Partnerships and the Foreign Affiliate Regime

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INTRODUCTION

A Canadian corporation that held substantial interests\(^1\) in the shares of a foreign corporation through a partnership was, until recently, at a significant disadvantage compared to holding the shares of the foreign corporation directly. Amendments to the foreign affiliate rules of the Income Tax Act (Canada) ("Tax Act") proposed by the Department of Finance on June 5, 2000 (which are a revised version of draft amendments issued on November 30, 1999) (the "revised proposal"), will offer relief such that a Canadian corporation should now be largely indifferent as to whether substantial interests in foreign corporations are held through a partnership or through one or more corporations. This paper provides a brief review of the status of partnerships within the foreign affiliate regime as it existed prior to the revised proposal. This is followed by a detailed review of the revised proposal together with a selected analysis of the opportunities and pitfalls to Canadian corporations that hold substantial interests in foreign corporations through either domestic or foreign partnerships.

\(^1\) In using the term “substantial interest” we mean that level of interest necessary to characterise the foreign corporation as a foreign affiliate of a Canadian corporation. In particular, a non-resident corporation is a foreign affiliate of a taxpayer resident Canada if (a) the taxpayer’s equity percentage is not less than 1%, and (b) the total of the equity percentages in the corporation of the taxpayer and each person related to the taxpayer (ignoring double counting) is not less than 10%. 
PART I: The Existing Rules

A Canadian corporation may become subject to Canadian tax in respect of certain income related to a foreign corporation either pursuant to section 91 of the Tax Act in respect of foreign accrual property income ("FAPI") earned by a controlled foreign affiliate or pursuant to section 90 of the Tax Act in respect of foreign source dividends. Where the dividend paying corporation is a foreign affiliate of the recipient corporation, the recipient corporation may be entitled to a deduction for some or all of the dividends received. The amount of the deduction will depend, generally, upon the surplus pool from which the dividend is paid. Where the dividend is paid from exempt surplus, the recipient corporation will be entitled to a deduction for the whole of the dividend paid (less applicable withholding taxes). Where the dividend is paid out of an affiliate’s taxable surplus, the recipient corporation will be entitled to a deduction for all or some of the dividend paid, depending, generally, upon the extent by which the taxable surplus dividend had been subject to foreign income taxes prior to distribution, and, generally, upon the extent by which the taxable surplus dividend was subjected to foreign withholding taxes upon repatriation. Where the dividend is paid out of a foreign affiliate’s pre-acquisition surplus, the recipient will again be entitled to a deduction for the whole of any dividend paid (net of withholding taxes). However, payment from this last account results in a reduction in the cost base of the foreign affiliate’s shares. Where the cost base becomes negative, the recipient corporation will realize a capital gain equal to the amount by which the pre-acquisition surplus dividend exceeds the recipient’s cost base in the shares. The statutory scheme for these deductions is laid out in section 113.

Section 113 can apply only where:

(i) a corporation resident in Canada is receiving the dividend on a share owned by it,
(ii) the recipient of the foreign source dividend is a corporation resident in Canada, and

(iii) the non-resident corporation paying the dividend is a foreign affiliate of the Canadian corporation receiving the dividend.

Canada Customs and Revenue Agency ("CCRA") administered section 113 such that a Canadian corporation that held substantial interests in the shares of a non-resident corporation through a partnership would not be entitled to a deduction under section 113. According to the CCRA, the shares of the foreign corporation are owned by the partnership of which the Canadian corporation is a member, and not by the Canadian corporation directly. Accordingly, CCRA stated that the foreign corporation would not be a foreign affiliate of the Canadian corporation because the term foreign affiliate is defined as requiring the shares of the foreign corporation to be owned by a corporation (rather than by a partnership of which the corporation is a member). Furthermore, since the shares are not owned by the Canadian corporation, any dividends paid by the foreign corporation are not received by the Canadian corporation, rather they are received by the partnership of which the Canadian corporation is a member.

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3 Foreign affiliate of a taxpayer resident in Canada is defined in subsection 95(1) to mean a non-resident corporation in which (a) the taxpayer’s equity percentage is not less than 1%, and (b) the total equity percentages in the corporation owned by the taxpayer and of each person related to the taxpayer is not less than 10%. Equity percentage is defined in subsection 95(4) to mean a taxpayer’s direct equity percentage, together with all percentages each of which is the product obtained when the person’s equity percentage at that time is in any corporation is multiplied by that corporation’s direct equity percentage at that time in the particular corporation. Direct equity percentage means the percentages of the issued class that is owned, if the person owns shares of only one class of the corporation. Where the shares of more than one class are owned by a particular shareholder, it is the highest of such proportions. CCRA considers the shares of a foreign corporation held through a partnership to be owned by the partnership rather than by the members of the partnership individually.
CCRA’s position effectively denied Canadian corporations holding their interests in foreign corporations through partnerships access to the foreign affiliate system.⁴ Thus, Canadian corporations that were members of partnerships which owned shares of foreign corporations were denied access both to deductions available under section 113 in respect of foreign source dividends received through a partnership, and to the deemed dividend election available under subsection 93(1). Moreover, Canadian corporations whose foreign affiliates were members of partnerships in receipt of dividends through that partnership that would otherwise be exempt surplus dividends (had their interest in the dividend paying corporation been held directly) would be required to account for these dividends as FAPI.

