Substantive CCPCs and Changes to the Integration Regime for Domestic and Foreign Income

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Introduction

Budget 2022 proposed to significantly expand the scope of the refundable tax regime to include certain non-Canadian-controlled private corporations (CCPCs) that are controlled in fact or in law by Canadian residents. The first part of this paper provides an overview of the proposed substantive CCPC regime and its implications, as follows:

- the types of corporations that will be subject to the proposed legislation;
- background on the common types of non-CCPC planning undertaken prior to the proposed substantive CCPC regime, including a discussion of the drawbacks and benefits of undertaking such planning from an integration perspective; and
- commentary on what to do with corporations that are now subject to the proposed substantive CCPC regime, including an overview of potential pitfalls and planning opportunities.

The paper then discusses the legislative proposals to overhaul the corporate taxation and integration regime for foreign accrual property income (FAPI) and

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dividends prescribed to have been paid out of the taxable surplus and hybrid surplus of a foreign affiliate (FA). This discussion focuses on the following:

- the proposed amendment to reduce the relevant tax factor to 1.9 for CCPCs and substantive CCPCs, and its impact on the foreign accrual tax deduction against FAPI and deductions against taxable surplus and hybrid surplus dividends under section 113 of the Income Tax Act;[1]
- the proposed amendment to address integration through changes to the definitions of capital dividend account (CDA) and general rate income pool (GRIP), including close consideration of the impact of these changes on the treatment of non-capital-gain FAPI income, FAPI capital gains, capital gains includible in hybrid surplus, and active business income includible in taxable surplus, with numerical examples illustrating the results of these proposals across all provinces and territories; and
- the ways in which these proposed amendments could significantly affect current international structures, and how they change the landscape for the future structuring of foreign investments.

Since this paper is intended for advisers of CCPCs, some of whom may not have extensive specialized knowledge of the international tax provisions of the Act, the paper occasionally walks through concepts that are necessary for the comprehension of the subject covered but that may not have been impacted by the proposed amendments.

Finally, the paper highlights two concerns that, in our view, the Department of Finance should consider before the proposed legislation is enacted, and it calls on the Canada Revenue Agency (CRA) to provide tools to help taxpayers and their advisers comply with FAPI and surplus computations.

The New Substantive CCPC Status and How It Affects Former Non-CCPC Planning

The Substantive CCPC

The introduction of the proposed substantive CCPC regime in Budget 2022 seeks to achieve greater tax neutrality by applying the corporate refundable tax regime to certain types of investment income and capital gains earned by private corporations controlled by Canadian residents that would not otherwise be considered CCPCs.[2] If enacted, the proposed substantive CCPC rules would apply for taxation years that end on or after April 7, 2022, albeit with some narrow exceptions.[3]

The proposed definition of a substantive CCPC in amended subsection 248(1) is a private corporation (other than a CCPC) that

> (a) is controlled, directly or indirectly in any manner whatever, by one or more Canadian resident individuals, or
>
> (b) would, if each share of the capital stock of a corporation that is owned by a Canadian resident individual were owned by a particular individual, be controlled by the particular individual.[4]

This definition mirrors in many respects the definition of a CCPC. A private corporation would be considered a substantive CCPC where one or more Canadian residents exercised de facto[5] control over the corporation, or if each share of the corporation owned by related and unrelated Canadian residents resulted in a hypothetical Canadian shareholder obtaining de jure control of the corporation.

A corporation could also be deemed to be a substantive CCPC under a new anti-avoidance rule in proposed subsection 248(43). The purpose of this anti-avoidance rule is to prevent taxpayers from circumventing the substantive CCPC regime in situations where Canadian residents have a material economic interest in a corporation but do not have legal or factual control. Proposed subsection 248(43) reads as follows:

> For the purposes of this Act, if it is reasonable to consider that *one of the purposes of any transaction* (as defined in subsection 245(1)), or series of transactions, is to cause a corporation that is resident in Canada (other than a Canadian-controlled private corporation or a corporation that is, in absence of this subsection, a substantive CCPC) *to avoid tax otherwise payable under section 123.3 on the corporation's aggregate investment income*, the corporation is deemed to be a substantive CCPC from the time that the transaction or series of transactions commenced until the earliest time at which the corporation
>
> (a) becomes a Canadian-controlled private corporation,
> (b) is subject to a loss restriction event, or
> (c) ceases to be resident in Canada.[6]

