International Fiscal Association
(Canadian Branch)

2007 Travelling Lectureship

"Are the Surplus Rules Surplus?"

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The Canadian foreign affiliate rules are an unique amalgam of avoidance rules to ensure that portfolio income earned indirectly through controlled foreign intermediaries remains taxable and to defer and in practice eliminate taxation of foreign business income also earned indirectly through foreign intermediaries in the interest, among others, of promoting the international competitiveness of Canadian businesses. In both contexts, the rules anticipate and relieve double taxation by rationalizing the application of foreign and Canadian tax to these foreign sources of income through tax credit and exemption.

Much of the complexity of the foreign affiliate rules is attributable to tracking foreign income (and tax) as it is earned relative to periods in which Canadians are direct or indirect shareholders of foreign companies that earned the income, taking into account the degree of foreign tax that may be borne by that income, or more accurately the likelihood that this income would have been subjected to taxation according to tax rules that Canada has evaluated to be meaningful in its terms. This tax accounting regime, which is intrinsic to the architecture and orderly operation of the foreign affiliate rules, divides foreign income into "taxable" and "exempt" pools. In turn, the "taxable" pool includes investment income that is taxed currently to controlling direct or indirect Canadian shareholders; income derived from active businesses carried on or by foreign companies resident in countries with which Canada does not have a tax treaty; and taxable gains from the disposition of shares of foreign corporations.

In view of Canada's extensive treaty network and the commercial realities that affect where business likely is and, indeed in practical terms, probably only can be conducted, foreign business income is largely exempt from Canadian tax until distributed ultimately to individual shareholders of Canadian corporations. To the extent that foreign business income is earned outside Canada's treaty network, there is an implicit assumption, or perhaps presumption, that it has borne little taxation or is earned within a jurisdiction that does not share the same adherence to rigorous tax policy norms as Canada. Consequently, though there is still a competitive interest to be served in not taxing the income as it is being earned but before it is distributed, Canada is not prepared to cede taxation of that income absolutely.

It is interesting to observe then that much of the complexity of the Canadian surplus rules supporting the foreign affiliate system, including the focus of many pending changes, arises from tracking income that Canada has expressed no interest in taxing currently, is rarely, we expect, distributed to its Canadian owner-shareholders as dividends, and indeed, with the support of rulings of the Canada Revenue Agency may be accessed by loans to those owner-shareholders. In short, a significant aspect of the surplus regime is devoted to protecting the future taxation of foreign income that in fact is never likely to be taxed, "base company" considerations aside.

Since December 2002, the foreign affiliate regime has been subjected to rigorous scrutiny that strikes at the essential tax policy underlying it. Apart from a number of technical changes that are for the most part relieving with general application as far back as 1994, proposed new rules seek to police transfers of property and the performance of services within a foreign corporate group to avoid the creation of exempt surplus (or non-recognition of losses) that would allow, in effect, "taxable" earnings to be distributed without tax to Canadian shareholders.

We think it is timely to question whether this direction of Canadian tax policy, which will come at the expense of simplicity and efficiency, is necessary, worthwhile, or even faithful to the underlying tenets of Canada's system for dealing with foreign indirect income. We assume that portfolio investment income is, should and will remain taxable to its economic owners without deferral through the application of the "foreign accrual property income" aspect of the foreign affiliate system or by way of the "non-resident trust" and "foreign investment entity" regimes. With this in mind, it seems that important and possibly controversial aspects of the proposed changes to the foreign affiliate rules dealing with the consequences of intra-group transactions aspire to preserve the taxation of foreign income that in practice may never be taxed. On the other hand, relieving the Canadian tax that conceivably would apply on the distribution of this income may encourage another long-standing aspiration of Canadian tax policy to encourage foreign earnings to be "repatriated" to Canada and redeployed by their owners in productive enterprise in a manner that advances Canadian economic interests. At the same time this should contribute to the relative ease of complying with and administering the foreign affiliate rules.

We make these observations in the context of changes being considered and in some cases implemented by other countries to simplify their "controlled foreign corporation" rules by adopting or considering adopting more directly a bias toward a territorial regime for taxing business income. This bias is already reflected as a fundamental and continuing element of the Canadian "CFC" system and its precursors. International developments in this area provide a useful foil for inquiring about our own rules. As well, Canada's tax rules affecting international business must take into account those of other countries that apply to Canadian taxpayers and the income they earn.

Before the most recent fundamental tax reform that created the "modern" foreign affiliate regime in the Income Tax Act and the Income Tax Regulations, the Canadian system for taxing foreign indirect income was essentially a territorial system for investment as well as business income. From 1976, the deferral and, for the most part exemption, from taxation of foreign indirect business income was preserved while an avoidance regime was enacted to eliminate advantages arising from earning investment income through foreign intermediaries. Since then, this basically "simple" system has undergone or been exposed to only a few significant changes that do not alter the basic design of the foreign affiliate or the tax policy objectives that it serves.

In the early 1980s changes were enacted and existing provisions refined to ensure that foreign corporate reorganizations did not transform business income or the nature of business assets into income or accreting value that would be taxable as "foreign accrual property income." These developments, which included adopting the notion of "excluded property," ensured that business income in all its manifestations remained within the exemption or at least deferral aspect of the system. In the mid 1990s, in response to unsuccessful attempts through court challenges to invest the notion "active business" with a predictable meaning consonant with the underlying tax policy of the foreign affiliate system, prescriptive changes were made to reinforce the avoidance aspect of the foreign affiliate system for taxing investment income.

Aside from certain technical changes and apart from those that most concern us, the proposed changes essentially reinforce the separation between investment and business income. In some cases the business nature of income transmitted between foreign affiliates or that arises collaterally in relation to their dealings and property is preserved. In other cases, proposals protect the integrity of the Canadian domestic tax base by resisting certain "base company" arrangements considered to contribute to domestic "base erosion" essentially at a taxpayer's election. All of these changes are fundamentally consistent with what amounts to a territorial system for taxing foreign business income.

The proposals that concern us relate to possibly significant design changes the force of which, it would appear, is mainly to prevent the avoidance of tax on income that has rarely, if ever, been taxable – undistributed taxable surplus. At the same time that the Canadian rules are becoming potentially more and intractably complicated, other countries engaged in similar reform appear to be headed in the other direction exploring and in some cases acting on the virtues of a "purer" exemption system. We have in mind, in particular, tax policy and in some cases legislative developments in Australia, New Zealand, the United States and certain European countries. In all cases, it is acknowledged that tax regimes need to police the inappropriate avoidance or deferral of taxation of investment income – income that has no intrinsic connection to the jurisdictional or corporate organizational circumstances in which it is earned - and as well so-called "base erosion" arising from exaggerated transfers between resident companies and foreign affiliates that unduly deplete the domestic tax base. That being said, however, and in light of international developments more generally concerning transfer pricing and the attribution of income to branches (permanent establishments) according to tax treaties, we think that Canada should seriously reconsider the utility of complex changes to our foreign affiliate rules that capture income that in fact is unlikely to be distributed to Canadian shareholders or if it were could be redeployed productively in the service of the economic objectives ultimately meant to be supported by the foreign affiliate rules.

In the 2007 Travelling Lectureship, we propose to test the proposition, with reference to the historical development of the Canadian foreign affiliate system and the developments as we see them in similar circumstances in other countries, that the tax policy underlying the foreign affiliate rules be reconsidered, that those aspects of the present system oriented fundamentally only to preserving the taxation of taxable surplus be abandoned and on that platform Canada consider reorienting the rules more directly to achieve territorial taxation of foreign business income.