It is not clear that CCRA’s position with respect to partnerships was correct in all respects.⁵ For example, although a partnership computes income in accordance with section 96 as a separate person, in law, a partnership does not exist as a separate person. Moreover, generally, property held by a partnership is considered to be held in common as to undivided interests based on the relative interests of the partners. Thus, it may be argued that the requirement that the corporation be receiving the dividend on a share owned by it may have been met. However, CCRA seems correct in its analysis that the definition of foreign affiliate which requires ownership of a specific equity percentage of shares. This

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⁴ The foreign affiliate system did take into account partnerships in the determination of excluded property. The definition of excluded property is relevant to the calculation of FAPI. Taxable capital gains and allowable capital losses of excluded property are not subject to FAPI. Paragraphs (d) and (e) of the definition of excluded property deemed a partnership to be a non-resident corporation with 100 shares and for each partner to own that number of shares that the fair market value of the foreign affiliates’ interest in the partnership is of all interests in the partnership. Where a foreign affiliate disposes of a partnership interest, that partnership interest could itself be excluded property or if such a partnership disposed of shares of a foreign corporation, such shares would be excluded property even though they are held by the partnership.

⁵ See for example "Tax Issues Affecting Partnerships" by Douglas S. Ewens 1997 CR 8:1 at 8:13.
requirement appears not to be satisfied by a co-ownership interest because the rules seem to require that a precise number of shares be held.

Since CCRA did not extend the foreign affiliate system to partnerships, most Canadian corporations simply avoided the use of partnerships in their international holding structures. This avoided any potential problems. However, the relatively recent proliferation of "hybrid" entities has exacerbated the partnership issue because entities in foreign jurisdictions commonly used to hold investments in the stock of corporations may more closely resemble a partnership rather than a corporation. Moreover, partnership laws, particularly in the U.S., are becoming more "corporate" such that they are an effective substitute for a corporation as an investment entity and their exact characterization under Canadian law is unclear.

PART II: The Revised Proposals

The revised proposals were first announced as part of a larger technical amendments proposal released on November 30, 1999. It is not clear what prompted the rules to be changed at this point, particularly, where the Mintz "Report of the Committee on Business Taxation" released in 1998 which addressed international taxation did not make any recommendation as to partnerships. Furthermore, the lack of integration of partnerships into the foreign affiliate system had been criticized, although not as a pressing problem. The original proposal was reviewed by the tax community and certain issues raised.

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Issues Addressed by the Revised Proposals

The revised proposals address several issues relating to partnerships. The first is the threshold issue for determining whether a non-resident corporation is a foreign affiliate of a Canadian corporation. The second is the allocation of surplus or income to the members of that partnership. The third involves the calculation of FAPI. The fourth considers provisions meant to permit a partner to elect dividend treatment in respect of shares of a foreign affiliate held by a partnership (including the application of stop loss rules). The fifth are consequential adjustments related to issues one to four.

The revised proposals have been selectively integrated into the existing foreign affiliate system. In many situations the rules apply only for a limited purpose and not throughout the Tax Act. Care must be taken to interpret the rules only in the limited circumstances in which they appear to be intended. Canadian corporate taxpayers should (with some of the exceptions noted below) now be indifferent from a Canadian tax perspective as to whether interests in foreign corporations are held directly or indirectly through a partnership. We do note, however, that the revised proposals seem to raise FAPI issues in some circumstances depending on how a foreign affiliate calculates its income for the purposes of FAPI. The revised proposals also do not provide Canadian corporations with the ability to make a deemed dividend election in respect of dispositions by corporation of partnerships investments where that partnership holds substantial interests in foreign corporation(s). These, together with other concerns, are addressed below.
Determination of Foreign Affiliate Status

Proposed subsection 93.1(1) deems each partner of a partnership to own that number of the shares of any class of the capital stock of a corporation owned by a partnership (or deemed by subsection 93.1(1) to be owned by the partnership) equal to the proportion of each member’s fair market value interest in the partnership.\(^8\) This is consistent with the manner in which partnerships are integrated into the definition of *excluded property* (which is also based upon fair market value). This test is not based upon either control or entitlement to distribution but given the ease by which entitlements may be manipulated, a value test seems reasonable. Taxpayers should be aware of their obligation to substantiate a fair market valuation of their partnership interests in case of audit.