In the explanatory notes accompanying the proposed legislation, the Department of Finance provided two examples of situations in which this anti-avoidance provision could apply: (1) where voting control is misaligned through the issuance of "skinny" voting shares to allow a non-resident to gain voting control of a CCPC, and (2) where a partnership or trust is interposed between Canadian residents and a corporation in a way that results in the corporation being neither a CCPC nor a substantive CCPC.[7]

The first example of the use of voting control shares could also be captured by the definition of substantive CCPC in subsection 248(1) since paragraph (a) of the definition applies a de facto control test, but to the extent that the CCPC was not factually controlled by residents of Canada, subsection 248(43) could apply. This example is supposed to illustrate that, but for "clear facts indicating otherwise,"[8] it would be the Department of Finance's view that one of the purposes of this type of arrangement would be to avoid tax otherwise payable under section 123.3.

The second example deals with the use of a partnership or trust to circumvent the substantive CCPC regime. In this case, the issued and outstanding shares of a CCPC (Canco) are owned by a limited partnership. Immediately prior to the realization of a large capital gain, the shares of the general partner corporation of the limited partnership are sold to a non-resident, causing the status of Canco to change from a CCPC to a non-CCPC. As in the first example, the explanatory notes provide that the de facto control test in the definition of a substantive CCPC in subsection 248(1) could apply, but if it did not, the anti-avoidance rule could.

Non-CCPC Planning

Non-CCPC planning has been undertaken for many years, although its scope and prevalence appear to us to have greatly increased over the last several years. Support for undertaking this type of planning was very generally grounded in the fact that the CCPC definition was carefully crafted to afford a number of benefits, including access to a low corporate tax rate through the small business deduction under section 125 and enhanced scientific research and experimental development (SR & ED) credits pursuant to subsection 127(10.1) and section 127.1.[9] There are many instances of taxpayers arguing to maintain their CCPC status.[10] This designation also contained some drawbacks, including the refundable tax mechanism.

In our view, a taxpayer ought to be entitled to choose to forgo the benefits associated with being a CCPC in favour of the benefits of not being one. After all, taxpayers should be entitled to arrange their affairs in a tax-efficient way.[11]

This view was buttressed by years of seeming inaction by the CRA where non-CCPC planning was seldom, if ever, challenged. An apparent example of this was *Gladwin*.[12] This case dealt with a series of transactions undertaken by a taxpayer that resulted in two capital gains being realized on the same economic gain, as a result of which the taxpayer doubled the CDA balance it would have otherwise had.

The keen observer may have noted that as part of the transactions undertaken by the taxpayer, Gladwin Realty Corporation had been discontinued under the Canada Business Corporations Act and continued to the British Virgin Islands (BVI) under the BVI Business Companies Act, 2004. As a result, the corporation ceased to be a CCPC.[13] The taxpayer's tax adviser testified that this particular transaction was undertaken to limit directors' liability concerns and to avoid additional tax on investment income under section 123.3.[14] The latter was necessary since the entire amount of the capital gain proceeds was to have been distributed through the payment of capital dividends, which could have made any refundable tax unrecoverable.

The non-CCPC planning did not appear to have been a point of contention with the CRA.[15] Surely, one would have thought, if there were to be a case where the CRA would show its dissatisfaction and challenge this type of planning, *Gladwin* would have been it. To be fair, perhaps the CRA had not fully turned its attention to the migration aspect of the planning undertaken by the taxpayer until a later date, and as a result it was unclear what should be inferred from the lack of a dispute on this point.[16] That, however, seems difficult to comprehend given the typical rigour surrounding the CRA audit and general anti-avoidance rule (GAAR) assessment processes.

Tables 1 and 2 illustrate the tax-deferral and integration advantages achieved through non-CCPC planning compared with earning the same income through a CCPC.

Using Ontario as an example, the combined federal and provincial tax rate for a non-CCPC earning $1,000 of passive investment income is 26.5 percent. By comparison, a CCPC in Ontario would be subject to an effective rate of 50.17 percent, with 30.67 percent being refundable on the payment of taxable dividends.

