taxnotes® international

Volume 83, Number 5 ■ August 1, 2016

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Reprinted from *Tax Notes Int'l*, August 1, 2016, p. 423

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FEATURED PERSPECTIVE

CIT: Foreign Banks and Canada's CFC System

by Nathan Boidman

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The Tax Court of Canada's *CIT* judgment, as well as two pending companion cases, sheds light on how the simple notion underlying controlled foreign corporation attribution rules – that CFCs' undistributed passive income should be taxed as earned – can evolve into complex, mechanical, and sometimes convoluted rules. This article focuses on that dynamic.

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The Tax Court of Canada's July 4 decision in *CIT Group Securities (Canada) Inc. v. The Queen*, 2016 TTC 163 (2016), involving an offshore lending operation provides an opportunity to review from a base erosion and profit-shifting perspective the nature of passive and investment income attribution systems. It also provides an excellent example of how a simple tax concept can be rendered complex by the modern approach to drafting antiavoidance tax law.

Since the 1962 advent of the U.S. controlled foreign corporation and subpart F system,[1] the notion of taxing (on an attribution basis) domestic shareholders on undistributed passive income of foreign subsidiaries (and some other investees) in the year the income is earned, with relief for foreign taxes, has spread to many developed and even some less developed countries.[2] The concept is simple enough, but its design raises difficult questions. One of the two most important is the manner in which a targeted foreign investee entity should be identified. A second crucial question is how to determine what activities and resulting income should be included in attributable subpart F income.

The second question arose in *CIT*, although there was no lack of challenge regarding the first.[3] In Canada the targeted corporation is called a "controlled foreign affiliate" (CFA), which is a nonresident corporation[4] of which a Canadian resident owns at least 10 percent of any class of shares, or 1 percent if related parties own at least 9 percent,[5] and which is controlled (by reference to voting share ownership) by that person alone or together with specific affiliated persons or no more than four other Canadian residents.

The composition of attributable income — referred to in Canada as foreign accrual property income[6] — is

[1]*See* IRC section 951 et seq.

[2]For details, see OECD, "Designing Effective Controlled Foreign Company Rules, Action 3 — 2015 Final Report" (Oct 5. 2015), and related initial and interim statements and reports.

[3]For example, contrary to the Canadian and U.S. approaches, the new EU anti-tax-avoidance directive defines a CFC by reference not only to share ownership or control of the foreign corporation, but also to its effective rate of tax, which must effectively be less than half the rate in the parent or shareholder country for the corporation to be a CFC.

[4]A corporation formed outside Canada that has its mind and management outside or inside Canada but is protected from full exposure to Canadian tax by a treaty dual-resident tiebreaker rule.

[5]That kind of nonresident corporation is a foreign affiliate under section 95(1) and (4) of Canada's Income Tax Act.

[6]ITA section 95(1).

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relatively simple. In principle it is income derived from passively holding property and gain from occasionally selling that property. It is distinguished from income from rendering services or actively making and selling or buying and reselling property, or actively managing or dealing with property that gives rise to income.

Canada's CFA-FAPI system was relatively consistent with that basic concept between 1976 and 1994. During those 18 years, FAPI was defined as income from property, denoting passive holding of property and determined by case law, or from a business other than an active business, a narrow, almost nonexistent category also determined by case law. Under that regime, most undertakings, including handling income-producing assets, required only a relatively modest level of continuous management to avoid inclusion in FAPI.[7]

All that changed in 1994 when FAPI was expanded to include many financial asset dealings that would have qualified as active business categorization under case law principles. That arose under a new investment business banner (section 95(1) of the Income Tax Act) and discrete rules sprinkled in ITA section 95(2) to 95(3.2) that established some basic additional requirements for active businesses to retain that character and not be included in FAPI. One requirement generally applies in all cases: The business must employ more than five persons full time. In some cases, the CFA must meet a specific status — for example, as discussed in *CIT*, being a foreign bank. In some cases, the activities of the CFA must be regulated, and in others, the activities of the Canadian shareholder must meet set standards — a requirement that also arose in *CIT*.

In *CIT*, the post-1994 dynamic is well seen. The CFA's basic business was active money lending and would have qualified as an active business under the pre-1994 rules whose income would not have been included in FAPI. But under the new rules, a complex analysis was required to determine whether the money-lending business income was FAPI.

