Tax Bulletin

March 2007

Budget 2007: Groundbreaking Changes on the Foreign Affiliate Front

Part IV of our Tax Series on the Canadian Federal Budget

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Budget 2007 has proposed several significant changes to the "foreign affiliate" rules contained in the *Income Tax Act* (Canada), which govern the taxation of foreign source business income earned by the "foreign affiliates" of Canadian resident corporations. If enacted, these changes could increase the tax burden associated with such foreign operations and dramatically alter the way such operations are structured and financed. This Tax Bulletin summarizes the key changes.

New Interest Deductibility Restrictions

Under the existing rules, a Canadian company is generally entitled to deduct the interest expense associated with any borrowings incurred for the purposes of financing the acquisition of shares (or other investments) in a foreign affiliate. This is the case notwithstanding the fact that certain types of income earned by that foreign affiliate - essentially, active business income of the foreign affiliate earned in (or through) a "designated treaty country" (known as "exempt surplus") - may be repatriated (as an "exempt surplus dividend") to the Canadian corporate shareholder free of any Canadian income tax liability (this is achieved by affording the Canadian corporate shareholder a deduction from income equal to the amount of the exempt surplus dividend).

Broadly stated, Budget 2007 proposes to eliminate, in most cases, the deductibility for Canadian corporate taxpayers of interest costs and "other borrowing costs" (not defined) associated with debt incurred to finance (directly or indirectly) their foreign affiliates (whether by way of share acquisition, capital contribution or loan). The one notable exception to this new rule will be in circumstances where the particular foreign affiliate generates non-exempt income (known as "taxable surplus"), in which case, the related interest and other expenses (which under the rules will be tracked in a "disallowed interest pool") may be deducted to the extent of the non-exempt income amount (with any remaining expenses available to be carried forward to any subsequent taxation year when additional non-exempt income is realized).

The new interest deduction restriction rules will apply to interest arising after 2007 insofar as debt incurred on or after March 19, 2007 is concerned (except where an agreement in writing was in place before that date). Modest grandfathering will be available with respect to interest payable under previously existing financing arrangements (i.e., deductibility will continue to be available until the earlier of the current term of the particular debt obligation and 2008, in the case non-arm's length debt arrangements, or 2009 in the case of arm's length debt arrangements).

Deemed Active Business Income Changes

Under the existing foreign affiliate rules, certain receipts by foreign affiliates, which would otherwise subject the Canadian corporate shareholder to immediate taxation (as "foreign property accrual income" or "FAPI"), are deemed to be "active business income" and potentially eligible for the beneficial exempt surplus treatment described above. Such receipts generally include those amounts, such as royalties, interest and lease payments, received from other foreign affiliates of the Canadian corporate taxpayer along with certain related non-resident corporations, provided the subject payment reduces the active business income of the payer.

For taxation years of foreign affiliates commencing after 2008, Budget 2007 proposes to narrow the scope of paying entities to which these beneficial active business deeming rules apply to those entities in which the Canadian corporate taxpayer has a "qualifying interest" (essentially meaning the direct or indirect ownership of 10% or more of the votes and share value in the particular corporation).

Tax Information Exchange Measures

Budget 2007 proposes that all new and renegotiated tax treaties will be required to include comprehensive tax information exchange clauses consistent with those endorsed by the OECD. Further, for certain select countries (apparently to be identified by the government at its discretion) without treaties in effect, stand alone "Tax Information Exchange Agreements" (TIEAs) (again consistent with those endorsed by the OECD) will be proposed.

This expanded tax information exchange initiative will be buttressed by certain changes to the surplus characterization provisions contained in the foreign affiliate rules, which the government hopes will serve as an incentive to induce the revenue authorities in the particular targeted countries to participate. In summary, the exemption under the rules for dividends received out of active business income earned by foreign affiliates in "designated treaty countries" will be extended to include such income earned by foreign affiliates residing in a country that has entered into a TIEA. On the other hand, active business income earned by foreign affiliates in countries that have no treaty or TIEA with Canada will be taxed in the hands of the Canadian corporate taxpayer on an accrual basis (i.e., as FAPI). This latter rule will not apply, however, in the case of countries where TIEA negotiations have commenced, provided, in the case of negotiations that commence after March 19, 2007, the relevant TIEA is completed within five years of the commencement date or, in the case of existing negotiations, the relevant TIEA is completed before 2014.

Impact on Existing Foreign Affiliate Amendments

Budget 2007 indicates, with no definitive guidance as to timeline, that previously announced technical tax changes regarding the taxation of foreign affiliates (which are voluminous) will be reviewed and evaluated in light of the above measures.

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The foreign affiliate rule changes proposed by Budget 2007 will no doubt be a subject of much consideration over the coming weeks and months as Canadian corporations evaluate their impact upon existing structures and those being planned for the future.

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