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# Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal

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## INTRODUCTION

The thesis of this note is that the current links between the foreign affiliate rules and Canada's tax treaties should be eliminated. Under the foreign affiliate rules, exempt surplus is restricted to active business income earned in a country with which Canada has a treaty ("treaty country") by foreign affiliates resident in a treaty country. In addition, most of Canada's tax treaties require Canada to exempt from tax dividends received by Canadian corporations out of the exempt surplus of foreign affiliates resident in the other country. More recent treaties entered into since 1998, however, do not contain such a provision. Although this change in Canadian treaty policy is welcome, it is insignificant without appropriate changes to the foreign affiliate rules.

This note argues that the links between the foreign affiliate rules and tax treaties have caused distortions in both Canada's tax treaty network and the foreign affiliate rules. The note recommends that the exemption for dividends received out of exempt surplus should not be included in Canada's tax treaties and that the requirement for foreign affiliates to be resident in treaty countries in order to earn exempt surplus should be deleted from the foreign affiliate rules. As a result, tax treaties and the foreign affiliate rules would operate independently of one another.

## OVERVIEW OF CANADA'S TAX TREATY NETWORK AND THE FOREIGN AFFILIATE RULES

### The Foreign Affiliate Rules

The Canadian foreign affiliate rules provide a combined exemption/credit system for dividends received by a Canadian corporation from a foreign affiliate. A foreign affiliate is a foreign corporation in which a Canadian corporation owns 10 percent or more of the shares of any class.

All dividends received from foreign corporations are included in income.<sup>1</sup> Dividends received by a Canadian corporation from a foreign affiliate are deductible in computing the corporation's taxable income to the extent that the dividends are

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received out of the foreign affiliate's exempt surplus.<sup>2</sup> Dividends received by a Canadian corporation out of a foreign affiliate's taxable surplus qualify for deductions in respect of the foreign withholding taxes on the dividends and the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividends are paid.<sup>3</sup> These deductions are equivalent to credits for foreign withholding taxes and underlying foreign taxes. Dividends from a foreign affiliate are deemed to have been paid first out of the affiliate's exempt surplus and then out of its taxable surplus.<sup>4</sup> Dividends received from a foreign affiliate in excess of its exempt and taxable surplus are deemed to have been received out of pre-acquisition surplus. Dividends received out of pre-acquisition surplus are deductible in computing taxable income<sup>5</sup> but are subtracted in computing the adjusted cost base of the shares in the foreign affiliate.<sup>6</sup>

The exempt surplus of a foreign affiliate includes the exempt portion of capital gains, certain taxable capital gains, and dividends received out of the exempt surplus of other foreign affiliates of the Canadian corporation.<sup>7</sup> The most important inclusion in exempt surplus is income from an active business carried on in a designated treaty country by a foreign affiliate resident in a designated treaty country. In addition, in certain circumstances income from property is deemed to be income from an active business in a designated treaty country and therefore is included in exempt surplus.<sup>8</sup> The most important example of this type of income is interest earned by a foreign affiliate from financing other foreign affiliates resident in treaty countries that use the funds to finance active business operations carried on in treaty countries.

The taxable surplus of a foreign affiliate consists of all the income earned by an affiliate that is not included in its exempt surplus.<sup>9</sup> In particular, taxable surplus includes any passive investment income (foreign accrual property income or FAPI), dividends received out of the taxable surplus of other foreign affiliates, and active business income earned in non-treaty countries.

In summary, dividends from foreign affiliates received by Canadian corporations are either exempt from Canadian tax or are taxable with a credit for the underlying foreign taxes on the income out of which the dividend is paid. The rationale for the exemption for dividends out of exempt surplus is that exemption from Canadian tax is warranted only if the income out of which the dividends are paid is derived from an active business carried on in a treaty country by a foreign affiliate resident in a treaty country. Thus, two criteria determine the availability of the exemption: the nature of the income earned by a foreign affiliate, and the country in which the foreign affiliate is resident and the income is earned. Limiting the exemption for dividends from foreign affiliates to active business income relates to international competitiveness. For Canadian-based multinational corporations carrying on active businesses in treaty countries through foreign affiliates, the only tax on the income derived from these businesses is the tax levied by the foreign country. Therefore, such corporations are not subject to any additional tax burden as compared to corporations resident in the foreign country and other foreign corporations doing business in the country. Limiting the exemption to income earned in treaty countries is an attempt to ensure that the income is subject to foreign tax that is roughly

comparable to the Canadian tax that would have been levied on the income if the income had been earned directly by the Canadian corporation. As discussed below, the treaty country requirement can be justified only as a proxy for a requirement that a country levy tax at rates and on a base roughly comparable to Canadian tax. As we shall see, the implementation of the exemption system has not been faithful to this rationale because Canada has entered into treaties with several countries that operate as tax havens.

The legislative history of the foreign affiliate rules is not explicit about the policy underlying the exemption for dividends out of exempt surplus. It has been suggested that the exemption system might be intended to operate as an incentive for Canadian multinationals to invest in treaty countries rather than as a proxy for a credit system.<sup>10</sup> It has also been suggested that the exemption system is justified on grounds of international competitiveness<sup>11</sup> or as a means of providing tax sparing for developing countries.<sup>12</sup> Some countries, such as the Netherlands, provide an exemption for all foreign business income and for dividends from foreign corporations irrespective of the level of foreign tax on the income. Nevertheless, it seems reasonably clear that, when the foreign affiliate rules were introduced in 1972, there was no intention to provide any incentive for Canadian corporations to invest abroad, whether in treaty countries or otherwise. The 1966 Royal Commission on Taxation recommended that the income of foreign affiliates should be subject to a minimum tax, Canadian or foreign, of 30 percent levied on a current basis.<sup>13</sup> The 1969 white paper recommended a combined exemption/credit system for dividends from foreign affiliates that, with slight modifications, is the current Canadian system. The white paper stated that the underlying policy objective of its recommendations was "neither to provide an incentive to Canadians to invest abroad, nor to place a barrier in the way of their doing so."<sup>14</sup>

If the Canadian exemption is intended to be an incentive for foreign investment or to allow Canadian corporations to compete internationally, it is difficult to understand why the exemption is restricted to investments in foreign affiliates in treaty countries.<sup>15</sup> The exempt surplus system was adopted as part of the 1972 tax reform to replace a system under which all dividends received from 25 percent owned foreign corporations were exempt from Canadian tax. Moreover, it must be remembered that in 1972 Canada had tax treaties with only 16 countries, most of which were high-tax countries.<sup>16</sup> Accordingly, in 1972 Canada moved from a complete exemption system to a system restricted to dividends out of active business income earned by foreign affiliates in only 16 countries and a credit system for all other dividends. In this context, the exemption system is better viewed as a proxy for a credit system rather than an incentive for foreign investment in treaty countries.<sup>17</sup>

Nevertheless, some people may argue that the legislative history of the foreign affiliate rules concerning the original policy intention of the exemption system is unclear or that the policy intention has changed over the years. These people argue that the exemption system is necessary to allow Canadian corporations to compete internationally or to provide an incentive for Canadian corporations to invest in treaty countries. In my opinion, the exemption system cannot be justified on this basis; the exemption system can be justified in tax policy terms

only as a proxy for a credit system. Active business income earned by Canadian corporations from foreign sources (that is, foreign branch income) is subject to Canadian tax with a credit for any foreign tax on the income. Dividends received from foreign corporations out of the active business income of foreign affiliates in non-treaty countries is similarly subject to Canadian tax with a credit for any withholding taxes and any underlying foreign corporate taxes. Therefore, dividends from treaty country foreign affiliates should be exempt only if the income out of which the dividends are paid is subject to foreign tax in the treaty country that is reasonably comparable to Canadian tax.

