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Privately Owned Foreign Affiliates Caught in Canadian Budget Crossfire

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OVERVIEW

The ambit of the notion of being caught in a crossfire is wide and can extend from the literal live ammunition battlefield or other place of actual armed conflict to the object of this article: proposed Canadian anti-avoidance tax rules applicable to matters conceptually removed, in whole or in part, from the mischief that prompted the legislative action.

This more figurative crossfire relates to certain Canadian *Income Tax Act* (the Act) changes proposed by the Department of Finance in its April federal budget[1] affecting the taxation of certain Canadian investors in certain *foreign resident corporations* earning passive income. The casualties of the crossfire are such investors (although in one case they will be beneficiaries), and the crossfire element is the likelihood that the proposals would have never seen the light of day but for, ironically, a (separate) legislative response considered necessary to counter certain tax reduction arrangements involving (Canadian) privately owned *Canadian-resident corporations* also earning passive income — the mischief in this legislative crossfire.

The discussion below will explore how tax law could bring together something as seemingly unrelated as planning involving foreign resident corporations and planning involving Canadian-resident corporations.

There is a background to the crossfire, a link of the background to the crossfire and the crossfire. Each is considered in turn.

Background to Crossfire

High-net-worth Canadian taxpayers who reside in Canada's two largest provinces (Ontario and Quebec) pay a combined federal and provincial tax rate of roughly 53% on interest income, foreign portfolio dividends, and half of capital gains. Special lower rates apply to dividends from Canadian-resident corporations.

Canadian-resident corporations pay a combined federal and provincial tax rate of roughly 27% (26.5% in Canada's two largest provinces) on interest and half of capital gains and foreign portfolio dividends (portfolio income) unless they are ''Canadian-controlled private corporations'' (CCPCs). Those are corporations resident in Canada and governed by Canadian corporate law (because they were formed in Canada and not redomiciled elsewhere or were formed in another country and continued into Canada) and are not controlled by nonresidents or by a Canadian public corporation and are not themselves a Canadian public corporation.[2]

Since the mid-'90s, a CCPC pays a special high tax rate that is just above 50% (50.2% in Ontario and Quebec) on portfolio income, designed to eliminate any significant advantage for a high-net-worth individual earning portfolio income through a Canadian holding company (that is, a CCPC) compared to earning it directly.

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[1] Budget 2022, Dep't of Finance Canada, Tax Measures: Supplementary Information (Apr. 7, 2022).

[2] *See* Act sec. 125(7).

In order to basically equalize the overall tax paid on directly earned portfolio income as opposed to that earned by a CCPC and then distributed to the individuals as shareholders, four mechanisms are employed. First, roughly 60% of the tax initially paid by the CCPC is refunded to it upon paying sufficient dividends.[3] Second, if the CCPC has realized a capital gain, the non-taxed half goes into a ''Capital Dividend Account'' (CDA) which can be distributed without tax to a Canadian-resident individual.[4] Third, there is gross-up factor when a CCPC pays a taxable dividend, and fourth, an integrated special credit that will produce a (special) tax rate lower than the standard (in Ontario 47.74% and in Quebec 48.7%) on the dividend. That will produce overall tax of around 58%.[5]

LINK OF THE BACKGROUND TO THE CROSSFIRE

The foregoing background has been in place for the last 30 years or so, but it is only recently that a strategy has been developed for CCPCs to avoid the targeted purpose of the rules for their portfolio income. That strategy is remarkably simple. It is for a CCPC to take the relatively simple step of eliminating the requisite ''Canadian corporation'' status by continuing (also referred to as redomiciling) to a compatible foreign jurisdiction so that it ceases to be a CCPC (although by retaining mind and management in Canada, residency in Canada continues). CCPC status can also be eliminated through certain other means. The former CCPC becomes eligible to pay only about half the tax it has been paying. Furthermore, where capital gains are involved, this is like having your cake and eating it because the CDA aspect of a CCPC continues to apply after its CCPC status ceases.[6]

In recent years this (strategy) has become a veritable industry, and it grew increasingly clear that the government would react.

And it did — announcing in the April Budget (note 1) that it would counter the strategy by labelling such former CCPCs as Substantive CCPCs and rendering them subject to the same rules as apply to actual CCPCs.

But the Budget proposals did not stop there, with taxpayer arrangements that have no economic effects other than to reduce taxation (a situation that doesn't necessarily trigger Canada's general anti-avoidance rule under section 245 of the Act). Instead the Budget catches in a legislative crossfire longstanding standard private Canadian-owned (foreign) nonresident corporation arrangements for a variety of foreign active business and/or investment-type interests. In one case the results will be appropriate, in another case totally inappropriate, and in a third seem unexpectedly favourable for taxpayers.