Table 1 CCPC Investment Income Integration

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Corporate tax													
Taxable income	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Federal													
Basic rate (paragraph 123(1)(a))	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%
Less provincial abatement (subsection 124(1))	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%
Less general rate reduction (subsection 123.4(2))	—	—	—	—	—	—	—	—	—	—	—	—	—
Plus refundable tax (section 123.3)	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%	10.67%
Federal tax payable	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%	38.67%
Provincial													
Provincial rate	12%	8%	12%	12%	11.5%	11.5%	14%	14%	16%	15%	12%	11.5%	12%
Provincial tax payable	12%	8%	12%	12%	11.5%	11.5%	14%	14%	16%	15%	12%	11.5%	12%
Total corporate taxes	**50.67%**	**46.67%**	**50.67%**	**50.67%**	**50.17%**	**50.17%**	**52.67%**	**52.67%**	**54.67%**	**53.67%**	**50.67%**	**50.17%**	**50.67%**
Cash prior to RDTOH recovery	**$493**	**$533**	**$493**	**$493**	**$498**	**$498**	**$473**	**$473**	**$453**	**$463**	**$493**	**$498**	**$493**
RDTOH refund (subsection 129(1))	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%	−30.67%
Net corporate taxes	**20.00%**	**16.00%**	**20.00%**	**20.00%**	**19.50%**	**19.50%**	**22.00%**	**22.00%**	**24.00%**	**23.00%**	**20.00%**	**19.50%**	**20.00%**
Corporate cash available for distribution	**$800**	**$840**	**$800**	**$800**	**$805**	**$805**	**$780**	**$780**	**$760**	**$770**	**$800**	**$805**	**$800**

(Table 1 is concluded on the next page.)

Table 1 Concluded

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Personal tax													
Eligible dividend	—	—	—	—	—	—	—	—	—	—	—	—	—
Eligible dividend tax	—	—	—	—	—	—	—	—	—	—	—	—	—
Non-eligible dividend	$800	$840	$800	$800	$805	$805	$780	$780	$760	$770	$800	$805	$800
Non-eligible dividend tax rate	48.89%	42.30%	41.82%	46.67%	47.74%	48.70%	47.75%	48.27%	47.04%	48.96%	44.05%	36.82%	37.79%
Personal tax	$391	$355	$335	$373	$384	$392	$372	$377	$358	$377	$352	$296	$302
After-tax cash	**$408.88**	**$484.68**	**$465.44**	**$426.64**	**$420.69**	**$412.97**	**$407.55**	**$403.49**	**$402.50**	**$393.01**	**$447.60**	**$508.60**	**$497.68**
Global ETR	**59.1%**	**51.5%**	**53.5%**	**57.3%**	**57.9%**	**58.7%**	**59.2%**	**59.7%**	**59.8%**	**60.7%**	**55.2%**	**49.1%**	**50.2%**
Comparison													
Top personal rate on investment income	53.5%	48.0%	47.5%	50.4%	53.5%	53.3%	53.3%	54.0%	51.4%	54.8%	48.0%	47.1%	44.5%
Underintegration	**5.6%**	**3.5%**	**6.0%**	**6.9%**	**4.4%**	**5.4%**	**5.9%**	**5.7%**	**8.4%**	**5.9%**	**7.2%**	**2.1%**	**5.7%**

CCPC = Canadian-controlled private corporation; RDTOH = refundable dividend tax on hand; ETR = effective tax rate.

— Not applicable.