CIT

In *CIT*, the Tax Court of Canada found that a regulated Barbados subsidiary (CCG Trust Corp.) of taxpayer CIT Group Securities (Canada) Inc., a Canadian corporation that originated or purchased interest-bearing corporate debt, did not earn income attributable to and taxed in the hands of the Canadian parent under the CFA-FAPI system.[8] That was because the income qualified as active business income that is not FAPI under judicial principles; was not income from an investment business, a component of FAPI, because the subsidiary was earning income from money lending and it employed more than five full-time employees[9]; and was not income from dealing or trading in debt obligations.[10] The third reason was because CCG qualified for an exception for CFAs considered foreign banks under section 95(1), the activities of which were regulated. The requirement in section 95(2)(l)(IV), that the Canadian parent carried on a regulated financial services business in Canada, was also satisfied.

The question whether the exception for foreign banks applied was made relevant by the court deciding a threshold question in favor of the government — namely, whether ITA section 95(2)(l) applied to a CFA that was not primarily dealing or trading in debt obligations, but instead was primarily lending money (an activity addressed by the FAPI investment business component). The rule states that it applies to the income from a business whose principal purpose ''is to derive income from trading or dealing in indebtedness (which for purpose of this paragraph includes the earning of interest on indebtedness).'' It clearly applies to a business whose principal purpose is to derive income from trading or dealing in indebtedness, but its ambiguous wording makes it unclear whether it extends to a business whose principal purpose is earning interest on indebtedness.

The taxpayer argued that the parenthetical served simply to bring into account any interest earned on indebtedness that was being dealt in or traded, but the court agreed with the government that it effectively was another component of the rule bringing in money lending. The court did not seem to frame its analysis using a simple question: If the legislature intended the rule to be interpreted as the government suggested, why didn't it simply drop the parentheses and put the word ''or'' before the words ''the earning of interest on indebtedness''?[11] In any event, once the court brought the CFA's money-lending activities into the rule, the application of the exception for foreign banks became relevant.

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[7]There were a few antiavoidance categories, such as service businesses run by affiliated parties or charging fees to Canadian affiliated parties. *See* ITA section 95(2)(b). There was also case law respecting operation of residential real estate that required more than continuous routine management.

[8]The income that the government sought to attribute was actually not the income of CCG, but rather the income of nine other Barbados subsidiaries to which CCG paid its income in the form of interest on loans that funded its operations and which interest income those subsidiaries claimed was recharacterized as active business income, not FAPI, under ITA section 95(2)(a)(ii) on the basis that CCG's income was active business income, not FAPI. But if CCG's income was FAPI (before payment of the interest), the interest income of the nine subsidiaries would not be recharacterized as active business income under section 95(2)(a)(ii) but instead would be FAPI. It was that income that the government sought to attribute to CIT.

[9]*See* ITA section 95(1), paras. (a)(ii), (b), and (c)(i).

[10]ITA section 95(2)(l).

[11]The rule would then apply to the income from a business whose principal purpose ''is to derive income from trading or dealing in indebtedness or the earning of interest on indebtedness.''

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Was CCG a foreign bank under section 95(1) for purposes of the exception in section 95(2)(l)(iii)? Its business entailed borrowing money from Barbados affiliates and using the borrowed funds to lend money or purchase debt obligations in arm's-length transactions.

Under section 95(1) (with reference to section 2(e) of Canada's Bank Act), a foreign bank includes a foreign corporation that ''engages, directly or indirectly, in the business of providing financial services and is affiliated with another foreign bank.''[12] CCG's U.S. sister company CIT Bank used the word ''bank'' in its name and engaged in financial services, satisfying the affiliated part of the definition, and CCG's own lending and debt-purchasing activities fell under the broad concept of financial services. Thus, it was a foreign bank. Separately, CCG showed that its activities were subject to oversight by the Barbados central bank, so it satisfied all the requirements in section 95(2)(l)(iii).

Therefore, CCG's income[13] of C $225 million for the years 2003-2009 was not FAPI and there was no income to attribute to CIT under ITA section 91.

The court also dismissed the government's ancillary claims that because some CIT shareholders, through a partnership, had dividend rights set by the CCG operations, the overall structure was a ''conduit'' to transfer CCG's income to its partners, which should be taken into account in interpreting ITA section 95(2)(l).

Relation to Other Pending Cases

There are two other cases pending that involve Barbados-based financial operations, FAPI, and FAPI exceptions based on foreign bank-related status and arrangements. Will *CIT* be directly on point?

