corporation that is wound up into a parent corporation under subsection 88(1), or that is vertically amalgamated into a parent corporation in an amalgamation to which subsection 87(11) applies, or that is a predecessor in certain amalgamation squeeze-outs. These definitions broadly trace back to predecessor corporations pursuant to successive amalgamations or wind-ups.

**Designated Acquired Corporation**

The final new definition in subsection 95(1) relevant to this discussion is that of a “designated acquired corporation” of a taxpayer. This includes an antecedent corporation of the taxpayer if the taxpayer acquired control of the antecedent corporation and, immediately before the acquisition of control, the taxpayer dealt at arm’s length with the antecedent corporation.

Recall that an antecedent corporation of the taxpayer includes a Canadian corporation that is wound up or vertically amalgamated into the taxpayer under subsection 88(1) or 87(11). Thus, where a Canadian purchaser corporation acquires control of an arm’s length Canadian target corporation and then causes the target to be wound up or vertically amalgamated into the Canadian purchaser corporation, the target will be a designated acquired corporation.

The beneficial effect of the new carve-out rule can be illustrated in a typical example. Suppose a Canadian target corporation owned a foreign affiliate that, in turn, owned a capital property that is not excluded property (for instance, as is commonly the case, shares of a lower-tier foreign affiliate with assets that are not all or substantially all active business assets). Suppose the top-tier foreign affiliate has a cost of $10 in the lower-tier foreign affiliate shares, and those shares increase in value to $50. The Canadian purchaser corporation then purchases 100% of the shares of the Canadian target corporation and subsequently winds it up or vertically amalgamates it into the purchaser. This is commonly done to effect a tax cost bump of the non-depreciable capital properties of the Canadian target corporation.
corporation under paragraph 88(1)(d), or to permit interest expense on funds borrowed by the purchaser to finance the purchase of the shares of the Canadian target corporation to be deducted against income earned from the business of the Canadian target corporation. As a result of the winding-up or vertical amalgamation, the Canadian purchaser corporation directly acquires the top-tier foreign affiliate shares formerly owned by the Canadian target corporation. Suppose the non-excluded property shares of the lower-tier foreign affiliate continue to increase in value to $100, at which time they are sold by the top-tier foreign affiliate of the Canadian purchaser corporation, triggering a capital gain and a consequential FAPI inclusion under section 91 for the Canadian purchaser corporation.

But how much FAPI must the Canadian purchaser corporation recognize, and how is it calculated? New paragraph 95(2)(f) tells us that for purposes of determining the top-tier foreign affiliate’s capital gain from the disposition of property, the foreign affiliate is deemed to be resident in Canada, and new paragraph 95(2)(f.14) tells us to use Canadian currency. As a deemed Canadian-resident corporation, the regular rules in sections 38 and 39 of the Act apply to compute the capital gain. The top-tier foreign affiliate’s capital gain otherwise determined in this example is $90 ($100 proceeds of disposition less its $10 historical adjusted cost base).

Under the prior version of the carve-out rule, the result depended arbitrarily on whether the Canadian target corporation was wound up or amalgamated into the purchaser. If it was an amalgamation, the prior carve-out rule would not have applied, and the entire $90 capital gain of the top-tier foreign affiliate would give rise to a $45 FAPI inclusion (i.e., the taxable capital gain). This is because that prior rule would not have excluded the $40 capital gain on the lower-tier foreign affiliate shares that had accrued while the top-tier foreign affiliate was a foreign affiliate of the Canadian target corporation before its purchase by the Canadian purchaser corporation.