### **Canada's Tax Treaty Network**

As of January 2002, Canada had 75 comprehensive income tax treaties in force with other countries.<sup>18</sup> An additional 5 treaties were signed and awaiting the enactment of implementing legislation. Negotiations have commenced with another 11 countries. Therefore, it is likely that in a few years Canada will have tax treaties with approximately 90 countries.

The Canadian treaty network includes all of Canada's major trading partners. It also includes all of the member countries of the OECD, with the exception of Greece and Turkey, and negotiations for treaties with Greece and Turkey are underway. It is not surprising that Canada has tax treaties with these countries. Cross-border transactions, including trade, investment, and the movement of individuals, between Canada and these countries is commonplace and growing. Tax treaties facilitate such cross-border activities. What is surprising, however, is that Canada has tax treaties with many countries that can only be described as minor trading partners. For example, Canada has treaties with Kurdistan, Uzbekistan, and Papua New Guinea; a treaty has also been signed with Lebanon, and negotiations have commenced with Armenia, Gabon, and Moldova.

Canada's tax treaty network includes treaties with several countries that are generally known as tax havens—for example, Barbados, Cyprus, Ireland, and Luxembourg. Moreover, Canada has treaties with a number of countries that have special low-tax regimes for certain types of entities or income. For example, Denmark, Belgium, the Netherlands, Hungary, and Switzerland all provide low-tax regimes for certain holding companies, headquarters companies, and other special corporations. Finally, Canada has signed a treaty with Kuwait and is currently negotiating with the United Arab Emirates, countries that levy income tax only on foreign corporations doing business in Kuwait or the United Arab Emirates (and in the case of the United Arab Emirates, only foreign corporations engaged in oil and gas and banking activities).

The growth of the Canadian tax treaty network over the past 25 years has been extraordinary.<sup>19</sup> As noted above and discussed in more detail below, the introduction of the foreign affiliate rules in 1972 made the exemption for dividends from foreign affiliates of Canadian corporations conditional on the existence of a tax treaty between Canada and the country in which the foreign affiliate is resident and carrying on business. Before 1972, dividends received by Canadian corporations

from foreign corporations were exempt if the Canadian corporation owned at least 25 percent of the shares of the foreign corporation. Consequently, restricting the exemption to dividends from foreign affiliates in treaty countries was a drastic change in the system. To soften the effects of the adoption of the foreign affiliate rules, in 1972 the government committed itself to expanding Canada's tax treaty network and thereby to expanding the exemption system for dividends from foreign affiliates of Canadian corporations. Given that the tax treaty network has expanded from 16 countries in 1972 to 75 countries currently, the government has clearly delivered on its commitment.

Although there may be many reasons why a country may wish to enter into a tax treaty with another country, in Canada's case the primary impetus for entering into tax treaties is the exemption for dividends from foreign affiliates. Any Canadian corporation that is carrying on an active business in a foreign country that imposes income tax or a reasonable proxy for an income tax has a legitimate case for requesting the federal government to enter into a tax treaty with that country.

## **THE RELEVANCE OF TAX TREATIES FOR THE FOREIGN AFFILIATE RULES**

### **Designated Treaty Country**

When the foreign affiliate rules were first introduced (in 1972 but effective from 1976), exempt surplus of a foreign affiliate included income from an active business carried on by the affiliate in a listed country if the affiliate was resident in a listed country. Regulation 5907(11) contained a list of countries for this purpose. Listed countries were intended to be countries with which Canada had concluded tax treaties. Because of difficulties encountered in amending the regulations, the list of countries came to include countries with which Canada had commenced treaty negotiations but had never concluded a tax treaty and did not contain some countries with which Canada did have a tax treaty.<sup>20</sup> It was clear that the list of countries was flawed. Criticisms on this point and other aspects of the FAPI and the foreign affiliate rules were raised in the 1992 auditor general's report<sup>21</sup> and the consequential report of the Public Accounts Committee of the House of Commons.<sup>22</sup> One of the recommendations of the latter report was that the list of countries in regulation 5907(11) be revised. In 1995, as part of a package of amendments to the FAPI and the foreign affiliate rules, the listed-country approach was repealed and new rules were adopted whereby the exempt surplus system would operate automatically with respect to countries with which Canada had entered into a tax treaty.

Under the 1995 amendments, a foreign affiliate's active business income is included in its exempt earnings (and thereby in its exempt surplus) only if the affiliate is resident in a "designated treaty country" and the affiliate's income from an active business is earned in a "designated treaty country."<sup>23</sup> In regulation 5907(11), a country is defined to be a designated treaty country if Canada has entered into a comprehensive income tax treaty with the country that has entered into force and has effect for a particular taxation year of a foreign affiliate. Regulation 5907(11.1) provides that a treaty is deemed to have entered into force and to

have effect for any taxation year of a foreign affiliate beginning with the year in which the treaty is signed and ending with the last day of the last year to which the treaty applies. In general, treaties enter into force once instruments of ratification have been exchanged between the countries. However, treaties often contain provisions establishing an effective date of the treaty that differs from the date of entry into force. The rule in regulation 5907(11.1) ensures that, irrespective of these dates, a country's status as a designated treaty country (or not) applies only for whole taxation years of foreign affiliates. Although a country is a designated treaty country only when the treaty enters into force, once the treaty enters into force the country is considered to be designated for the taxation year in which the treaty was signed and any subsequent years. Similarly, if a treaty is terminated, the country remains a designated treaty country until the end of a foreign affiliate's last taxation year to which that treaty applies.

As indicated earlier, currently there are 75 countries that are designated treaty countries within the meaning of regulation 5907(11). In addition, tax treaties have been signed with another 5 countries but have not yet entered into force. Also as noted earlier, several of the countries that are designated treaty countries for purposes of the foreign affiliate rules provide preferential rates of tax for certain types of income or entities, and can be used effectively as tax havens. These low-tax regimes are widely used by Canadian taxpayers. Treating these countries as designated treaty countries for purposes of the foreign affiliate rules is inconsistent with the rationale underlying the rules, as discussed above. Designated treaty countries should be restricted to countries that impose corporate tax roughly comparable to the Canadian corporate tax. As I have argued above, the exemption for dividends received by a Canadian corporation out of the exempt surplus of a foreign affiliate can be justified only as a proxy for a foreign tax credit system. Under a foreign tax credit system, dividends received from foreign affiliates are taxable and a credit is available for any foreign withholding taxes on the dividends and for the underlying foreign taxes on the income out of which the dividends are paid. If the foreign withholding taxes and the underlying foreign corporate taxes are equal to or greater than the Canadian taxes, any Canadian tax on the dividends will be completely offset. Providing an exemption for such dividends is a simpler method of achieving the same result than would be achieved under a foreign tax credit system.

This justification for the exemption system as a proxy for a foreign tax credit system breaks down to the extent that the exemption is extended to dividends received from foreign affiliates that are not subject to foreign taxes roughly comparable to the Canadian corporate tax. For example, foreign affiliates resident and carrying on business in Ireland are subject to an Irish corporate tax rate of only 12 percent, which is about one-third of the Canadian rate.

