# NEW CANADIAN RULES ON THE TAXATION OF FOREIGN INCOME

*by Sonja Chong*

"The Budget raises revenue in the fairest way possible. It better targets incentives, closes loopholes, and brings equity to Canada's tax system." - *The Honourable Paul Martin, February 22, 1994.*

On February 22, 1994, the Minister of Finance announced major changes to the foreign affiliate rules which govern the taxation of foreign source income.

While it remains to be seen whether this budget will bring equity to Canada's tax system, it will certainly tighten the rules relating to earning foreign income.

## Background

The rules relating to foreign affiliates of Canadian companies are complex. They seek to ensure that Canadian companies carrying on business outside Canada through foreign companies are not placed at a disadvantage compared to multi-national companies based in other countries. On the other hand, the rules also seek to ensure that foreign affiliates cannot be used to shelter passive income (whether foreign or Canadian) or income that has been diverted somehow from Canada.

Historically, the rules had been designed so that a Canadian shareholder would not pay tax on active business income of a foreign company until that income was paid as a dividend to the shareholder. In addition, the dividend would be received tax-free by a Canadian parent company if the foreign affiliate resided in a "listed country" prescribed by the Income Tax Act (Canada). This is particularly attractive if the affiliate is in a low-tax jurisdiction.

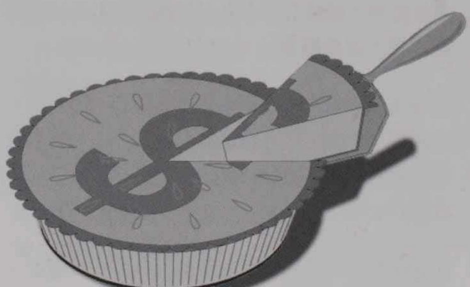
On the other hand, foreign accrual property income (FAPI), which consists of passive income such as interest, rents, dividends, and certain capital gains of a controlled foreign affiliate, is subject to Canadian tax as it is earned by the foreign company. This rule is extremely onerous as it requires advance payment of Canadian tax, even though no funds have been repatriated to Canada.

## Proposed amendments

The amendments are to be effective for taxation years starting in 1995. If enacted, they will:

- *expand the definition of a foreign affiliate;*
- *for the first time, define active business income and FAPI, and in doing so, eliminate a variety of international tax structures designed to avoid Canadian tax;*
- *disallow the deduction of business losses against the FAPI of a foreign affiliate; and*
- *limit "listed countries" to those countries which have a tax treaty with Canada.*

This article does not review the changes. Rather, it highlights through an example, the more significant changes as applied to a Canadian person with business interests in Hong Kong.



## An illustration

A Canadian resident individual, Mr. Wong, emigrated to Canada in 1990. Mr. Wong owns:

- *an eight per cent interest in a Hong Kong company (HKCo). The other 92 per cent is owned by his brother. HKCo has one employee and owns a number of flats in Hong Kong, generating annual rental income of C$200,000;*
- *a Canadian company (Canco) which imports toys from a Hong Kong company (Subco). Subco is owned equally by Mr. Wong and his brother. It buys the toys from China at C$10 per unit and sells them to Canco for C$12 per unit, thus netting a per unit profit of C$2. Canco then sells the toys to Canadian wholesalers for a profit of C$3 per unit. The toys are shipped directly from China to Canada.*

**The question is: How would the proposed amendment affect Mr. Wong's tax position?**

Starting in 1995, Mr. Wong will have to include C$16,000 of rental income as his personal FAPI. This happens even if he does not receive any dividends from HKCo. The reason is HKCo will now be Mr. Wong's controlled foreign affiliate (CFA) since his brother, i.e., a related person, controls HKCo. Previously, Mr. Wong would not have any FAPI inclusion since he owned less than 10 per cent of HKCo. This resulted from a change in the definition of foreign affiliates, and may have unforeseen and adverse tax consequences.

While FAPI of a controlled foreign affiliate is taxed on a current basis, foreign active business income is taxed only upon repatriation. Currently, there are no "bright line" rules to distinguish active from passive income. In Mr. Wong's case, since Subco is in the business of buying and selling toys, i.e., a trading business, arguably, it is engaged in active business. As such, its C$2 of trading profit will only be subject to Hong Kong tax. This is about to change.

Mr. Wong will now be required to include 50 per cent (i.e., his share) of the trading profits of Subco as FAPI. This is so unless all or substantially all (generally interpreted to be 90 per cent or more) of the gross income from Subco from the sale of property is derived from sales to arm's length entities.

## Conclusion

The new rules will have far-reaching tax consequences for many international structures. Some arrangements will need to be altered, and others dismantled altogether. Now is the time to review international operations before the new rules come into effect. ◆

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