Table 2 Non-CCPC Investment Income Integration

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Corporate tax													
Taxable income	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Federal													
Basic rate (paragraph 123(1)(a))	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%
Less provincial abatement (subsection 124(1))	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%	−10%
Less general rate reduction (subsection 123.4(2)) . . .	−13%	−13%	−13%	−13%	−13%	−13%	−13%	−13%	−13%	−13%	−13%	−13%	−13%
Plus refundable tax (section 123.3)	—	—	—	—	—	—	—	—	—	—	—	—	—
Federal tax payable	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Provincial													
Provincial rate	12%	8%	12%	12%	11.5%	11.5%	14%	14%	16%	15%	12%	11.5%	12%
Provincial tax payable	12%	8%	12%	12%	12%	11.5%	14%	14%	16%	15%	12%	11.5%	12%
Total corporate taxes	**27.0%**	**23.0%**	**27.0%**	**27.0%**	**26.5%**	**26.5%**	**29.0%**	**29.0%**	**31.0%**	**30.0%**	**27.0%**	**26.5%**	**27.0%**
Cash prior to RDTOH recovery	**$730**	**$770**	**$730**	**$730**	**$735**	**$735**	**$710**	**$710**	**$690**	**$700**	**$730**	**$735**	**$730**
RDTOH refund (subsection 129(1))	—	—	—	—	—	—	—	—	—	—	—	—	—
Net corporate taxes	**27.0%**	**23.0%**	**27.0%**	**27.0%**	**26.5%**	**26.5%**	**29.0%**	**29.0%**	**31.0%**	**30.0%**	**27.0%**	**26.5%**	**27.0%**
Corporate cash available for distribution	**$730**	**$770**	**$730**	**$730**	**$735**	**$735**	**$710**	**$710**	**$690**	**$700**	**$730**	**$735**	**$730**

(Table 2 is concluded on the next page.)

Table 2 Concluded

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Personal tax													
Eligible dividend	$730	$770	$730	$730	$735	$735	$710	$710	$690	$700	$730	$735	$730
Eligible dividend tax	36.54%	34.31%	29.64%	37.79%	39.34%	40.11%	33.51%	41.58%	34.23%	46.20%	28.92%	28.33%	33.08%
Non-eligible dividend	—	—	—	—	—	—	—	—	—	—	—	—	—
Non-eligible dividend tax rate	—	—	—	—	—	—	—	—	—	—	—	—	—
Personal tax	$267	$264	$216	$276	$289	$295	$238	$295	$236	$323	$211	$208	$241
After-tax cash	**$463.26**	**$505.81**	**$513.63**	**$454.13**	**$445.85**	**$440.19**	**$472.08**	**$414.78**	**$453.81**	**$376.60**	**$518.88**	**$526.77**	**$488.52**
Global ETR	**53.7%**	**49.4%**	**48.6%**	**54.6%**	**55.4%**	**56.0%**	**52.8%**	**58.5%**	**54.6%**	**62.3%**	**48.1%**	**47.3%**	**51.1%**
Comparison													
Top personal rate on investment income	53.5%	48.0%	47.5%	50.4%	53.5%	53.3%	53.3%	54.0%	51.4%	54.8%	48.0%	47.1%	44.5%
Underintegration	**0.2%**	**1.4%**	**1.1%**	**4.2%**	**1.9%**	**2.7%**	**-0.5%**	**4.5%**	**3.2%**	**7.5%**	**0.1%**	**0.3%**	**6.6%**

CCPC = Canadian-controlled private corporation; RDTOH = refundable dividend tax on hand; ETR = effective tax rate.

— Not applicable.

An individual resident in Ontario subject to the highest marginal tax rate, however, would be incentivized to not pay a non-eligible dividend from the CCPC to recover the non-eligible refundable dividend tax on hand (NERDTOH) account since the personal tax rate on non-eligible dividends is 47.74 percent. The resulting effective combined corporate and personal tax rate would be 57.9 percent, which is 4.4 percent higher than the rate that would have applied if that income had been earned directly by that individual, and 7.73 percent higher than the rate if that dividend had not been paid.

Plan Mechanics

Non-CCPC planning has typically been used in two scenarios: (1) the sale of property or shares that would have resulted in the realization of a capital gain, and (2) where a future stream of investment income (rents, interest, royalties, foreign portfolio dividends, or capital gains) was anticipated. Implementing a non-CCPC plan typically took one of two forms: (1) corporate residency planning ("corporate residency planning"), and (2) the loss of a corporation's CCPC status through the sale or issuance of voting control shares or the issuance of an option to acquire voting control to a non-resident individual or public corporation ("voting rights planning").

Corporate Residency Planning

Under subsection 125(7), a CCPC is defined as a "private corporation" that is a "Canadian corporation." A "Canadian corporation" is defined in subsection 89(1) to be

> a corporation that is resident in Canada at that time and was
> (a) incorporated in Canada, or
> (b) resident in Canada throughout the period that began on June 18, 1971.