For a partnership in which partners have contributed a pro-rata share of partnership property and are entitled to the same pro-rata share of income and losses, the precise valuation would not seem to matter. However, where partnerships have different entitlements to income or loss or different entitlements on dissolution, valuation may prove to be a burdensome task.

Consider the following example. Example 1: Canco1 and Canco2 are both members of a partnership in which the fair value of the partnership interests are divided 60:40 between them, and the partnership owns 100 shares (being all the shares outstanding) of a foreign corporation.

Applying subsection 93.1(1) would result in Canco1 being considered to own 60 shares of the foreign corporation (for the sole purpose of determining whether the foreign corporation is a *foreign affiliate* of Canco1) and for Canco2 being

\(^8\) The subsection applies for the purposes of determining the status of the non-resident corporation as a *foreign affiliate* of a corporation resident in Canada for the purposes of subsections 93.1(2), 20(12), sections 93 and 113 (and any regulations made for the purposes of those sections), section 95 (to the extent that section is applied for the purposes of those provisions) and section 126.
considered to own 40 shares of the foreign corporation (for the sole purpose of
determining whether the foreign corporation is a foreign affiliate of Canco2.) The
result, therefore, is that the foreign corporation is a foreign affiliate of Canco1 and
a foreign affiliate of Canco2. Moreover, the foreign corporation is also a
controlled foreign corporation of both Canco1 and Canco2 (although not as a
result of the application of subsection 93.1(1) which is not applicable for that
purpose). 9

Example 2: Canco1 and an individual resident in Canada are both members of a
partnership in which the fair value of the partnership interests are divided 1:99
between them, the individual owns all the shares of Canco1 and the partnership
owns 100 shares (being all the shares outstanding) of a foreign corporation.

Applying subsection 93.1(1) would result in Canco1 being considered to own 1
share of the foreign corporation (for the sole purpose of determining whether the
foreign corporation is a foreign affiliate of Canco1). Ordinarily, subsection 93.1(1)
would not apply to treat the individual as being considered to own directly any of
the shares of the foreign corporation. However, in this circumstance, since
Canco1 owns 1% directly of the shares of the foreign corporation, the foreign
corporation could still be a foreign affiliate of Canco1, if shares of the foreign

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9 The conclusion that the foreign corporation is a controlled foreign affiliate of both
Canco1 and of Canco2 is not free from doubt. The deeming rule in subsection 93.1(1) is only
applicable in determining status as a foreign affiliate and not status as a controlled foreign affiliate.
Accordingly, even though Canco1 is deemed to hold 60 shares of the foreign corporation in
determining the foreign affiliate status of the foreign corporation to it, it is not deemed to own those
shares in determining whether the foreign corporation is a controlled foreign affiliate of Canco2.
The issue, therefore, is whether the requirements of the definition of controlled foreign affiliate are
met in the context of applying general legal principles. First, is the partnership a “person resident
in Canada” - the answer is yes if it is relevant to the calculation of either Canco1 or Canco2’s
income from the partnership. Since the definition of controlled foreign affiliate is relevant to the
FAPI income of both Canco1 and Canco2, it would be so. Secondly, does either Canco1 or Canco2
deal not at arm’s length with the partnership? Since this is an arm’s length test, it would be
surprising for a partner (who by the very nature of a partnership is a person carrying on business in
common with a view to profit with the other partner) could assert that as to the partnership itself, it
deals factually at arm’s length regardless of control. Moreover, even without subsection 93.1(1),
under usual partnership property ownership theories, each partner is seen as a co-owner of all
partnership property. Accordingly, even if no specific shares are held, the shares of the foreign
corporation are held jointly by only two Canadian residents and the control test is met.
**Allocation of Surplus**

Section 113 is only available where, in addition to the dividend paying corporation being a foreign affiliate of the recipient corporation, the shares of the dividend paying corporation are owned by the recipient corporation and dividends paid by the foreign corporation are received by the recipient corporation. Proposed subparagraph 93.1(2) addresses these technical requirements. Specifically, paragraph 93.1(2)(a) deems, for the purposes of sections 93 and 113 (and any regulations made for that purpose) each member of a partnership to have received from the dividend paying corporation the proportion of any dividend received by the partnership that the fair market value of the member’s interest in the partnership is of the fair market value of all the members’ interests in the partnership. Secondly, paragraph 93.1(2)(c) deems, for the purpose of
applying section 113, the shares of the foreign corporation to be owned by the members of the partnership.