### **Residence of a Foreign Affiliate in a Designated Treaty Country**

As mentioned earlier, in order for the active business income earned by a foreign affiliate to be included its exempt surplus, the foreign affiliate must be resident in a designated treaty country and the income must be earned from an active business

carried on in such a country. Until the 1995 amendments to the foreign affiliate rules, residence was not defined for this purpose; as a result, the basic test of central management and control applicable to the residence of Canadian corporations also applied for purposes of determining the residence of a foreign affiliate. This situation was unacceptable because it allowed corporations to incorporate subsidiaries in unlisted tax havens, such as Bermuda, but have central management and control of the corporation exercised in a treaty country, such as the United States. In these circumstances, a foreign affiliate could earn exempt surplus from any businesses carried on in listed countries even though it was not subject to tax in the United States on its worldwide income (because only corporations incorporated in the United States are subject to US tax on their worldwide income).

Regulation 5907(11.2) was introduced in 1995 to prevent this type of tax planning.<sup>24</sup> To qualify for exempt surplus treatment, a foreign affiliate must be resident in a designated treaty country both for purposes of Canadian tax law (reflecting the central management and control test of corporate residence) and for purposes of the treaty between Canada and the country.<sup>25</sup>

The residence article of most Canadian tax treaties follows closely the wording of article 4 of the OECD model treaty.<sup>26</sup> Under article 4 of the OECD model treaty, a person, which includes a corporation, is a resident of a contracting state if it is liable to tax under the laws of that state by reason of domicile, residence, place of management, or any other criterion of a similar nature. In a few Canadian treaties, place of incorporation is added to the list of criteria in the residence article.<sup>27</sup> The wording of the residence article in the OECD model treaty and in Canadian tax treaties raises a number of difficult issues of interpretation. For example, what does "liable to tax" mean? What is the common element that justifies reference to domicile, residence, place of management, and place of incorporation as the basis for taxation? What are criteria of a similar nature?

Some limited guidance with respect to the concept of corporate residence for the purpose of tax treaties is provided by the Supreme Court of Canada's decision in the *Crown Forest* case.<sup>28</sup> That case involved the issue of whether a corporation incorporated in the Bahamas with its head office in the United States was a resident of the United States for purposes of the Canada-US tax treaty. The corporation did not pay any US tax because it qualified for the exemption for international shipping companies in the Internal Revenue Code. The Supreme Court held that the corporation was not a resident of the United States for purposes of the treaty because the corporation was not liable to US tax on the basis of any of the enumerated criteria, or any similar criteria. According to Justice Iacobucci,

the most similar element among the enumerated criteria is that, standing alone, they would each constitute a basis on which states generally impose full tax liability on worldwide income. . . . In this respect, the criteria for determining residence in Article IV.1 involve more than simply being liable to taxation on some portion of income (source liability); they entail being subject to as comprehensive a tax liability as is imposed by a state.<sup>29</sup>

Since under US income tax law only corporations incorporated in the United States are subject to tax on their worldwide income, the Bahamian corporation could not qualify as a resident of the United States for purposes of the treaty.

Unfortunately, the Supreme Court's decision in the *Crown Forest* case raises more questions than it answers.<sup>30</sup> It is generally accepted that residence for treaty purposes is not limited to persons who are, in the words of the Supreme Court, "subject to as comprehensive a tax liability as is imposed by a state." For example, it is clear that governments, government agencies, and exempt organizations such as charities and pension funds are residents of a country even though they are exempt from tax in the country. Further, it is generally accepted that, if a country taxes on a territorial basis or on a remittance basis, persons subject to such a tax regime are considered to be residents of the country for treaty purposes even though they are not taxable on their worldwide income. The application of the "liable to tax" requirement to transparent entities such as partnerships and trusts is problematic because they are not liable to tax.

With respect to the foreign affiliate rules, the *Crown Forest* case raises enormous difficulties. As noted earlier, many foreign affiliates of Canadian corporations are established in tax haven countries with which Canada has a treaty. Often these foreign affiliates qualify for preferential tax regimes in these countries. For example, several countries offer preferential regimes for international holding companies under which the holding company is exempt from tax on dividends received from foreign corporations, exempt from withholding tax on dividends paid to non-residents, and exempt from capital gains tax on the disposition of shares of the operating subsidiaries it owns. In contrast, other corporations established and doing business in such countries are usually subject to significantly higher rates of tax. Similarly, several countries offer special regimes for international business corporations (IBCs) that earn primarily or exclusively foreign-source income. These international holding companies and IBCs arguably do not satisfy the Supreme Court's test of being subject to as comprehensive a tax liability as a country imposes. As indicated earlier, however, the application of this test is problematic. Canadian-controlled private corporations and even corporations qualifying for the manufacturing and processing profits credit are not subject to as comprehensive a tax liability as Canada imposes. Yet virtually everyone would acknowledge that such corporations should be treated as residents of Canada for purposes of Canada's tax treaties. Therefore, not all foreign companies qualifying for preferential regimes in foreign countries are disqualified as residents of those countries for purposes of a treaty.

Despite the Supreme Court's reference to as comprehensive a tax liability as a country imposes, there seems to be general agreement that a resident of a country for treaty purposes is a person whose connections with that country entitle the country to tax the person on worldwide income, even though the country may decide not to impose tax on the person for some reason. The relevant connections with a country are those enumerated in the treaty (domicile, residence, place of management) or any similar criterion. Thus, if a country exercises its taxing



jurisdiction over corporations incorporated or managed in the country, those corporations would be considered to be residents of the country for purposes of the treaty despite the fact that such corporations qualify for special no-tax or low-tax regimes. Not surprisingly, the Canada Customs and Revenue Agency (CCRA) has not completely accepted this approach. It has sometimes taken the position that foreign affiliates taking advantage of preferential tax regimes are not residents of the foreign country for purposes of the treaty.<sup>31</sup>

It is difficult to distinguish between foreign affiliates that are subject to sufficient tax liability in the foreign country to be considered treaty residents and those foreign affiliates that are not, even on the basis of some notion of tax abuse. If a charity that is exempt from tax in a country is nevertheless considered to be a resident of the country for purposes of the treaty, how can a foreign affiliate incorporated and managed in a country be treated any differently, even if it is subject to a low rate of tax or is exempt from tax? The important point in this regard is that the CCRA should not be placed in the untenable position of policing entitlement to the exempt surplus system through the inadequate requirement of residence in a treaty country.

Whatever the concept of a treaty resident means, it is clear that corporations that are expressly excluded from a treaty and corporations that are treated as flowthrough entities for tax purposes cannot qualify as residents of the country for purposes of the treaty. Exclusion provisions in tax treaties are quite common.<sup>32</sup> Under the terms of several Canadian tax treaties, certain foreign corporations are excluded from the benefits of the treaty. For example, article XXX(3) of the Canada-Barbados tax treaty<sup>33</sup> provides that the treaty does not apply to Barbados IBCs. As a result, such corporations would not be treated as residents of Barbados for purposes of the foreign affiliate rules.<sup>34</sup> Thus, the general rule in regulation 5907(11.2)(a) would have excluded all Barbados IBCs, certain offshore companies in Cyprus, holding companies in Luxembourg, and other foreign corporations from qualifying for exempt surplus treatment. However, a special rule alters this result and allows these corporations to qualify.