When a corporation resident in Canada is, for instance, continued to a non-treaty jurisdiction such as the British Virgin Islands, the corporation is deemed to have been incorporated in that foreign jurisdiction.[17] Therefore, provided that the corporation was not in existence on June 18, 1971, it would no longer be a "Canadian corporation" or a "taxable Canadian corporation."[18] The corporation would, however, continue to be a "private corporation," which is important for, among other reasons, preserving integration on capital gains through the CDA mechanism.

The mechanics of completing a corporate residency migration plan are generally quite straightforward. For example, a Canadian-resident individual who is the sole shareholder of a CCPC (Holdco) whose only asset is a portfolio of marketable securities may desire to take advantage of a non-CCPC plan by going through the following steps:

1) Incorporate a new Canadian holding corporation (New Holdco) under the laws of a province of Canada. This corporation would be a "taxable Canadian corporation" and subject to tax in Canada.
2) Transfer the shares of Holdco to New Holdco on a tax-deferred basis under subsection 85(1).
3) Continue Holdco from Canada to the British Virgin Islands under the BVI Business Companies Act, 2004.
4) The sole director of Holdco would continue to be a Canadian-resident individual. All management and control functions associated with Holdco would continue to be exercised in Canada.[19]

Although transferring Holdco under New Holdco is not technically required to implement corporate residency planning, it is prudent to do so to help ensure the proper tax integration of future distributions from Holdco to Canadian-resident individuals. For example, if the marketable securities portfolio held by Holdco included shares of a dividend-paying Canadian public corporation, Holdco would be subject to part IV tax on those dividends in the year of receipt. In order to recover or avoid any part IV tax liability, Holdco would need to pay taxable dividends. If these dividends were paid directly by Holdco to a Canadian-resident individual, the recipient would not be subject to the gross-up and credit mechanisms provided for in subsection 82(1) and section 121.[20] In other words, these dividends would be taxed at regular income tax rates, resulting in much higher effective tax rates compared to those applicable when Holdco was a CCPC and a taxable Canadian corporation.

By interposing New Holdco, Holdco can recover any part IV tax by paying a dividend to it. New Holdco can in turn recover its part IV tax liability through the payment of a dividend to a Canadian-resident shareholder, who can then use the dividend gross-up and tax credit mechanisms to achieve something closer to proper integration.

As discussed further below, for taxpayers who are already in this type of structure, the use of a Canadian holding corporation that is a CCPC may also be useful in addressing certain other shortcomings of the proposed substantive CCPC regime.

Voting Control Planning

Two common strategies for causing a CCPC to become a non-CCPC were through the sale or issuance of voting control shares or the issuance of an option to acquire control of a CCPC to a non-resident or public corporation. For different reasons, both of these options result in a corporation becoming a non-CCPC. Moreover, in comparison to the corporate residency planning discussed above, these plans could be viewed as less aggressive and easier to execute from a commercial perspective, depending on the facts of the situation.

Voting Control Shares

The definition of a CCPC in subsection 125(7) provides that a private corporation that is a "Canadian corporation" would not be a CCPC where

> (a) a corporation [is] controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation), by one or more corporations described in paragraph (c), or by any combination of them,
> (b) a corporation that would, if each share of the capital stock of a corporation that is owned by a non-resident person, by a public corporation (other than a prescribed venture capital corporation), or by a corporation described in paragraph (c) were owned by a particular person, be controlled by the particular person, [or]
> (c) a corporation a class of the shares of the capital stock of which is listed on a designated stock exchange.

Through the issuance of voting control shares to a non-resident, a CCPC would cease to be a CCPC. This strategy could be particularly attractive where, for example, a non-resident family member was interested in becoming a shareholder in the family business.

Share Acquisition Rights

In a similar vein, providing an option to either a non-resident or a public corporation that was subject to paragraph 251(5)(b) also became a common strategy to achieve the non-CCPC advantage. In framing this particular strategy, it is worth noting that the drafters of paragraph 251(5)(b) crafted this provision with the idea that CCPC status was something to be desired, and therefore its loss would generally not be in the best interest of a taxpayer. The broad scope of paragraph 251(5)(b) reflects this.