And as will be shown in the next section, the link and common element between the focused mischief of Substantive CCPCs and the arguably similar effects available through privately owned non-resident corporations is rather thin. It is portfolio income but without capital gains which never provided preferred results when realized through a nonresident corporation because the substantial benefits of the CDA are not available.

THE CROSSFIRE

This section examines the direct background to the crossfire and examines the crossfire.

Direct Background

A nonresident corporation is a ''foreign affiliate'' (FA) vis-à-vis a Canadian resident if 10% or more of any class of its stock is owned directly or indirectly by such Canadian.[7] An FA is also a ''controlled foreign affiliate'' (CFA) vis-à-vis a Canadian if it is controlled (by reference to ownership of more than 50% of voting shares) by the Canadian, by certain other persons, or by a combination of the Canadian and certain other persons.[8]

Subject to the effects of OECD Pillar Two,[9] undistributed active business income of an FA or CFA is not taxed in the hands of its Canadian shareholders. Furthermore, under Canada's exempt surplus system, there is no Canadian tax upon the distribution of active business income to a Canadian corporate shareholder (including a CCPC) by an FA resident in a country with which Canada has an income tax treaty or a tax information exchange agreement, provided the income is earned in that or other treaty country.[10] That is also the result where the treaty aspect is not

[3] *See* Act sec. 129(4).

[4] *See* Act sec. 83.

[5] That is 50% . \$100 – 60% thereof (that is \$20) plus, say, 47.74% . \$80 (\$38) or \$58 — or 58%.

[6] The CDA applies to all ''private corporations,'' which is defined in section 89(1) as resident corporations that are not a public corporation and not controlled by such a corporation.

[7] Such status also arises if the Canadian owns as little as 1% but certain affiliated persons own the difference up to 10%. *See* Act secs. 95(1) and (4).

[8] *See* Act sec. 95(1).

[9] See the author's recent article series: *Pillar Two: Effects on Canadian Multinationals*, 51 Tax Mgmt. Int'l J. No. 4 (Apr. 1, 2022); and *Pillar Two: Effects on Canadian Multinationals — Part 2*, 51 Tax Mgmt. Int'l J. No. 5 (May 6, 2022).

[10] *See* Act secs. 90 and 113; Income Tax Regulations, part 5900.

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met but the FA has paid at least 25% tax on the active business income, under Canada's taxable surplus system provided under the rules referenced in note 10.

A very different notion applies if the FA is also a CFA and it earns income that generically is passive, or so deemed, and that more specifically comes within the pool of income that section 95(1) of the Act stipulates is ''Foreign Accrual Property Income'' (FAPI).

In that case, the Canadian shareholder is (1) required to include in income (as would a U.S. shareholder of a CFC with Subpart F income under Internal Revenue Code rules) its share of the FAPI determined before taxes thereon paid by the CFC are taken into account under section 91(1) *and* (2) may deduct from income (as a proxy for a (foreign tax) credit in respect of any taxes paid by the CFA) a portion considered taxed at the shareholder's standard statutory tax rate. For example, under current law if the shareholder is a corporation the relevant standard tax rate is considered to be 25% and if the CFA has paid 25% tax on the FAPI it would be considered fully tax paid. That effect would be achieved by allowing the corporation a deduction of 100% under section 91(4) against the 100% inclusion under section 91(4). The mechanics of that illustrative 100% deduction is the multiplication of the 25% tax assumed paid by the CFA (called the ''foreign accrual tax'' (FAT) in section 95(1)) by the notion — the ''relevant tax factor (RTF)'' which is defined in section 95(4) of the Act as ''4'' in the case of a corporate shareholder (reflecting the above-mentioned standard Canadian tax rate of 25%).

If the FAT was assumed to be 20%, the section 91(4) deduction would only be 80% (4 · 20%) leaving 20% taxable, which at a notional standard 25% tax rate would be 5%, bringing the overall tax rate up to the objective 25%.

The third part of the direct background is the intricate statutory architecture applicable where an FA (whether or not a CFA) realizes a gain on selling the shares of a lower-tier FA, all or substantially all of the property of which is used in carrying on an active business. Such shares are termed ''excluded property'' under section 95(1). Such a gain is excluded from FAPI and instead is included in ''hybrid surplus'' which is reduced by any taxes paid by the CFA. Under current law, certain deductions that are allowed under section 113 to a Canadian corporate shareholder receiving a dividend out of hybrid surplus where the CFA has paid at least a 12.5% tax on the gain eliminates any Canadian tax on the hybrid surplus distribution.