Regulation 5907(11.2)(c) provides that a foreign affiliate will qualify as a treaty resident of a country if it would be resident for purposes of the treaty but for a provision in the treaty specifying that the treaty does not apply to the affiliate.<sup>35</sup> The effect of this provision is to ignore the effect of the exclusion provision in the treaty. Thus, a Barbados IBC will qualify for exempt surplus if its central management and control is in Barbados and if it would be a resident of Barbados for purposes of the Canada-Barbados treaty, ignoring the exclusion provision. In other words, Barbados IBCs must be considered to be liable to tax under the laws of Barbados by reason of one of the enumerated criteria or a similar criterion. According to the *Crown Forest* case, IBCs must be subject to as comprehensive a tax liability as Barbados imposes in order to qualify as residents of Barbados for purposes of the treaty. IBCs are subject to Barbados tax at a maximum rate of 2.5 percent. The normal Barbados corporate tax rate is 40 percent. Nevertheless, according to the previous analysis, treaty residence does not require the payment of substantial tax,

or even any tax, to a country. It is understood that the CCRA does not challenge the entitlement of ordinary Barbados IBCs to exempt surplus treatment. As explained in more detail below, regulation 5907(11.2)(c) provides convincing evidence of the complete lack of integrity in the Canadian foreign affiliate rules.

The requirement of treaty residence for purposes of the exempt surplus system also causes a problem with respect to foreign corporations that are treated as flow-through entities under the foreign tax law. For example, certain US entities, such as limited liability companies (LLCs), are treated as corporations and foreign affiliates for Canadian income tax purposes but may be treated as transparent or flowthrough entities for US tax purposes if the appropriate election is made under the check-the-box rules. A US LLC that is treated as a transparent entity is not liable to tax under US law and therefore cannot qualify as a resident of the United States for purposes of the treaty. Therefore, such LLCs would not qualify for exempt surplus treatment. Regulation 5907(11.2)(b) alters this result by providing that a foreign affiliate will be treated as a resident of a country for purposes of the treaty if it would be a treaty resident on the assumption that it was treated as a corporation under the foreign law.

### **ASSESSMENT OF THE LINK BETWEEN TAX TREATIES AND THE FOREIGN AFFILIATE RULES**

The previous section has described in some detail the significance of tax treaties, or more specifically, residence in a designated treaty country, for purposes of the foreign affiliate rules. Next it is appropriate to assess the relationship between tax treaties and the foreign affiliate rules from the perspective of both those rules and the treaties.

Looking first at the effects on the foreign affiliate rules, the key issue is whether it makes sense to have the exemption system for dividends from foreign affiliates apply to active business income earned in treaty countries by foreign affiliates resident in treaty countries. An ancillary part of this issue is whether it makes sense to require foreign affiliates to be resident in a country for purposes of the treaty between Canada and the country. It is convenient to examine this ancillary issue separately from the key point.<sup>36</sup>

As explained earlier, in my opinion, the exemption for dividends from foreign affiliates is justifiable only as a proxy for a foreign tax credit system. Therefore, the exemption should be available only for dividends paid by a foreign affiliate if the aggregate of the underlying foreign corporate tax paid by the affiliate and the foreign withholding tax on the dividend is equal to or exceeds the Canadian corporate tax rate.<sup>37</sup> Under these conditions, as a means of providing relief from international double taxation, an exemption is arguably simpler than a foreign tax credit, in terms of compliance and administration.

To achieve simplicity, the exemption for dividends from foreign affiliates cannot operate on the basis of the actual foreign tax paid by particular affiliates. Such a system would be tantamount to a foreign tax credit system because it would require the computation of the income of each foreign affiliate in accordance with Canadian tax rules. As a result, countries that have an exemption system that is intended

to be a substitute for a credit system need a proxy for the actual foreign tax paid by a foreign affiliate. Several countries, including Canada, use a listed country or designated jurisdiction approach for this purpose.<sup>38</sup> Under this approach, the exemption applies only to dividends received from foreign affiliates resident in certain designated countries.<sup>39</sup> Generally, only high-tax countries are listed so that the exemption system operates as a reasonable proxy for a credit system.

The next issue is how to determine which countries should be designated as high-tax countries. Theoretically, countries should not be listed unless the aggregate of the corporate tax and withholding tax on dividends paid to Canadian corporations is equal to or greater than the Canadian corporate tax rate. Moreover, any foreign affiliates qualifying for a preferential tax regime offered by a country should be excluded from the exemption system. The Canadian foreign affiliate rules use the existence of a treaty with a country as a proxy for ensuring that the country levies tax comparable to Canadian tax. The idea behind this simplistic approach is that Canada would enter into tax treaties only with high-tax countries. Although this approach may have been workable in 1976, when Canada had few treaties, it is clearly inadequate currently. The existence of a treaty with a country offers no assurance that foreign affiliates in the country are subject to foreign tax comparable to Canadian tax. As the earlier overview of Canada's tax treaty network indicates, Canada has treaties with several countries that can be, and are, used as tax havens. Canadian multinationals use foreign affiliates established in these treaty countries to earn income that is subject to low or no tax in the foreign country and no Canadian tax when repatriated to Canada as dividends. It may be appropriate for several reasons for Canada to have tax treaties with countries that function as tax havens; but it is not appropriate for these countries to qualify as high-tax countries for purposes of the exempt surplus system.

Therefore, in my view, basing the exemption system for dividends from foreign affiliates on the existence of a treaty with a foreign country is wrong. The best evidence of the inadequacy of the treaty country requirement is regulation 5907(11.2)(c). As discussed earlier, this rule allows IBCs in certain treaty countries (Barbados, Cyprus, and Luxembourg) to qualify as residents of a designated treaty country even though they are expressly excluded from the treaty. Such corporations are expressly excluded from the benefits of tax treaties for the obvious reason that they are not subject to sufficient tax in the treaty country to justify treating them as residents. If IBCs are not entitled to the benefits of tax treaties because they are not subject to a sufficient level of tax, they should clearly not be entitled to the benefits of the exempt surplus system. They would not be entitled to those benefits but for the specific rule in regulation 5907(11.2)(c).

If foreign affiliates, such as Barbados IBCs, that are excluded from treaties are granted the benefits of the exempt surplus system, it must be asked why foreign affiliates that are resident in non-treaty countries and are subject to rates of tax significantly in excess of the tax rates to which IBCs are subject do not get the same benefits. It cannot be argued that Canada gets the right to exchange of information with respect to IBCs because the treaty does not apply to IBCs. In other words, the effect of regulation 5907(11.2)(c) is that the requirement of a treaty between

Canada and the foreign country is irrelevant with respect to foreign affiliates excluded from treaties, such as Barbados IBCs. Therefore, in principle, other non-treaty foreign affiliates should qualify for the exempt surplus system as long as they are subject to tax at rates equal to or higher than IBCs. Of course, such affiliates do not qualify for exempt surplus treatment. When the 1995 amendments to the foreign affiliate rules were made, the government had no intention to exclude Barbados IBCs, and other foreign affiliates excluded from tax treaties, from the benefits of exempt surplus treatment. Such affiliates had previously qualified for the exempt surplus system even though they should not have qualified in tax policy terms. Obviously, the government was not prepared to annoy Canadian multinationals by depriving them of the use of foreign affiliates excluded from treaties, and, in particular, Barbados IBCs.

The foregoing analysis indicates that the requirement of the existence of a tax treaty between Canada and another country for purposes of the foreign affiliate rules is completely inappropriate. The foreign affiliate rules should be revised to sever the link with tax treaties. This result can be accomplished readily by listing countries for purposes of the exempt surplus system on the basis of criteria that ensure that listed countries levy tax comparable to Canadian tax. The following three criteria would be appropriate for this purpose:

1. Income should be computed on a reasonably comprehensive basis under the foreign tax law that is roughly similar to the computation of income for purposes of the Canadian corporate tax.
2. The aggregate of the foreign corporate tax and the withholding tax on dividends should be roughly comparable to the Canadian corporate tax rate. Perhaps a small difference between the foreign rate and the Canadian rate might be acceptable in the interests of simplicity.
3. The foreign country must have a reasonably effective tax administration to ensure that the corporate and withholding taxes are actually collected.