These deeming rules will clearly integrate partnerships into the foreign affiliate rules for the purposes of section 113 where the partnership allocates the dividends to its partners based upon the relative fair market values of their respective interests. Where, however, the partnership allocates dividends on a basis other than the fair market value of each partner’s proportionate interest in the partnership, certain anomalies can result.10 This is demonstrated by the following example.

Example 3: Canco1 and Canco2 are both members of a partnership in which the fair value of the partnership interests are split 50:50 between them, and the partnership owns 100 shares (being all of the shares outstanding) of a foreign corporation ("FA1") which is resident in and carries on an active business in a treaty country. Canco1 and Canco2 are not related. Canco1 and Canco2 have agreed, for reasons other than the minimization of tax, to allocate dividends earned by the partnership on the shares of FA1-75% to Canco1 and 25% to Canco2. FA1 currently has an exempt surplus balance of $100.

Assume FA1 pays a dividend of $100 to the partnership. There are a number of things occurring relevant to the computation of tax for Canco1 and Canco2. First, paragraph 93.1(2)(a) will deem each of Canco1 and Canco2 to have received $50 of the dividend paid to the partnership for the purpose of sections 93 and 113 (and the regulations thereunder). Secondly, section 96 will apply to the partnership since both partners are corporations resident in Canada. Under section 96, the partnership will have a dividend of $100 of which 75% is allocated to Canco1 (which thus has income of $75) and 25% is allocated to Canco2.

(which thus has income of $25) included pursuant to section 96 and paragraph 12(1)(l). Thirdly, subparagraph 93.1(2)(d)(i) will apply to reduce the amount potentially deductible under section 113 by Canco1 and Canco2 to an amount equal to the respective income inclusions arising under section 96. Fourthly, the partnership must review its FAPI position (because it is deemed to be a person resident in Canada) and it owns all of the shares of FA1, making it a controlled foreign affiliate of the partnership. However, in this situation there is no FAPI income earned by the foreign affiliate and thus no inclusion to the partnership. In summary, in example 3, Canco1 will have an income inclusion under section 96 of $75 but will only be able to deduct an amount of up to $50 (being the amount of dividend deemed received). The excess income would be taxable as ordinary income although it would retain its source as a dividend. Canco2, on the other hand, will have an income inclusion of only $25 and its entitlement for a dividend deduction is only $25. If the full dividend had been paid in respect of exempt surplus, only $75 of the $100 has been used to reduce Canadian income and there is nothing in the rules to preserve the $25 of surplus allocable to Canco2 in respect of further distributions. Furthermore FA1’s exempt surplus balance will be decreased by the full amount of the dividend paid ($100); this notwithstanding that only $75 of the $100 dividend was able to be deducted under section 113 as an exempt surplus dividend. Canadian corporate taxpayers (and their foreign affiliates) should therefore be careful to structure their partnership interests in a manner that avoids these results.

The revised proposals also make a change to the definition of FAPI in section 95 that is consequential to the changes in section 93.1. The effect of this rule is best reviewed by an example.

Example 4: Canco1 owns all the shares of a foreign corporation FA1, and FA1 and Canco2 are both members of a partnership in which the fair value of the partnership interests are equal but they have agreed to a 75:25 distribution of
income. The partnership owns 100 shares (being all the shares outstanding) of a
foreign corporation FA2. FA2 pays an exempt surplus dividend to the
partnership, with the following results. Under section 96, the partnership has
received a dividend from FA2 of $100. It accordingly has income of $100 that is
distributable to the partners. Pursuant to subsection 93.1(2), FA1 has for the
purposes of section 113 received a dividend of $50 (but has income under
section 96 of $75). Pursuant to section 91, Canco1 must include in its income as
FAPI, the FAPI of FA1. FA1 has an inclusion in FAPI under section 96 of $75
under A of the definition of FAPI in section 95. 11 In addition, under new part H of
the definition of FAPI, FA1 is entitled to reduce FAPI by the portion of the
dividend deemed received by FA1 as a result of paragraph 93.1(2)(a) (being
$50). Consequently, Canco1 has FAPI in example 4 of $25 and FA1 has
received an exempt surplus dividend of $50.

The revised rules also introduced a specific section in subparagraph 93.1(2)(d)(ii)
to address partnerships with more than one affiliate of a Canadian corporation.

Example 5: Canco1 owns all of the shares of FA1 and FA2. FA1 and FA2 are
both members of a partnership, in which the fair value of the partnership interests
are equal but they have agreed to distribute income 60:40. The partnership
owns all the shares of FA3. FA3 pays an exempt surplus dividend to the
partnership of $100.