Paragraph 251(5)(b) deems control, for the purposes of the definition of a CCPC, to be acquired where

> at any time a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently,
> (i) *to, or to acquire, shares of the capital stock of a corporation or to control the voting rights of such shares, the person shall*, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, *be deemed to have the same position in relation to the control of the corporation as if the person owned the shares at that time*,
> (ii) to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of the corporation, the person shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to

> the control of the corporation as if the shares were so redeemed, acquired or cancelled by the corporation at that time,
>
> (iii) to, or to acquire or control, voting rights in respect of shares of the capital stock of a corporation, the person is, except where the right is not exercisable at that time because its exercise is contingent on the death, bankruptcy or permanent disability of an individual, deemed to have the same position in relation to the control of the corporation as if the person could exercise the voting rights at that time, or
>
> (iv) to cause the reduction of voting rights in respect of shares, owned by other shareholders, of the capital stock of a corporation, the person is, except where the right is not exercisable at that time because its exercise is contingent on the death, bankruptcy or permanent disability of an individual, deemed to have the same position in relation to the control of the corporation as if the voting rights were so reduced at that time [emphasis added].

Subparagraph (i) aligns particularly well for transactions between a Canadian-resident vendor selling voting control shares of a CCPC to a non-resident or public company. In that context, the application of paragraph 251(5)(b) causes a CCPC to become a non-CCPC, typically on the signing of a purchase and sale agreement (if not sooner). Whereas in the past tax advisers may have gone to great lengths to avoid the application of paragraph 251(5)(b) in order to preserve certain attributes of being a CCPC, given this new context, the application of paragraph 251(5)(b) could be a welcome result.

Now What? Considerations for Dealing with Substantive CCPCs

Legislative Amendments

On August 9, 2022, the Department of Finance released a number of legislative proposals, which included measures affecting the enactment of the new substantive CCPC regime.[21] Under these proposals, a substantive CCPC is treated in the same fashion as a CCPC for certain purposes, including the application of the corporate refundable tax regime to investment income, but not for others, including most of the beneficial aspects of being a CCPC, such as the ability to access the small business deduction, enhanced SR & ED credits, and a three-year normal reassessment period.

Another notable difference is the consequence of becoming or ceasing to be a substantive CCPC. Unlike in the regular CCPC context, where a corporation maintains its status during the entirety of a particular taxation year and where it ceases to do so a taxation year-end results,[22] there is no equivalent rule in the substantive CCPC context. Instead, the substantive CCPC regime appears to employ a point-in-time test. This distinction is apparent in the various proposed amendments where substantive CCPC status is relevant. For example, proposed section 123.3 provides that

> [t]here shall be added to the tax otherwise payable under this Part for each taxation year by a corporation that is a *Canadian-controlled private corporation throughout the year or a substantive CCPC at any time in the year*, an amount equal to 10 2/3% of the lesser of . . .[23]

and amended paragraph (a) of variable D of the definition of "low rate income pool" (LRIP) in subsection 89(1) is proposed to read as follows:

> [i]f the non-CCPC was *a substantive CCPC at any time in its preceding taxation year or would*, but for paragraph (d) of the definition **Canadian-controlled private corporation** in subsection 125(7), be a *Canadian-controlled private corporation in its preceding taxation year*, 80% of its *aggregate investment income* for its preceding taxation year.[24]

Leaving aside the practical difficulties of determining whether a non-CCPC is a substantive CCPC at any point in time, in terms of whether refundable taxes and LRIP apply on aggregate investment income (AII), determining at which time(s) during a taxation year a non-CCPC becomes or ceases to be a substantive CCPC appears to be a moot point, because those provisions apply to the extent that the non-CCPC was a substantive CCPC *at any time* during the relevant taxation year. However, there could still be instances where pinpointing the point in time at which a non-CCPC is a substantive CCPC is important, such as where a corporation held capital property with unrealized gains, as discussed below under the heading "Valuing Accrued Gains Prior to Becoming a Substantive CCPC."