It might be appropriate to require that there be an income tax treaty between a country and Canada, although such a requirement is not necessary. The existence of a treaty would assist Canadian tax authorities in obtaining information concerning foreign affiliates resident in the country. There is clearly a significant difference between using the existence of a tax treaty as the sole criterion, as under the current rules, and using it as one of several criteria. However, the link between tax treaties and the foreign affiliate rules would still exist.

If a country that qualifies for listing under the criteria set out above provides special tax preferences for certain corporations or certain income, those corporations and foreign affiliates that earn the preferential income should be excluded from benefiting from the exempt surplus system.<sup>40</sup> For example, if Barbados is listed, IBCs resident in Barbados should be excluded.

A complete discussion of this proposed listed country approach is beyond the scope of this note. It is raised here to show that there is an alternative to the

existing designated treaty country rule—an alternative that does not involve any significant change to the policy of the foreign affiliate rules. I recognize that the proposed listed country approach requires the CCRA or Finance officials to make difficult decisions about which countries to list and to monitor the list on an ongoing basis. In contrast, the designated treaty country rule operates automatically. However, the fundamental point is that the designated treaty country rule lacks any integrity. It is fundamentally deficient and should be replaced.

If reliance on the existence of a treaty between Canada and another country were eliminated from the foreign affiliate rules, the current requirements for a foreign affiliate to be resident in a designated treaty country and to earn income from an active business carried on in a designated treaty country also would be eliminated. It would be necessary to have some rule to connect a particular foreign affiliate to a particular listed country for purposes of determining entitlement to the benefits of the exempt surplus system. The rule should be that a foreign affiliate is a resident of a listed high-tax country if the affiliate is subject to tax under the laws of that country on its worldwide income.<sup>41</sup> Residence in accordance with the Canadian central management and control test (the pre-1995 rule) would not be appropriate because it would not ensure that foreign affiliates are subject to tax in a country on their worldwide income. The recommended approach is similar to the test for treaty residence but avoids reference to the provisions of the treaty. It does, however, require reference to the foreign tax law to determine if and on what basis a foreign affiliate is subject to tax in the country. If the existence of a treaty with a country were retained as one of the criteria for listing countries, the current rule in regulation 5907(11.2)(a) also could be retained. It would not be necessary, in my opinion, to require foreign affiliates to also be resident in a listed country under the Canadian central management and control test of corporate residence, although that requirement could be retained quite easily as well.

Severing the link between tax treaties and the foreign affiliate rules would be beneficial not only for the foreign affiliate rules but also for Canada's tax treaty network. The need to enter into a tax treaty with virtually every country in which a Canadian corporation is carrying on an active business would be eliminated. The decision to conclude a tax treaty with a country would be based on several factors, not primarily or exclusively on access to the exempt surplus system. Although, in my view, it is doubtful that Canada needs tax treaties with 90 countries, Canada's treaty network is unlikely to shrink just because the link between the treaties and the foreign affiliate rules is severed. However, unlinking tax treaties and the foreign affiliate rules may remove the pressure for Canada to enter into additional treaties and may permit Canadian tax officials to focus their efforts on renegotiating the more important existing treaties.

## **THE RELEVANCE OF THE FOREIGN AFFILIATE RULES FOR TAX TREATIES**

Most of Canada's tax treaties entered into after 1976, when the foreign affiliate rules became effective, until the late 1990s provided that Canada would give relief

from double taxation in respect of dividends from foreign affiliates by allowing corporations resident in Canada to deduct dividends out of exempt surplus in computing their taxable income. This relief is expressly subject to the existing provisions of Canadian law and to any subsequent modifications of those provisions. However, the general principle of the provision cannot be altered without contravening the treaty. A typical exempt surplus provision in these treaties reads as follows:

Subject to the existing provisions of the law of Canada regarding the determination of exempt surplus of a foreign affiliate and to any subsequent modification of those provisions—which shall not affect the general principle hereof—for the purpose of computing Canadian tax, a company resident in Canada shall be allowed to deduct in computing its taxable income any dividend received by it out of the exempt surplus of a foreign affiliate resident in [the treaty country].

Not all of the exempt surplus provisions are exactly the same. For example, the treaty with France refers to the “principle” rather than the “general principle” of exemption. Also, some treaties use the expression “regarding the taxation of income from a foreign affiliate” rather than “regarding the determination of exempt surplus of a foreign affiliate.”

Two pre-1972 treaties, those with Ireland and Norway, have not yet been renegotiated and do not contain any protection for the exemption of dividends out of exempt surplus. The treaty with Brazil contains a special provision exempting from Canadian tax dividends paid by a Brazilian company to a Canadian company out of active business income but does not refer explicitly to exempt surplus. None of the treaties contains any provision with respect to relief for dividends received by a Canadian corporation out of the taxable surplus of a foreign affiliate.

It seems reasonably clear that the exempt surplus provision was used as an incentive to get countries to enter into treaties with Canada during the 1970s and early 1980s. As explained earlier, the exemption for dividends out of exempt surplus was not available for foreign affiliates in unlisted countries, and the existence of a treaty, or at least the commencement of treaty negotiations with a country, was a prerequisite for listing. This incentive did not exist for countries that already had treaties with Canada. For example, Ireland and Norway were listed countries and are now designated treaty countries for purposes of the foreign affiliate rules, even though there is no exempt surplus provision in the treaties with these countries. Therefore, the only difference between these two countries and other treaty countries is that, with respect to Ireland and Norway, Canada could alter its domestic law concerning dividends out of exempt surplus without violating the treaty.

Article 23 of the OECD model treaty authorizes either the exemption or the credit method as a means of relieving double taxation. With respect to dividends, this means that Canada must either exempt dividends received by Canadian residents from corporations resident in the treaty partner or allow a credit for any foreign withholding taxes on the dividends. The OECD model treaty is silent with

respect to relief for underlying foreign taxes paid by a foreign corporation on income out of which a dividend is paid. The commentary on article 23 of the model treaty deals with the issue of an indirect credit for underlying foreign taxes and concludes that “[i]n the end, it appeared preferable to leave States free to choose their own solution to the problem.”<sup>42</sup> Canada has not made any reservation on article 23 of the OECD model treaty or any observations on the commentary.

The exempt surplus provision in Canada’s tax treaties goes well beyond the requirements imposed by article 23 of the OECD model treaty. All that Canada is required to do by virtue of the OECD model treaty is to provide a credit for any foreign withholding taxes imposed on such dividends.

The meaning of the typical exempt surplus provision contained in most of Canada’s tax treaties is far from clear. The relief is expressly “subject to the existing provisions of the law of Canada regarding the determination of exempt surplus.” This reference makes it clear that the details for the deduction for dividends received by Canadian corporations out of the exempt surplus of foreign affiliates (or at least for the calculation of exempt surplus) are provided by Canadian law, not by the treaty. Also, the reference to the “existing” provisions means the exempt surplus provisions of the Act at the time the treaty was signed or entered into. However, the treaty relief is also subject to subsequent modifications of the exempt surplus rules. What is not clear is whether the reference to the general principle of the provision is intended to apply to both the exempt surplus provisions at the time the treaty is entered into and any subsequent modifications of those provisions, or just the latter. This issue of interpretation is crucial to the scope and effect of the provision.<sup>43</sup>

If the limitation of the general principle applies to both the existing exempt surplus provisions and any subsequent modifications, the exempt surplus provision in the treaty establishes an exemption under the treaty that is independent of Canadian law. To the extent that the exempt surplus provisions at the time a particular treaty is entered into conflict with the general principle of the exempt surplus provision in the treaty, the general principle of the treaty will prevail. Moreover, on this interpretation, arguably the effect of the treaty is to freeze the exempt surplus rules for foreign affiliates resident in a particular country at the time the treaty with that country was entered into. Thus, the treaty would entitle Canadian corporations to relief for dividends out of exempt surplus on the basis of the exempt surplus rules at the time the treaty was entered into, irrespective of subsequent changes to those rules restricting the relief.