Under paragraph 93.1(2)(a) each of FA1 and FA2 is deemed to receive a
dividend of $50. Under section 96 (if applied to calculate the income of FA1 and
FA2), FA1 has income of $60 in A and would otherwise deduct $50 under H.
Therefore its net FAPI income would be $10. However, in computing the income

11 It is not clear that in this circumstance that the exception in paragraph (b) for income arising from a
dividend from another foreign affiliate would apply. Technically, there is an income inclusion
under paragraph 12(1)(f) (from section 96) that is a distribution of partnership income and not a
dividend.
of FA2, the amount included in income for section 113 in respect of the dividend (which until this subparagraph applies would be $50) is limited to $40 (i.e. the amount allocated under section 96) (assuming that H was nil and did not otherwise reduce FAPI and assuming that subsection 93.1(2) did not apply at all to FA2). The net result is that FA1 has an exempt surplus entitlement limited to $50 and FA2 has a similar entitlement limited to $40. Without the application of subparagraph 93.1(2)(d)(ii) that entitlement would have been $50.12

Partnership Expenses

As stated above, proposed paragraph 93.1(2)(d) imposes limitations upon the amount of a dividend deductible under section 113 where that dividend is received by a partnership. The original November 30 draft of proposed subparagraph 93.1(2)(d)(i) limited the amount of the deduction under section 113 to the amount "included in income pursuant to subsection 96(1) in respect of the dividend". The drafting of the November 30 proposals spawned considerable controversy. Commentators pondered whether the drafting of the November 30th proposals mandated that the deduction under section 113 be limited to the net dividend received (that is; the dividend net of any related expenses) or the gross amount of dividend received. Limiting the amount deductible to the net dividend would be inconsistent with CCRA’s administrative position regarding the deductibility of dividends received through a partnership from a taxable Canadian corporation.13 Limiting the amount deductible would also deny Canadian corporations holding substantial interests in foreign corporations through a partnership access to a central feature of the Canadian foreign affiliate regime:

12 There is ambiguity in the language in subparagraph 93.1(2)(d)(ii) in its reference to "the amount included in the other affiliates income" which more properly should refer to the amount deemed received in respect of the dividend.

13 Specifically, CCRA allows Canadian corporations to deduct the gross amount of such dividends received.

the ability to deduct the gross amount of any *exempt surplus* dividend received together with any expenses made or incurred for the purpose of earning that dividend.

The revised proposal now refers to "the amount of the dividend *included in its income* pursuant to subsection 96(1)". This is the language that was proposed by Lockwood’s critique of the original proposals and requested by him to make clear that the gross dividend could be included and expenses netted. Accordingly, the change in drafting to proposed 93.1(2)(d)(i) appears aimed at allowing for the deduction of the gross amount of dividend received. While the legislation still does not expressly deal with the gross/net issue, commentators have suggested that in the context of Canadian dividends earned through a partnership, paragraph 96(1)(f) (which preserves the source of a dividend) can be used to allow dividends to retain their source even if expenses are netted against them in the computation of income at the partnership level.14

These new rules would appear to permit new financing structures involving partnerships.

Example 6: Canco1 and a wholly owned Canadian subsidiary Canco2 form a Canadian partnership (P) in country X. Assume that P can elect to be treated under the laws of country X to be taxed as a separate entity from its partners. Assume Canco1 already owns Subco, an operating business in country X. Canco1 could then roll its interest in Subco to P on a rollover basis in exchange for partnership interest. P would then borrow the funds required by Subco for its active business expansion and contribute these funds to Subco in the form of equity.

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14 See Ewens, supra at p. 8:21.
Deemed Dividend Election and Application of the Stop Loss Rules

Deemed Dividend Election

Subsection 93(1) of the Tax Act provides special rules whereby a corporation resident in Canada may elect to convert all or part of a capital gain arising on the disposition of shares in a foreign affiliate to be a deemed dividend. The purpose of the subsection is to enable the disposing corporation to fully use the deduction available to it under subsection 113, had all or part of the proceeds of disposition been received as a dividend. The provision applies automatically to foreign affiliates where one foreign affiliate disposes of the shares of another foreign affiliate and those shares constitute excluded property.\(^\text{15}\)

Subsection 93(1) can apply only where a corporation resident in Canada (or a foreign affiliate of a corporation resident in Canada) disposes of a share of the capital stock of a foreign affiliate. Where a corporation resident in Canada holds substantial interests in foreign corporations through a partnership and that partnership disposes of an interest in a foreign corporation, the shares of the corporation, according to CCRA’s administrative policy, are characterized as having been disposed by the partnership and not the corporation resident in Canada.\(^\text{16}\) Moreover, prior to the introduction of proposed subsection 93.1(1), the foreign corporation whose shares are being disposed could not constitute a foreign affiliate of the corporation resident in Canada.