However, under the new carve-out rule in paragraph 95(2)(f), in determining the top-tier foreign affiliate’s capital gain, we must exclude the portion of the $90 capital gain, if any, that can reasonably be considered to have accrued while no person held the property (i.e., the lower-tier foreign affiliate shares) was a specified person or partnership. It has already been determined in this example that the Canadian target corporation is a designated acquired corporation in respect of the Canadian purchaser. Accordingly, as a designated acquired corporation in respect of the Canadian purchaser, the Canadian target corporation cannot itself be a specified person or partnership in respect of the Canadian purchaser, nor can the top-tier foreign affiliate of the Canadian target corporation be a specified person or partnership in respect of the Canadian purchaser. The top-tier foreign affiliate did not become a specified person or partnership in respect of the Canadian purchaser until the moment the Canadian purchaser purchased the shares of the Canadian target corporation and the top-tier foreign affiliate became a foreign affiliate of the Canadian purchaser. Consequently, the $40 portion of the capital gain that accrued before the Canadian purchaser purchased the shares of the Canadian target corporation must be excluded from the capital gain computation under the new carve-out rule. As a result, the top-tier foreign affiliate has a reduced capital gain of only $50 (i.e., the portion of the capital gain that accrued after the top-tier foreign affiliate became a foreign affiliate of the Canadian taxpayer), and the FAPI inclusion is the reduced $25 taxable capital gain amount.

**Tax Cost Bump Equivalency – Fresh Start**

In some respects, the new “designated acquired corporation” feature of the paragraph 95(2)(f.1) carve-out rule can be conceptualized as a tax cost bump applicable to property held by a foreign affiliate at the time control of its Canadian parent corporation is acquired. This is analogous to the tax cost bump provided under paragraph 88(1)(d) for non-depreciable capital property held directly by a Canadian target corporation at the time control is acquired. In the example above, the operation of the new carve-out rule excludes the $40 of capital gain that accrued to the top-tier foreign affiliate before the acquisition of control of its parent, the Canadian target corporation. The effect is the same as if the Act permitted the top-tier foreign affiliate to increase, or bump, its tax cost of the lower-tier foreign affiliate shares up to their $50 fair market value at the time of the acquisition of control – the capital gain would still be determined as $50, but it would be computed as the difference between the $100 proceeds of disposition and the $50 bumped adjusted cost base, rather than by excluding the accrued $40 capital gain from the $90 capital gain otherwise determined.

However, the analogy to the paragraph 88(1)(d) tax cost bump is not complete. For instance, the paragraph 95(2)(f.1) carve-out rule is in fact a broader “fresh start” rule because it can also exclude accrued business income treated as FAPI (i.e., the item A FAPI components) and is not limited to accrued gains on non-depreciable capital properties. The paragraph 95(2)(f.1) carve-out also applies to exclude accrued losses. Another difference is that the paragraph 95(2)(f.1) carve-out rule operates by excluding the portion of capital gain/loss or business income/loss in a foreign affiliate that can reasonably be considered to have accrued, generally, before the acquisition of control. This does not result in a permanent, fixed reset of tax cost at a
designated amount as in paragraph 88(1)(d). So for example, post-acquisition of control fluctuations in value of a capital property of a foreign affiliate can give rise to results that would differ from a paragraph 88(1)(d) bump mechanism if applied to foreign affiliates. Suppose in the example above, after the acquisition of control of the Canadian target corporation, the lower-tier foreign affiliate shares decrease in value from $50 back to the original $10 cost amount and then increase in value to $100 and are sold by the top-tier foreign affiliate for a capital gain of $90. Is it still reasonable to exclude the $40 portion of the gain as having accrued before the acquisition of control, or is really the entire $90 capital gain attributable to the post-acquisition of control period?

Note also that the paragraph 95(2)(f.1) carve-out applies whether or not the Canadian purchaser corporation makes a bump designation under paragraph 88(1)(d) upon the winding-up or vertical amalgamation of the Canadian target corporation. The notion of the paragraph 88(1)(d) tax cost bump of assets directly owned by a Canadian target corporation is that the purchaser, if it winds up or vertically amalgamates the target and acquires the underlying assets, should be treated as though it directly acquired the underlying assets, by “pushing down” the tax cost paid for the target shares onto the underlying assets. The “fresh start” result for income and gain accrual under the paragraph 95(2)(f.1) carve-out rule has a similar effect, in that it produces the same result that would be obtained if the Canadian purchaser corporation had directly acquired the foreign affiliates of the Canadian target corporation.