This argument is available to Canadian corporations in many situations as a result of the 1995 amendments to the foreign affiliate rules. One effect of those amendments was to define income from an active business restrictively so that some amounts that were previously included in exempt surplus were included in FAPI and thereby in taxable surplus. For treaties entered into before 1995 with a typical exempt surplus provision, it can be argued that the treaty entitles Canadian corporations to continue computing exempt surplus of foreign affiliates in those treaty countries on the basis of the pre-1995 exempt surplus rules.

If the general principle of the exempt surplus provision in the treaty applies only to subsequent modifications of the Canadian exempt surplus rules, the effect of the treaty provision is more modest.<sup>44</sup> Under this interpretation, the exemption for dividends out of exempt surplus is whatever the rules of Canada provide from time to time. The effect of the treaty provision is not to freeze the exempt surplus provisions for foreign affiliates resident in a particular country at the time the treaty with that country was entered into. The treaty will override only changes to the exempt surplus system that adversely affect the general principle of the exempt surplus provision in the treaty.<sup>45</sup>

The meaning of the reference to the “general principle” of the exempt surplus provision of the treaty has not been considered by the courts. Similar wording in article XXV(8) of the Canada-US treaty<sup>46</sup> dealing with thin capitalization was at issue in *Ramada Ontario Ltd. v. The Queen*.<sup>47</sup> The wording of the relevant part of article XXV(8) is “including any subsequent modification of such provisions that does not change the general nature thereof.” In contrast, the exempt surplus provision in all Canada’s treaties refers to the general principle “hereof,” meaning the exemption provided by the treaty, not the domestic exempt surplus rules. The Tax Court of Canada appeared to interpret the “general nature” of the thin capitalization rules as being equivalent to their purpose. The court stated:

[T]he word “general” found in both “general nature” and “general principle” shows a focus on the whole provision, or set of provisions, in question. If only one item has been modified, as in this case, it is unlikely to be enough to change the situation. The impact, or the form, of the provision must be substantially altered.<sup>48</sup>

Although it is difficult to identify the general principle of the exempt surplus provision of the treaty precisely, the principle appears to be that dividends paid out of the exempt surplus of foreign affiliates resident in the treaty country must be exempt from Canadian tax. By virtue of article 3(2) of most treaties, the critical terms (“exempt surplus” and “foreign affiliate”) in the exempt surplus provision have the meaning that they have under Canadian income tax law (at the time the treaty is applied, not when it was entered into). The most important ingredient of exempt surplus is income earned in a treaty country by a foreign affiliate resident in a treaty country. The treaty may permit minor changes to the definition of active business, such as occurred in 1995, depending on how the exempt surplus provision in the treaty is interpreted, as discussed earlier. However, unless the exempt surplus provision were construed to be meaningless, which is unlikely, it would override the unilateral elimination by Canada of the exemption for dividends out of exempt surplus. Therefore, for example, if Canada converted the exemption system into a credit system, any treaties with an exempt surplus provision would require Canada to continue to provide an exemption for dividends out of exempt surplus paid by foreign affiliates resident in such countries. Similarly, if, as suggested earlier, the foreign affiliate rules were to be amended to use a listed country approach, rather than the current designated treaty country approach, the



exemption for dividends out of exempt surplus would continue to apply to foreign affiliates in countries with which Canada has a tax treaty with an exempt surplus provision.

Tax treaties entered into since 1998 do not contain any exempt surplus provision. Most of these treaties (those with Algeria, the Czech Republic, Jordan, Kuwait, Lebanon, Luxembourg, the Netherlands, Portugal, Senegal, and Venezuela) provide only that Canada will give a credit against Canadian tax payable for any tax paid to the other country on profits arising in the other country. The treaties with Australia, Ecuador, Germany, Peru, and the Slovak Republic, however, provide that Canada will give an indirect foreign tax credit for the underlying foreign corporate tax paid by a corporation resident in the other country in computing the Canadian tax paid on a dividend received by a Canadian corporation from such a corporation.<sup>49</sup> The Canadian corporation must own at least 10 percent of the voting power of the corporation resident in the other country.

The indirect foreign tax credit provision in these five treaties is strange because, unlike the exempt surplus provision, the indirect credit provision does not mesh well with the foreign affiliate rules. Under paragraph 113(1)(b) of the Act, Canadian-resident corporations are entitled to a deduction in computing taxable income in respect of the underlying foreign tax applicable to a dividend paid out of the taxable surplus of a foreign affiliate. The underlying foreign tax applicable to the dividend is grossed up by the relevant tax factor in order to arrive at an amount equal to the foreign affiliate's pre-tax income on the assumption that its income was taxable at the basic Canadian corporate tax rate. The deduction under paragraph 113(1)(b) is roughly equivalent to an indirect foreign tax credit; however, it is clearly not a credit against tax. Therefore, making the indirect credit in the treaties with Australia, Ecuador, Germany, and Peru "[s]ubject to the existing provisions of the law of Canada regarding the allowance as a credit against Canadian tax of tax payable in a territory outside Canada" does not seem to make sense because the existing provisions of domestic law do not provide any indirect credit.<sup>50</sup> The reference should be to the provisions of the Act regarding the deduction of underlying foreign tax applicable to dividends out of taxable surplus, or perhaps just to dividends out of taxable surplus. Furthermore, the treaty provision operates for dividends from foreign corporations in which a Canadian corporation controls, directly or indirectly, at least 10 percent of the voting power. The deduction under paragraph 113(1)(b) applies to dividends from a foreign affiliate, which is defined to be a foreign corporation in which a Canadian corporation owns at least 10 percent of the shares of any class.<sup>51</sup> For the foreign affiliate rules, the number of shares of a class is the relevant criterion; voting rights, which are critical under the treaty, are irrelevant under those rules.<sup>52</sup>

The new credit provision may be interpreted as establishing an independent treaty credit for the underlying foreign taxes paid by a foreign affiliate on its income out of dividends that are paid to its Canadian corporate shareholders. On this interpretation, the reference to the provisions of Canadian law regarding the foreign tax credit means the credit under section 126. The taxable surplus provisions of the

Act are irrelevant. Accordingly, in computing the credit under section 126 with respect to a dividend received by a Canadian corporation from a foreign corporation in which the Canadian corporation owns at least 10 percent of the voting power, the Canadian corporation is entitled to a credit for foreign withholding taxes on the dividend and the foreign corporate tax payable on the profits out of which the dividend was paid. The difficulty is that section 126 does not provide any rules as to how to calculate such an indirect foreign tax credit. Also, if the new indirect credit provision refers to section 126, it is difficult to reconcile the wording of the standard direct credit treaty provision and the wording of the new indirect credit provision. The direct credit provision refers to "the existing provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada." This language clearly reflects the credit under section 126 of the Act. In contrast, the corresponding phrase in the indirect credit provision, quoted above, refers to "the allowance as a credit against Canadian tax of tax payable." If both provisions were intended to refer to section 126, presumably the same language would have been used in both.