In the foregoing context, the Budget crossfire discussed next has three prongs, the first of which is appropriate, the second of which is obviously inappropriate, and the third of which seems to have some unexpected benefits for taxpayers. The uncertainty stems from the absence at this point of specific statutory proposals, the comments that follow being based on the general framework provided by the Budget materials.

Prong 1: Proposals Respecting FAPI

Current law, incorrectly, treats all Canadian corporations non-CCPCs and CCPCs the same under the CFA/FAPI system.

It wrongly assumes the two groups pay the same rate of tax on passive income in the way it deals with the mechanics that are intended to implement the basic immediate attribution of FAPI of the CFA to its Canadian shareholders, as explained above.

The mechanics where a non-CCPC Canadian corporation owns a CFA that earns $1,000 of interest or portfolio dividend income and pays at least 25% tax are intended to emulate the situation where such corporate shareholder earns the interest directly and pays 25% foreign tax directly and takes a direct credit for it under section 126 of the Act.

As explained above, that emulation takes the form of adding the $1,000 to the corporate shareholder's income under section 91(1) and deducting under section 91(4) the product of the tax paid by the CFA, $250, multiplied by the RTF of 4.

So the non-CCPC would have no net FAPI inclusion and no Canadian tax on the attribution. And that is in harmony with a direct earning of the interest income.

The error in the current system is that the exact same section 91(1) and (4) provisions apply where the shareholder of the CFA is a CCPC so that it pays no tax on the FAPI attribution even though it would pay over 50% if the interest were earned directly (as explained earlier).

Given the latter, in order to give the same result whether the interest is earned by the CFA or the CCPC shareholder, the RTF for the 91(4) deduction should not be 4 (reflecting the tax rate of a non-CCPC about 25%) but instead it should be 1.9 (reflecting the tax rate of a CCPC just above 50%).

And that is what the Budget (appropriately) proposes. That means that in this example, where the shareholder is a CCPC, the 91(4) deduction would not be $1,000 but instead only $250 times 1.9 or $475 (in order to have a $1,000 offset, the CFA would have to pay above $500 of tax).

So with a 91(1) addition of $1,000 and a 91(4) deduction of $475, giving net taxable income of $525, the CCPC would pay about $265 of tax (of which about $160 would be refundable) and the overall foreign and Canadian tax before distribution by the

CCPC would be an appropriate roughly $515, whereas under current law, it would be just the foreign tax of $250.

What happens when the CFA distributes its $750 to the CCPC?

Under both current law and the Budget, there would be no taxable income. Under current law, that results from a section 90 inclusion of $750, which is offset by deductions under section 113(1)(b), as $250 times 3 (RTF 4 – 1) equals $750.

Under the Budget, there would also be an inclusion of $750 under section 90 and there would be two deductions that total $750.

First, under 113(1)(b), there would be a deduction of $250 times 1.9 minus 1.0 or $225. Second, under section 91(5), there would be a deduction of $525, the amount by which the adjusted cost base to CCPC in the shares of CFA are increased by section 92 because of the net FAPI attributed.

The last part is the tax on full distribution by CCPC to individual shareholder. The first thing to note is that the Budget does not intend to materially change the net overall after-tax amount realized by the shareholder which is as follows under current law.

Under current law, CCPC distributes $750 to shareholder at an integrated gross-up and credit rate of, say, 40%, producing tax of $300. Overall tax is $550, leaving net $450.

The Budget is supposed to leave roughly the same $450. To arrive at that result, a new element is required, namely a new tax-free distribution factor. The CCPC will now pay Canadian tax on FAPI attribution of $265 of which $160 is refundable. CCPC received $750 from CFA with no tax. Therefore, assuming the refundable mechanics work, CCPC can distribute $645 ($750 – $265 + $160).

The Budget proposes that about $225 of the $645 go into the CDA leaving $420 to be taxed as a taxable dividend at a rate of about 47.7% or $200. Therefore, that leaves the shareholder with $445 $645 minus $200 — essentially the same as the $450 under current law.

The CDA of $225 is the foreign tax of $250 multiplied by the new RTF of 1.9 minus 1.0 or $250 times 0.9. That is not spelled out in the Budget but appears to be implied by the word description of the CDA in the Budget.

Prong 2: FA Proposal Related to Non-Treaty-Country Active Business Income

Prong 2 proposes revised rules where a CCPC receives a distribution from an FA out of non-treaty-country active business income that has borne tax of at least 25%. There will be tax under the Budget proposals, whereas there would be no such tax under current law. This makes no sense and will work as follows.