The requirement that the capital stock of a foreign affiliate be disposed of by a corporation (rather than by a partnership of which the corporation is a member) is addressed by proposed subsection 93(1.2). Proposed subsection 93(1.2) does

\(^{15}\) As defined in 95(1).

\(^{16}\) This conclusion follows from CCRA’s that share of a foreign corporation held through a partnership are owned by the partnership and not by the members of the partnership.
not deem the corporate partner to dispose of the shares. Rather, where a corporation resident in Canada is a member of a partnership making the disposition, proposed subsection 93(1.2) permits the corporation resident in Canada to make an election similar to that available to Canadian corporations disposing of interests in foreign affiliates directly. Specifically, the proposed provision allows the Canadian corporation to elect to have four thirds\(^{17}\) of any taxable capital gain realized on a disposition by a partnership of which the corporation resident in Canada is a member to be deemed to have been received by the Canadian corporation as a dividend on the share being disposed. The election applies automatically where a foreign affiliate is a member of a partnership that disposes of a share of a foreign affiliate that is excluded property.\(^{18}\)

The proposed amendments to section 93 fail to allow a Canadian corporation (or a foreign affiliate of the Canadian corporation) the ability to make an election in respect of a disposition by the Canadian corporation (or a foreign affiliate of the Canadian corporation) of a partnership interest where that partnerships holds substantial interests in the shares of a foreign corporation. Where such a disposition occurs, all underlying surplus is lost (unless the surplus is otherwise extracted prior to the disposition by means of dividend, in which case foreign withholding tax may apply).

**Loss Limitation Rules**

Subsection 93(2) is a loss limitation rule that reduces the loss otherwise realized on the disposition of a share of a foreign affiliate by either a Canadian corporation or a foreign affiliate. The loss otherwise realized is reduced by the

\(^{17}\) Presumably, this rate will be adjusted to reflect the new capital gains inclusion rate.

\(^{18}\) Proposed 93(1.3).
amount of any exempt dividend received prior to disposition by any of the following:

- the particular corporation resident in Canada;
- a foreign affiliate of the particular corporation;
- another corporation related to the particular corporation; or
- a foreign affiliate of a corporation resident in Canada that is related to the particular corporation.

Exempt dividend is defined, in the case of a corporation resident in Canada, as any dividend deductible by the corporation by virtue of paragraphs 113(1)(a), (b), or (c). Where the dividend is received by a foreign affiliate, exempt dividend is defined to mean any exempt or taxable surplus dividend previously received, net of any income or profits tax paid by the foreign affiliate in respect of the dividend. The loss is reduced, however, only to the extent that those exempt dividends have not already reduced a capital loss or an allowable capital loss under subsection 93(2), (and proposed subsections 93(2.1) to (2.3)).

Proposed subsections 93(2.1), 93(2.2) and 93(2.3) essentially broaden the stop-loss rules to account for both dispositions by partnerships and dispositions of partnership interests. Specifically, proposed subsection 93(2.1) applies to deny the capital loss on the disposition of shares by a partnership where a member of the partnership is a corporation, and the shares being disposed of are the shares of a foreign affiliate of a corporation resident in Canada. Proposed subsection 93(2.2) applies to deny a loss on the disposition of a partnership interest where that partnership has a direct or indirect interest in the shares of a foreign affiliate. Finally, proposed subsection 93(2.3) applies to deny the capital loss on the disposition of a partnership interest by a partnership where the partnership interest being disposed of as a direct or indirect interest in the shares of a foreign affiliate. In all cases, the amount of loss is reduced by the amount of exempt
dividends previously received, and only to the extent those exempt dividends have not already reduced a capital loss under subsection 93(2) and proposed subsections 93(2.1) to (2.3).

Another point is noteworthy. In all cases, the revised proposals provide that the stop-loss rules will not apply where the loss occurs at the foreign affiliate level and the property being disposed of is excluded property, or an interest in a partnership that has a direct or indirect interest in the shares of a foreign affiliate that would be excluded property, had the interest been held directly. The inapplicability of the stop-loss rules in these circumstances will result in a surplus reduction. This is considered in greater detail below.

The limitation imposed by subsection 93(1.2) on the amount that can be elected to be deemed to be received as a dividend may also have some effects. Where a foreign affiliate is a member of a partnership that disposes of a share in another foreign affiliate, the election made under subsection 93(1.2) cannot be greater than four-thirds of the taxable capital gain from disposition of the shares. Where the shares of a foreign affiliate are disposed of directly (that is, directly by a corporation and not through a partnership), the amount of the election is limited to the disposing corporation’s proceeds of disposition. The limitation to fourthirds the capital gain may result in an erosion of surplus when compared to the amount of surplus that could have been used had the shares been held directly. Typically, however, because of proposed subsection 93(2) (carving dispositions of excluded property from application of the stop-loss rules) the potential for erosion should be marginal. This may best be demonstrated by example.