One case is *Rigel Financial Holdings Inc.*[14] According to the taxpayer's notice of appeal, Rigel owned a CFA, Dancap Bank (Barbados) Inc. The CFA obtained a license to carry on international banking under Barbados's International Financial Services Act and was regulated by the Central Bank. It had eight or nine full-time employees and engaged in ''proprietary trading of currencies, precious metals, private equity securities, debt instruments, derivatives and alternative investments (which it conducted principally with arm's-length persons) as well as the provision of financial services.'' It could not accept deposits from third parties.

The government assessed C $6.4 million of FAPI by rejecting the argument that the bank qualified for the exception for business carried on by a foreign bank having more than five employees and whose activities are regulated.

The taxpayer relies on the definition of foreign bank in section 2(a) and (c) of the Bank Act. That distinguishes its case from *CIT*, which relied on section 2(e). But the way the Tax Court rejected some of the government's arguments in *CIT* augurs well for taxpayers in other cases involving foreign bank status. Another distinguishing factor is that the rule in dispute in *CIT*, ITA section 95(2)(l), is not at issue here — rather, the case focuses on the meaning of an investment business under section 95(1). A third distinguishing factor is that the government's June 2014 reply to the taxpayer's appeal invokes Canada's general antiavoidance rule under ITA section 245,[15] which was not discussed in *CIT*.

The second case is *Loblaw Financial Holdings Inc.*, which raises questions similar to those in *Rigel* and different from *CIT*.[16] It involves the investment business component of FAPI, not ITA section 95(2)(l), as well as elements of the definition of foreign bank other than section 2(e) of the Bank Act. Further, the government has invoked GAAR in support of its specific, rule-based position and relies on the ''adventure or concern in the nature of trade'' component of FAPI.[17]

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[12]That is paragraph (e) of the definition in section 2. That the definition includes an entity that: (a) is a bank according to the laws of any foreign country where it carries on business; (b) carries on a business in any foreign country that, if carried on in Canada, would be, wholly or to a significant extent, the business of banking; (c) engages, directly or indirectly, in the business of providing financial services and employs, to identify or describe its business, a name that includes the word ''bank,'' ''banque,'' ''banking,'' or ''bancaire,'' either alone or in combination with other words, or any word or words in any language other than English or French corresponding generally thereto; (d) engages in the business of lending money and accepting deposit liabilities transferable by cheque or other instrument; (e) engages, directly or indirectly, in the business of providing financial services and is affiliated with another foreign bank; (f) controls another foreign bank; or (g) is a foreign institution, other than a foreign bank within the meaning of any of paragraphs (a) to (f), that controls a bank incorporated or formed under Canada's bank Act. See related comments below on two pending cases.

[13]And that of nine sister Barbados subsidiaries.

[14]*Rigel Financial Holdings Inc. v. The Queen*, 2014-800(IT)G (TCC), taxpayer notice of appeal filed Mar. 14, 2014.

[15]GAAR allows the government to disallow a ''tax benefit'' under Canadian tax law that arises from a transaction or series of transactions that was not undertaken primarily for ''bona fide purposes other than to obtain the tax benefit'' (termed an avoidance transaction) unless the transaction does not misuse a provision of the ITA (or a tax treaty) or abuse the ITA or treaty read as a whole.

[16]*Loblaw Financial Holdings Inc. v. The Queen*, 2015-2998(IT)G (TCC), taxpayer notice of appeal filed July 2, 2015.

[17]An adventure or concern in the nature of trade refers to speculative acquisitions and dispositions of property that are not so regular, continuous, or systematic as to be considered a straightforward part of the taxpayer's business. The ITA taxes a Canadian resident on income from business (not necessarily carrying on business) and under section 248(1) deems a business to include a trade-related adventure or concern. For a nonresident, Canadian tax applies to business income only if the nonresident carries on business in Canada; case law has excluded an adventure or concern in the nature of trade. The legislative drafters wanted to tax CFAs' trade-related adventure or concern under

(Footnote continued on next page.)

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Those decisions should shed light on Canada's CFA-FAPI system and augment what has been learned from *CIT*. Further, the government in 2014 moved to narrow the scope of activities and arrangements that meet the regulated entity-based exception to the investment business rule. ITA section 95(2.11) would extend to all those situations the requirement in *CIT* and section 95(2)(l) that the Canadian parent of the CFA itself be a regulated financial institution in Canada. ◆

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the FAPI rules and did that by making income from property a base component of FAPI and defining income from property to include an adventure or concern in the nature of trade.

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