Interestingly, with the release of the December 18, 2009 draft foreign affiliate amendments, Finance has changed its approach in this regard with respect to the proposed surplus adjustments and bump limitations. Previously, proposed Regulations 5905(5.1) and (5.2) had the effect of resetting to nil all historic surplus and deficit balances in the chain of foreign affiliates under a top-tier foreign affiliate of the Canadian target corporation that is acquired by a Canadian purchaser corporation and bumped under paragraph 88(1)(d). While these rules will be enacted on a transitional basis as new Regulations 5905(5.11) and (5.12) applicable to amalgamations or windings-up occurring after February 27, 2004, they will be replaced with a new rule in proposed Regulation 5905(5.2) applicable to acquisitions of control occurring after December 18, 2009. Under this new rule, the historical surplus and deficit balances in the Canadian target corporation’s foreign affiliates will generally survive the acquisition of control, regardless whether the Canadian purchaser corporation effects a paragraph 88(1)(d) bump of the relevant top-tier foreign affiliate. Instead, proposed Regulation 5905(5.2) will potentially grind the exempt surplus of the top-tier foreign affiliate so that the aggregate of the “tax-free surplus balance” of the affiliate, determined on a group basis, plus the Canadian target corporation’s cost of the top-tier foreign affiliate shares, does not exceed the fair market value of the top-tier foreign affiliate shares at the time of the acquisition of control. In a similar vein, a new bump limitation in proposed Regulation 5905(5.4) will reduce the available paragraph 88(1)(d) bump room in respect of top-tier foreign affiliate shares to the extent of its “tax-free surplus balance”, determined on a group basis. In effect, Regulation 5905(5.2) will require a write-down of tax attributes analogous to paragraph 111(4)(c) (by reducing exempt surplus or creating an exempt deficit) where the group’s “tax-free surplus balance” plus the tax cost of the top-tier foreign affiliate shares exceeds the fair market value of those shares; and by corollary, Regulation 5905(5.4) will permit a write-up of tax attributes (under the paragraph 88(1)(d) bump) but only to the extent that the group’s “tax-free surplus balance” plus the bumped tax cost of the top-tier foreign affiliate shares does not exceed the fair market value of those shares at the time of the acquisition of control.

Thus, in at least this one important respect, Finance is conforming the acquisition of control consequences for foreign affiliate groups under the paragraph 95(2)(f.1) carve-out rule for “designated acquired corporations”, with the proposed surplus adjustment rules in the December 18, 2009 foreign affiliate amendments. In both cases, these rules are delinked from the paragraph 88(1)(d) tax-cost bump rules. That is to say, the effective bump or fresh start under paragraph 95(2)(f.1) for income and gain accrual where there is an acquisition of control of a Canadian target corporation with a foreign affiliate group applies regardless whether a paragraph 88(1)(d) bump designation is made; and similarly, the survival of the historic surplus balances in the target foreign affiliate group following an acquisition of control no longer depends on whether a paragraph 88(1)(d) bump designation is made. The historic surplus balances may be adjusted downward under new Regulation 5905(5.2) and may also constrain the amount of the paragraph 88(1)(d) bump under new Regulation 5905(5.4), but otherwise they survive the acquisition of control including where a bump designation is made.

**Election Considerations**

As noted above, Finance has given taxpayers until at least March 12, 2010 to make the election to retroactively apply the entire package of the new foreign affiliate income computation and calculating currency rules, including the new paragraph 95(2)(f.1) carve-out rule. If made, the election applies to all foreign affiliates of the taxpayer, and to all taxation years of those foreign affiliates
beginning after December 31, 1994, December 20, 2002, or February 27, 2004 (the taxpayer must choose one of these dates for retroactive application).

This one-time election opportunity is likely to be most relevant to any Canadian purchaser corporation that has, since 1994, acquired control of a Canadian target corporation with a pre-existing foreign affiliate group, where the Canadian target corporation was subsequently vertically amalgamated into the purchaser, on a paragraph 88(1)(d) bump transaction or otherwise. Where there is such a “designated acquired corporation”, the new paragraph 95(2)(f.1) carve-out rule can be retroactively applied by this election to potentially exclude the foreign affiliate’s historic capital gains or capital losses, or item A FAPI amounts, accrued up to the time of the acquisition of control of the designated acquired corporation.