Example 7: Canco1 has a 100% interest in the shares of a foreign corporation ("FA1") which has a 100% interest in the shares of another foreign corporation ("FA2"). The cost base of FA1’s shares in FA2 is $50. FA2 has a $100 exempt
surplus balance. The shares of FA2 are excluded property. FA1 disposes of the shares of FA2 for $100.

Subsection 93(1.1) deems subsection 93(1) to apply, with the result that the proceeds of disposition ($100) are reduced by the lesser of the amount of the capital gain ($50) and the net surplus ($100). However, notwithstanding the application of subsection 93(1.1), subsection 93(1) permits Canco1 to elect an amount in respect of the disposition other than the amount that was designated under subsection 93(1.1). The election is limited, however, to the proceeds of disposition ($100). Assuming Canco1 elects to have the full proceeds of disposition deemed a dividend, $100 of exempt surplus is moved from FA2 to FA1. Since Canco1 elected to have the full proceeds of disposition deemed a dividend, FA1 would realize a capital loss on the disposition equal to the deemed proceeds of disposition (0) less its adjusted cost base ($50). Since the shares of FA2 are excluded property, the stop-loss rules would not apply to limit the loss realized on the disposition, with the result that FA1 would realize a capital loss of $50 on the disposition. One quarter of the capital loss ($12.50) would be applied to reduce the exempt surplus balance of FA1, and three quarters of the loss ($37.50) would be included in FA1's taxable deficit account. Assuming FA1 had no beginning surplus balances, FA1 will be limited on the amount of exempt surplus dividend it can declare to $50 ($100 - $12.5 - $37.5).

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19 Subsection 93(1.1) actually provides that the corporation is deemed to have made an election under 93(1) and to have designated an amount prescribed by Regulation. The relevant Regulation is Regulation 5902(6), which provides, essentially, that the amount designated is the lesser of the capital gain realized and the amount that would have been received if the affiliate had paid dividends on all of its shares equal to the net surplus as determined under paragraph 5902(1)(a).

20 Presumably, these proportions will be adjusted to reflect the new capital gains inclusion rates.

21 Regulation 5901(1)(a)(ii) of the Regulations provides that a dividend is deemed to have been paid from exempt surplus only to the extent the affiliates exempt surplus exceeds its taxable deficit.
Example 8: Canco1 has a 100% interest in the shares of a foreign corporation ("FA1"). FA1’s interest in the partnership is 99% of the fair value of all such interests in partnership ("P"). P has a 100% interest in a foreign corporation ("FA2"). P’s adjusted cost base in the shares of FA2 is $50. FA2 has an exempt surplus balance of $100. P disposes of the shares of FA2 for proceeds of disposition equal to $100. The whole of the gain ($50) is allocated under the partnership agreement to FA1.

Proposed subsection 93(1.3) applies to deem proposed subsection 93(1.2) to apply, with the result that the proceeds of disposition are reduced by the lesser of the net surplus ($100) and capital gain realized on the transaction ($50). However, notwithstanding the application of subsection 93(1.3), subsection 93(1.2) permits Canco1 to elect an amount in respect of the disposition other than the amount that was deemed under subsection 93(1.3). The election is limited, however, to the amount of capital gain realized on the disposition. This contrasts with the full proceeds of disposition that could have been elected, had FA1 held its interests in FA2 directly (see above). The net result, therefore, is that only $50 of exempt surplus is moved from FA2 to FA1. However, since the rules have decreased the proceeds of disposition by only the $50 capital gain that would have been realized, no capital loss is realized on the transaction. Therefore, like the preceding example described above, only $50 of exempt surplus is available for distribution from FA1 to Canco (assuming FA1 had no surplus balances prior to the disposition of FA2).

The two foregoing examples demonstrate that Canco is likely indifferent to having held its interest in FA2 through a partnership as opposed directly through FA1. This resulted because the loss generated was effectively applied against exempt surplus. Where, however, FA1 has a taxable surplus balance, the creation of the taxable deficit offsets taxable surplus first, without thereafter reducing exempt surplus (assuming there is a sufficient taxable surplus balance).
Consequently, where a foreign affiliate of a Canadian corporation has taxable surplus and low underlying foreign tax, it will have a better result holding its share of FA2 through FA1 directly rather than in a partnership.

Similar to the situation described above, where the shares of FA2 are not excluded property, and FA2 has an exempt surplus balance in excess of any accrued capital gain on its shares, it would be more advantageous for FA1 to hold the shares in FA2, directly rather than through a partnership for the purposes of the deemed dividend election. This is because, in the case of non-excluded property; the stop-loss rules would apply to deny FA1 any loss realized on the shares to the extent of any exempt dividend received, thereby avoiding a "reduction" of FA1’s surplus balances.