The following is a summary of the provisions of the Act affected by the proposed amendments:

- section 89—the definitions of "capital dividend account," "general rate income pool," and "low rate income pool"
- section 95—the definition of "relevant tax factor"
- section 123.3—refundable tax on investment income
- section 123.4—full rate taxable income
- paragraph 129(1)(b)—dividend refund to a private corporation
- subsection 129(4)—the definitions of "eligible portion" and "non-eligible refundable dividend tax on hand"
- subsection 152(3.1)—the definition of "normal reassessment period"
- subsection 152(4.31)—consequential assessment of part IV tax
- subsection 248(1)—the definition of "substantive CCPC"
- subsection 248(43)—anti-avoidance rule

Dividends

Where a substantive CCPC earns AII, variable D of the definition of LRIP under proposed subsection 89(1) has been amended to provide that investment income must be added to the corporation's LRIP balance. This amendment provides that where a non-CCPC was a substantive CCPC at any time in its preceding taxation year, 80 percent of its AII from its preceding taxation year would be added to its LRIP balance.[25]

A further amendment to proposed variable G of the definition of LRIP is made to ensure that to the extent that a substantive CCPC earns AII in a particular year and distributes the investment income as a non-eligible dividend in the same taxation year, the mechanics of the 80 percent LRIP inclusion from the corporation's AII from the prior taxation year do not result in a double LRIP addition. Variable G provides that a taxable dividend paid in the particular year but before the particular time, or a taxable dividend paid in the preceding taxation year, should be taken into account in determining a substantive CCPC's LRIP balance.

There remains, however, an issue in instances where a substantive CCPC receives an eligible dividend from a portfolio investment in a Canadian-resident public corporation or where it earns income from an active business that it carries on. In these instances, a substantive CCPC is now forced to pay a non-eligible dividend to reduce its LRIP balance before it can pay an eligible dividend, which puts a substantive CCPC at a distinct disadvantage relative to a normal CCPC, which can pay an eligible dividend to the extent that it has a GRIP balance.[26]

The problem from an integration perspective is that taxpayers in all provinces are better off not paying a non-eligible dividend to recover corporate refundable tax when they are subject to tax at the highest personal marginal rate—see table 1. By comparison, paying an eligible dividend to recover part IV tax makes sense from an integration perspective in all provinces other than Ontario, Quebec, Nova Scotia, and Newfoundland and Labrador, as shown in table 3.

It may be possible to solve this conundrum by interposing a holding corporation that is a CCPC between the substantive CCPC and the Canadian-resident taxpayer. Since the holding corporation is a CCPC, it would be subject to the GRIP regime under subsection 89(1), and thus it would be able to pay an eligible dividend to the extent that it has a GRIP balance. For example, if the holding corporation received a non-eligible dividend (equal to the amount required to eliminate the substantive CCPC's LRIP balance) and an eligible dividend in an amount equal to the Canadian public corporation dividends, it should have a GRIP balance. The substantive CCPC should be able to eliminate its LRIP balance and recover its part IV tax in the process.

The interposed holding corporation should have an eligible refundable dividend tax on hand (ERDTOH) balance on account of its receiving an eligible dividend from a connected corporation (the substantive CCPC) that received a dividend refund from its ERDTOH balance.[27] Accordingly, the holding corporation should be able to recover its corporate refundable tax through the payment of an eligible dividend while avoiding the need to pay a non-eligible dividend to recover its NERDTOH balance.[28]

Table 3 Eligible Dividend Tax Integration

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Dividend	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Part IV tax (38⅓%)	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33
Net corporate cash	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**	**$616.67**
RDTOH	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33	$383.33
Eligible dividend	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Eligible dividend tax	36.54%	34.31%	29.64%	37.79%	39.34%	40.11%	33.51%	41.58%	34.23%	46.20%	28.92%	28.33%	33.08%
Personal tax	**$365.40**	**$343.10**	**$296.40**	**$377.90**	**$393.40**	**$401.10**	**$335.10**	**$415.80**	**$342.30**	**$462.00**	**$289.20**	**$283.30**	**$330.80**
Personal after-tax cash	**$634.60**	**$656.90**	**$703.60**	**$622.10**	**$606.60**	**$598.90**	**$664.90**	**$584.20**	**$657.70**	**$538.00**	**$710.80**	**$716.70**	**$669.20**
Comparison													
Corporate tax deferral	**−$17.93**	**−$40.23**	**−$86.93**	**−$5.43**	**$10.07**	**$17.77**	**−$48.23**	**$32.47**	**−$41.03**	**$78.67**	**−$94.13**	**−$100.03**	**−$52.53**

RDTOH = refundable dividend tax on hand; ETR = effective tax rate.