On the other hand, if the reference to the allowance of a credit against Canadian tax is intended to be a reference to domestic provisions other than section 126, it is unclear what those provisions are. The taxable surplus rules and the deduction under paragraph 113(1)(b) clearly relate to a deduction in computing taxable income, not a credit against tax payable or a deduction in computing tax payable. Because the new indirect credit provision in the treaty with the Slovak Republic refers to the provisions of the law of Canada and not the "existing" provisions, as the direct credit provision does, an argument might be made that the indirect credit is intended to refer to future domestic provisions that did not exist at the time the treaty was entered into. If so, however, the reference to subsequent modifications appears to be meaningless. Moreover, this argument cannot explain the treaties with Australia, Ecuador, Germany, and Peru, which refer to the existing provisions of the law of Canada. Given these difficulties and inconsistencies, it appears that the indirect credit provision in the treaty with the Slovak Republic contains a drafting error.

Whatever the indirect credit provision in recent treaties means, the important point for this note is that the Canadian government has clearly decided not to include the exempt surplus provision in any new treaties and to delete it in any existing treaties that are renegotiated. There has been no announcement or explanation by the Department of Finance of this change in Canada's treaty policy. Nor has the change received much public comment. The effect of the change is that these new treaties will not constrain Canada's ability to amend or even repeal the exempt surplus system with respect to foreign affiliates resident in these countries. Foreign affiliates resident in the countries with which treaties have been negotiated since 1997 are still able to pay dividends out of exempt surplus. The treaty does not deprive Canadian corporations of the benefit of the provisions of domestic law, such as exempt surplus, that are more beneficial than the provisions of the treaty.<sup>53</sup> If, however, Canada chose to amend or repeal the exempt surplus system, the new

treaties would not provide any protection against such changes. In contrast, as discussed earlier, the exempt surplus provision in many existing treaties would provide continuing access to the exempt surplus system despite changes to the Act limiting access to the system for foreign affiliates resident in those countries.

In my view, the decision not to include the exempt surplus provision in Canada's tax treaties is a sensible one. The provision seriously constrains Canada's ability to make major changes to the foreign affiliate rules with respect to any countries with treaties that contain such a provision. This constraint is not required by the OECD model treaty; it is self-imposed. Moreover, it is unlikely that Canada is able to extract any significant concessions from its treaty partners in consideration for the inclusion of an exempt surplus provision in the treaty. As explained earlier, under the foreign affiliate rules, the exempt surplus system is available to foreign affiliates in any treaty country, whether or not the treaty with a particular country contains an exempt surplus provision. Since the only effect of the exempt surplus provision is to limit Canada from making major unilateral changes to the exempt surplus rules, other countries would not likely be willing to give up much in exchange for the inclusion of the exempt surplus provision in the treaty.

## CONCLUSION

Currently, Canada's exemption system for dividends from foreign affiliates applies only to foreign affiliates resident in countries with which Canada has a tax treaty. Moreover, until recently, most of Canada's tax treaties contained a provision guaranteeing an exemption for dividends received out of exempt surplus of foreign affiliates resident in the treaty country. This note has argued that these links between the foreign affiliate rules and Canada's tax treaties should be severed. The exempt surplus provision in the treaties limits Canada's ability to make changes to the foreign affiliate rules to maintain the integrity of the exemption system. The requirement of residence in a treaty country as a proxy for ensuring that foreign affiliates are subject to foreign tax comparable to Canadian tax is deficient and undermines the tax policy justification for the exemption system.

## NOTES

- 1 Section 90 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.
- 2 Paragraph 113(1)(a).
- 3 Paragraphs 113(1)(b) and (c).
- 4 Regulation 5901(1).
- 5 Paragraph 113(1)(d).
- 6 Subsection 92(2).
- 7 Regulation 5907(1), the definition of "exempt surplus."
- 8 Regulation 5907(1), the definition of "exempt earnings," paragraph (d). Such income is also excluded from foreign accrual property income (FAPI) by virtue of subparagraph 95(2)(a)(ii).
- 9 Regulation 5907(1), the definition of "taxable surplus."

- 10 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), 6.7.
- 11 See J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72.
- 12 In a 1976 paper, Gérard Coulombe, then assistant director, Personal and International Tax Division of the Department of Finance, suggested that the exemption system was a way of providing tax sparing for developing countries. See Gérard Coulombe, "Certain Policy Aspects of Canadian Tax Treaties," in *Report of Proceedings of the Twenty-Eighth Tax Conference, 1976 Conference Report* (Toronto: Canadian Tax Foundation, 1977), 290-303, at 299. In my view, this aspect of the exemption system is more an unintentional consequence than an intentional policy objective. Coulombe's suggestion does not explain the application of the exemption system to developed countries and, in particular, to low-tax regimes provided by developed countries.
- 13 Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), 481-500.
- 14 E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969), 72.
- 15 Viewed as an incentive, the exemption should be available for all dividends out of business income and for business income derived from foreign branch operations.
- 16 The 16 countries were Australia, Denmark, Finland, France, Ireland, Jamaica, Japan, the Netherlands, New Zealand, Norway, South Africa, Sweden, Trinidad and Tobago, the United Kingdom, the United States, and West Germany.
- 17 In its response to the 1992 auditor general's report, the Department of Finance indicated that the exemption system is, "at least in part," a proxy for a foreign tax credit system. See Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992), 52.
- 18 See "Tax Treaties," on the Department of Finance Web site at [http://www.fin.gc.ca/treaties/treatystatus\\_e.html](http://www.fin.gc.ca/treaties/treatystatus_e.html).
- 19 See generally David A. Ward, "Canada's Tax Treaties" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1719-58.
- 20 The following countries were listed even though Canada did not have tax treaties with them: Antigua, Belize, Dominica, Liberia, Montserrat, Portugal, St. Kitts and Nevis-Anguilla, St. Lucia, St. Vincent, and Senegal. The following treaty countries were not listed: Czechoslovakia, Hungary, Luxembourg, Mexico, Nigeria, Papua-New Guinea, Poland, South Africa, and Zimbabwe.
- 21 *Supra* note 17, at 46-51.
- 22 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parliament, 3d session, 1991-92-93, issue no. 48, April 23, 1993.
- 23 Regulation 5907(1), the definition of "exempt earnings," subparagraph (d)(i). It is not necessary for the income to be earned in the same treaty country in which the foreign affiliate is resident.
- 24 The rules in regulation 5907(11.2) with respect to the residence of a foreign affiliate in a designated treaty country apply for purposes of the foreign affiliate rules generally. Although these residence rules are most important for purposes of determining which foreign affiliates earn exempt surplus, they are also applicable for other purposes, such as the election under regulation 5907(2.1) to use book depreciation rather than depreciation under the foreign tax law.
- 25 The meaning of regulation 5907(11.2)(a) is not readily apparent. It deems a foreign affiliate not to be resident in a country unless the affiliate is resident in the country for purposes of the treaty. Therefore, even if the negative deeming rule does not apply because a foreign affiliate is

a resident of the other country for purposes of the treaty, it is still necessary for the foreign affiliate to be resident in the country in accordance with Canadian tax law.