Consequential Amendments

Relevant Tax Factor

The "relevant tax factor" is relevant in determining the amount deductible in respect of foreign taxes under subsection 91(4) (in respect of FAPI’s inclusions) and paragraphs 113(1)(b) and (c) in respect of taxable surplus dividends received. Currently, "relevant tax factor" is defined as 2 in the case of an individual, and 1 divided by the percentage set out in paragraph 123(1)(a) (the current federal corporate tax rate) or approximately 2.63 in the case of a corporation. Revised proposals to the rules will amend this definition. "Relevant tax factor" will continue to equal 1 in the case of individuals and 2.63 in the case of corporation. However, with reference to partnerships, the term will be defined to equal "2.63" so long as all members of that partnership (other than non-resident persons) are corporations. Where any member of the partnership is an individual resident in Canada, the term will be defined to equal 2.
Canadian corporations entering into partnership with individuals resident in Canada should therefore be aware that the deduction in respect of foreign taxes to which they will be entitled under subsection 91(4) and paragraphs 113(1)(b) and (c) will be less than what they would have been entitled, had they held their interests in foreign corporations directly.

Adjustments for Pre-Acquisition Surplus Dividends Received

Where a corporation resident in Canada or a foreign affiliate of a corporation resident in Canada receives dividends on the shares of a foreign affiliate and those dividends are deducted by the Canadian corporation (or would have been deductible, had the recipient corporation been resident in Canada) as pre-acquisition surplus dividends, the amount of the pre-acquisition surplus dividend (net of withholding taxes) is deductible in computing the adjusted cost base to the recipient corporation of shares, of the foreign affiliate. This mechanism ensures that what effectively is a tax free return capital is appropriately reflected in the adjusted cost base of the shares.

Proposed subsections 92(4) to (6) provide for similar adjustments where the shares of a foreign affiliate are held through a partnership. However, whereas subsection 92(2) applies to adjust the cost base of the shares in question, proposed subsections 92(4) to (6) apply only in the case of a disposition, and generally adjusts the proceeds of disposition upwards (as opposed to adjusting cost base downwards) by the amount of pre-acquisition dividends received, net of withholding tax. Specifically, the rules provide that where a corporation resident in Canada, or a foreign affiliate of a corporation resident in Canada, disposes of an interest in a partnership, and that corporation or a foreign affiliate had received a dividend on a share of a foreign affiliate through the partnership that was deductible under paragraph 113(1)(d), or would have been deductible under paragraph 113(1)(d) had the recipient been resident in Canada, the
proceeds of disposition are adjusted upwards by the amount of the dividend deducted (or that would have been deducted, had the corporation been resident in Canada) net of withholding taxes. Likewise, where a partnership disposes of a share of a foreign affiliate, proposed subsections 92(5) and 92(6) will increase each member’s proceeds of disposition by the amount that was deductible under section 113(1)(d) (or would have been deductible under section 113(1)(d), if the member were a corporation resident in Canada) net of withholding tax.

**Deductibility of Previously Taxed FAPI**

Subsection 91(6) preserves the deductibility of previously taxed FAPI where the shares of a foreign affiliate are transferred between related Canadian corporations. Proposed subsection 91(7) provides a similar rule in respect of transfers of the shares of a foreign affiliate from a partnership to a taxpayer resident in Canada. Specifically, proposed subsection 91(7) provides that where a taxpayer resident in Canada acquires a share of a corporation, that is immediately after the acquisition, a foreign affiliate of the taxpayer from a partnership, of which the taxpayer or a corporation resident in Canada with which the taxpayer is not dealing at arm’s length at the time the share was acquired was a member, that the cost base of the shares is deemed to have been adjusted in accordance with the rules of section 92.

**Surplus Adjustments**

A number of consequential amendments are made to the regulations to ensure appropriate integration of the revised proposals. For example, amendments are made to regulation 5905 to reflect the introduction of proposed subsection 93(1.2).
Also, two proposed regulations are introduced to ensure that *equity percentage*, *surplus entitlement* of a share, and the *surplus entitlement percentage* can be appropriately computed where substantial interests in foreign corporations are held through a partnership. These are proposed regulations 5905(14) and 5905(15). Specifically, regulation 5905(14) deems the change to be an acquisition or disposition, as the case may be, for the purposes of Regulation 5905. Proposed regulation 5905(15) now deems each member of the partnership to own that proportion of the number of the shares held by the partnership that the fair market value of the member’s interest in the partnership is of the fair market value of all the member’s interests in the partnership.