Example.

CanCo is a CCPC, owned by a Canadian-resident individual.

CanCo owns FA, which earns $100 of active business income in a non-treaty country and pays 25% tax, leaving $75 of taxable surplus and $25 in underlying tax applicable (UTA) account.

FA pays $75 dividend to CCPC.

Under current law, CanCo:

- includes $75 in CCPC income under section 90; and
- deducts $75 under section 113(1)(b) in computing taxable income (RTF of 4 – 1 • UTA of $25).

Under the Budget, it will:

- deduct $22.50, as RTF is reduced to 1.9, so the calculation under 113(1)(b) is 1.9 minus 1 (0.9) times $25;
- so the net amount added to taxable income of CanCo is $75 minus $22.50 or $52.50 instead of $0 under current law.

CanCo pays about 50% tax on the $52.50 or $26.25 of which about 60% ($15.75) is refundable to CanCo when sufficient taxable dividends are paid to the shareholder.

The after-tax position of the shareholder of the CCPC after it distributes the balance is just about the same under the proposals as under current rules because a portion (equal to the 113(1)(b) deduction) will be flowed through the CDA. The big difference is where CanCo does not distribute — it is out of pocket by $26.25 per $75 received out of active business-related taxable surplus after a $25.00 foreign tax, whereas under current law, it is not out of pocket at all.

This new result does not seem right because if the CCPC earned the active business directly, it would only pay the foreign country 25% and pay nothing in Canada given the direct foreign tax credit that would be available under section 126 of the Act. This proposal should be dropped, even though it would have no effect if FA paid no tax.

Prong 3: Proposal on Hybrid Surplus

The Budget appears to moderately increase tax at the CCPC level on hybrid surplus but reduce overall tax significantly — a very favourable but totally unexpected result. (Bear in mind the caveat that detailed legislative proposals have not yet been issued.)

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Assume a CCPC owns an FA that sells shares of a lower-tier FA (FA2), that are excluded property, for a capital gain of $1,000, and FA pays 12.5% tax or $125.

Under current law, FA has a hybrid surplus of $875 and an underlying hybrid tax of $125, under Reg. 5907.

When FA distributes the $875 to its owner;

- it's added to income of CCPC under section 90;
- CCPC takes a deduction for half of the $875 or $437.50 under section 113(1)(a.1)(i) and another deduction of the underlying hybrid tax of $125 by multiplying it by 3.5 (the RTF of 4.0 – 0.5) or $437.50 under section 113(1)(a.1)(ii).

Therefore, with a foreign tax of 12.5%, there is no tax on the distribution to CCPC.

Then, under current law, the CCPC would have $875 to distribute to its individual shareholder at a tax cost of just under 40% or $350.

So, total tax is $125 + $350 equaling $475 for a 47.5% rate.

The analysis under the Budget is as follows.

The amount of the hybrid surplus and underlying hybrid surplus tax is the same, and on a distribution to the CCPC, there is the same section 90 inclusion and the same section 113(1)(a.1)(i) deduction of $437.50.

What changes is that the RTF is reduced from 4 to 1.9 and, therefore, the 113(1)(a.1)(ii) deduction is $125 times 1.9 minus 0.5 that is $175, leaving the CCPC with taxable income of $875 – $612.50 ($437.50 + $175) = $262.50 (as opposed to zero under current law).

The CCPC will pay just above 50% on the $262 or, say, $135 of which about 60% ($81) will be refundable.

Then, there will be an addition to CDA seemingly equal to the section 113 deductions above in respect of the distribution to the CCPC, which is $612.50, and that amount is also removed from a lower tax rate pool applicable to a taxable dividend paid by CCPC to its shareholder.

Therefore, the CCPC has $875 minus 135 plus 81 to distribute (assuming refundable mechanics work). That is $820. Of that, the CDA is $612.50, leaving $208 as taxable at, say, 47%, meaning tax of $96.

Total tax: $125 + $55 + $96 = $276. That is $200 less than under current law. Intended? If so, the government could give thought to extending CDA treatment to the tax-free half of any type of capital gain realized by an FA.

CONCLUDING COMMENTS

The foregoing shows clearly the need for the Budget proposals respecting Substantive CCPCs and by contrast the absence from the government's standpoint of any overall policy reasons for one of the three prongs of the FA proposals. And it shows the latter may be clearly characterized as being caught in legislative crossfire.

Quite simply it is reasonable to assert that, but for the Substantive CCPC issue, change proposals respecting FAs would have never seen the light of day.

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