- 26 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model treaty").
- 27 This addition is unnecessary from the Canadian perspective. Corporations incorporated in Canada are deemed to be resident in Canada under subsection 250(4). As a result, they are liable to tax in Canada by reason of their residence in Canada. In any event, if corporations incorporated in a country are taxable on their worldwide income, place of incorporation is clearly a criterion of a similar nature for purposes of article 4 of the OECD model treaty.
- 28 *The Queen v. Crown Forest Industries Ltd.*, [1995] 2 CTC 64 (SCC).
- 29 *Ibid.*, at 76.
- 30 See generally Allan R. Lanthier, "The Concept of Residence," in International Fiscal Association (Canadian Branch), *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Kingston, ON: International Fiscal Association (Canadian Branch), 2001), 13:1-21; and David A. Ward et al., "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries" (1996) vol. 44, no. 2 *Canadian Tax Journal* 408-24.
- 31 See Lanthier, *supra* note 30, at 13:13-15. The CCRA has taken the position that foreign-incorporated IBCs that are registered in Barbados are not residents of Barbados under the treaty because they are taxable only on profits arising in Barbados. However, Barbados enclave enterprises that qualify for a 10-year tax holiday and taxpayers subject to tax on a remittance basis are considered by the CCRA to be treaty residents. Also, the CCRA considers Barbados exempt insurance companies not to be residents of Barbados for purposes of both the treaty and the foreign affiliate rules.
- 32 The commentary on the OECD model treaty recognizes the use of this exclusion approach. Paragraph 15 of the commentary on article 1 of the model treaty provides that the improper use of tax-exempt or nearly tax-exempt corporations may be avoided "by denying the tax treaty benefits to these companies (the exclusion approach)."
- 33 The Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Bridgetown on January 22, 1980.
- 34 If a treaty explicitly does not apply to a corporation, it is impossible for the corporation to be considered a resident of the country for purposes of the treaty. It has been argued that, in the absence of the exclusion provision in the treaty, such IBCs would be residents for purposes of the treaty; otherwise, the exclusion provision would be unnecessary. See Lanthier, *supra* note 30, at 13:19-20.
- 35 This rule is qualified by the requirement that the exclusion provision in the treaty has not been amended after 1994. In effect, if an exclusion provision in a treaty is amended after 1994, Canada intends to exclude any foreign affiliates covered by the exclusion provision from the exempt surplus system.
- 36 Before the 1995 amendments to the foreign affiliate rules, the second issue did not exist because residence in a treaty country was exclusively a question of central management and control.
- 37 As discussed earlier, the exemption would also be limited to active business income earned in treaty countries.
- 38 For a discussion of the designated jurisdiction approach for purposes of controlled foreign corporation (CFC) rules, see generally Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986), 427-44; and Brian J. Arnold and Patrick Dibout, "General Report," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 86b, *Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends* (The Hague:

Kluwer Law International, 2001), 21-89, at 45-48. As of 2000, 16 of the 19 countries with CFC rules used a designated jurisdiction approach for that purpose.

- 39 There may be additional requirements with respect to the connection between a foreign affiliate and a country. For example, a foreign affiliate might be required to have a substantial presence in the country or to earn at least a specified percentage of its income from the country.
- 40 The Technical Committee on Business Taxation was also concerned about this problem, at least with respect to interaffiliate transactions. It recommended that Canada renegotiate its tax treaties "to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions." See *supra* note 10, at 6.22.
- 41 A foreign affiliate qualifying for a preferential tax regime under the laws of the foreign country would probably be considered to be a resident of the country under its laws. However, such an affiliate would not qualify for the exempt surplus system because, as mentioned earlier, the list of high-tax countries would exclude any inappropriate preferential regimes provided by the country.
- 42 Paragraph 52 of the commentary on article 23. The issue of an indirect credit for underlying foreign taxes is discussed in paragraphs 49 to 54 of the commentary on article 23. Most developed countries provide for an indirect credit in their tax treaties with other developed countries.
- 43 See Nick Pantaleo and John M. Ulmer, "Elimination of Double Taxation: Credit and Exemption Under Canada's Tax Treaties," in *Special Seminar on Canadian Tax Treaties*, *supra* note 30, 5:1-30, at 5:4-14.
- 44 Pantaleo and Ulmer, *ibid.*, at 5:7-8, take this view of the exempt surplus provision: "The reference to the 'general principle' does not represent an independent principle of treaty relief, because 'the internal law and the treaty relief are the same at the effective date of the treaty, and the general principle governs only amendments in the law.' [John F. Avery Jones et al., "Credit and Exemption Under Tax Treaties in Cases of Differing Characterization" (1996) vol. 36, no. 4 *European Taxation* 118-46, at 122.] The 'general principle' itself references the 'existing provisions of the law of Canada,' and thus cannot represent a principle greater than the provisions of internal law, subject to modification."
- 45 One difficulty with this interpretation is that before 1995 foreign affiliates in countries that had entered into treaties with Canada with exempt surplus provisions but were not listed in regulation 5907(11) would not have been entitled to the exempt surplus system. On the competing interpretation, they could rely on the treaty provision to get exempt surplus treatment despite not being listed in regulation 5907(11).
- 46 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the Canada-US treaty").
- 47 [1994] 1 CTC 2130 (TCC).
- 48 *Ibid.*, at 2140.
- 49 Article 23(1)(b) of the Agreement Between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Certain Other Taxes, the Prevention of Fiscal Evasion and Assistance in Tax Matters, signed at Berlin on April 19, 2001, provides as follows:

In the case of a resident of Canada, double taxation shall be avoided as follows: . . .

- b. Subject to the existing provisions of the law of Canada regarding the allowance as a credit against Canadian tax of tax payable in a territory outside Canada and to any subsequent modification of those provisions—which shall not affect the general

principle hereof—where a company which is a resident of the Federal Republic of Germany pays a dividend to a company which is a resident of Canada and which controls directly or indirectly at least 10 per cent of the voting power in the first-mentioned company, the credit shall take into account the tax payable in the Federal Republic of Germany by that first-mentioned company in respect of the profits out of which such dividend is paid.

The corresponding provisions in the treaties with Australia, Ecuador, and Peru are similar. The treaty with the Slovak Republic refers to the “provisions,” rather than the “existing provisions,” of the law of Canada.

- 50 In any circumstances where a Canadian corporation would be entitled to more generous relief by way of an indirect foreign tax credit than by way of a deduction under paragraph 113(1)(b), the treaty provides the corporation with the right to claim a credit. Presumably, the treaty provision would not allow a Canadian corporation to claim both a deduction under paragraph 113(1)(b) and a credit under the treaty.
- 51 Subsection 95(1), the definition of “foreign affiliate,” and subsection 95(4), the definitions of “direct equity percentage” and “equity percentage.”
- 52 Another difference between the indirect credit under the treaty and the deduction under paragraph 113(1)(b) is that the treaty limits the credit to the tax payable to the foreign country in which the corporation paying the dividend is resident. In contrast, the deduction under paragraph 113(1)(b) includes underlying foreign tax paid by other lower-tier foreign affiliates from which the affiliate paying the dividend to the Canadian corporation has received, directly or indirectly, dividends out of taxable surplus. The treaty provision is appropriate in this regard. Because the treaty is bilateral, it should deal only with tax paid by a foreign affiliate to the country in which it is resident.
- 53 Tax treaties are generally relieving in nature. Therefore, as a matter of treaty interpretation, if domestic law provides greater relief than a treaty, the taxpayer is entitled to the greater relief under domestic law. Moreover, virtually all of Canada’s tax treaties contain a provision that expressly provides that nothing in the treaty is intended to deprive a person of any deduction, credit, allowance, exemption, or other benefit available under Canadian law. See, for example, article XXIX(1) of the Canada-US treaty, *supra* note 46.