Of course, this election can work both ways. The examples discussed above have considered accrued capital gains on non-excluded property, so that the effect of the carve-out rule is beneficial for the purchaser because it can exclude or reduce gain that would otherwise be FAPI. The same beneficial effect arises in the context of accrued item A FAPI amounts. But if there are historic accrued capital losses on non-excluded property, or losses from item A FAPI amounts (i.e., item D FAPI amounts, namely losses from property, from a business other than an active business or from a non-qualifying business), then the effect of the retroactive application of the carve-out rule is to reduce the foreign affiliate’s FAPLs (foreign accrual property losses), which is adverse to the purchaser. Moreover, in some cases, the purchaser might have inherited accrued capital gains on excluded property assets, such that a retroactive application of the carve-out rule would exclude these accrued gains, and the additions to exempt surplus that arise on subsequent dispositions of the excluded property. Therefore, a careful review of the purchaser’s historic circumstances is in order before utilizing this welcomed one-time election opportunity.

— Geoffrey S. Turner, Davies Ward Phillips & Vineberg LLP

### 2010 Automobile Rates and Limits

In News Release No. 2009-125, dated December 31, 2009, the Department of Finance announced that for 2010, the automobile expense deduction limits and prescribed rates for automobile operating expense benefits would remain unchanged from those for 2009. These amounts are set out in a table in Volume 1 at ¶350, and for online and DVD users, under “Quick Links/Other/Automobile Rates and Limits”.

For vehicles acquired after 2009, the limit on the capital cost of passenger vehicles for purposes of capital cost allowance remains at $30,000, plus applicable federal and provincial sales taxes (Regulation 7307(1)); the limit on deductible leasing costs remains at $800 per month, plus applicable federal and provincial sales taxes (Regulation 7307(3)); and the maximum interest deduction for amounts borrowed to purchase an automobile remains at $300 per month (Regulation 7307(2)). The limit on tax-exempt allowances paid to employees for business use of the employee’s vehicle and that are deductible by employers remains at 52 cents per kilometre for the first 5,000 kilometres and 46 cents for additional kilometres (Regulation 7306). For Yukon Territory, Northwest Territories and Nunavut, these figures remain at 56 cents and 50 cents, respectively. The rate for determining the operating expense taxable benefit for the personal portion of automobile expenses paid for by an employer remains at 24 cents per kilometre (Regulation 7305(1)). This rate for taxpayers employed principally in selling or leasing automobiles remains at 21 cents per kilometre.

### CRA’s 2009 Meal and Vehicle Rates

The CRA has released the 2009 meal and vehicle rates that can be used by individuals to calculate meal and travel expenses for purposes of the northern residents’ deductions, moving expenses, and transportation to obtain medical services. The flat rate meal amount remains at $17 per meal to a maximum of $51 per day. For the simplified method of calculating vehicle expenses, the 2009 per kilometre rates are shown in the chart below.

<table>
<thead>
<tr>
<th>Province/Territory</th>
<th>Cents/kilometre</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alberta</td>
<td>51.5</td>
</tr>
<tr>
<td>British Columbia</td>
<td>52.0</td>
</tr>
<tr>
<td>Manitoba</td>
<td>49.0</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>50.0</td>
</tr>
<tr>
<td>Newfoundland and Labrador</td>
<td>53.5</td>
</tr>
<tr>
<td>Northwest Territories</td>
<td>58.0</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>50.5</td>
</tr>
<tr>
<td>Nunavut</td>
<td>58.0</td>
</tr>
<tr>
<td>Ontario</td>
<td>54.0</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>50.0</td>
</tr>
<tr>
<td>Quebec</td>
<td>57.0</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>47.5</td>
</tr>
<tr>
<td>Yukon</td>
<td>61.0</td>
</tr>
</tbody>
</table>