Valuing Accrued Gains Prior to Becoming a Substantive CCPC

Taxpayers will need to value property held by a substantive CCPC to ensure that any accrued and unrealized gains on property held on or before April 7, 2022 are not subject to AII. This somewhat surprising result follows from the way that the definitions of "aggregate investment income" and the "eligible portion" of a capital gain are amended to include the concept of a substantive CCPC. A corporation's "aggregate investment income" is the amount by which the "eligible portion" of the amount of any taxable capital gain exceeds the "eligible portion" of any allowable capital loss. The "eligible portion" is defined in proposed subsection 129(4) as follows:

> **eligible portion** of a corporation's taxable capital gains or allowable capital losses for a taxation year is the total of all amounts each of which is the portion of a taxable capital gain or an allowable capital loss, as the case may be, of the corporation for the year from a disposition of a property that, except where the property was a designated property (within the meaning assigned by subsection 89(1)), *cannot reasonably be regarded as having accrued while the property, or a property for which it was substituted, was property of a corporation other than a Canadian-controlled private corporation, a substantive CCPC, an investment corporation, a mortgage investment corporation or a mutual fund corporation.*[29]

Since the concept of a substantive CCPC did not exist prior to April 7, 2022 and because the substantive CCPC status is a point-in-time test,[30] the "eligible portion" of a capital gain included in the definition of AII should include only any accrued value on or after April 7, 2022, where that corporation was a non-CCPC prior to that date.

A simple example can illustrate the point. Assume that a corporation that was a non-CCPC on January 1, 2020 acquired capital property in the form of shares of another corporation for $1,000,000. The acquired shares were worth $1,500,000 on April 7, 2022 ("the substantive CCPC valuation date"). As shown in table 4, when those shares were later sold on December 31, 2022 for proceeds in the amount of $1,750,000, only $250,000 of the realized capital gain should be considered AII for the purposes of paragraph 129(4)(a).

This result aligns with the explanatory notes accompanying these changes, which state that the definition of "eligible portion" was amended "to ensure that the portion of a corporation's taxable capital gains or allowable capital losses for a taxation year that accrued while the property, or a property for which it was substituted, was property of a corporation that is a substantive CCPC."[31] This drafting is also similar to the bifurcation that exists under subclause 89(1)(a)(i)(C)(II) of the definition of CDA, which excludes the portion of any gain realized on the disposition of a property that can reasonably be regarded as having accrued while the property, or a property for which it was substituted, was property of a corporation controlled directly or indirectly in any manner whatever by one or more non-resident persons.

Table 4 Example: Substantive CCPC Accrued Capital Gain

Capital property acquired, January 1, 2020	
FMV	1,000,000
ACB	1,000,000
Substantive CCPC valuation date, April 7, 2022	
FMV	1,500,000
Accrued gain	500,000
Capital property sold, December 31, 2022	
FMV	1,750,000
ACB	1,000,000
Capital gain	750,000
"Eligible portion" subject to AII (subsection 129(4))	250,000
Portion not subject to AII (subsection 129(4))	500,000

FMV = fair market value; ACB = adjusted cost base; CCPC = Canadian-controlled private corporation; AII = aggregate investment income.

The Case for Not Doing Anything

The question remains: What should be done? It could be argued that these proposed rules may never be enacted, which is not without precedent. Many will recall the tumultuous introduction of section 246.1 on July 18, 2017, which was intended to address the CRA's longstanding concerns with surplus stripping. After much debate and consternation among practitioners and taxpayers with regard to the provision's drafting and application, the proposed rules were abandoned.

Another commonly cited reason for doing nothing is cost. Depending on the structure implemented, it may be necessary to continue a corporation back to Canada in order to avoid the application of the substantive CCPC regime, and the change in status from a CCPC to a non-CCPC may necessitate extra accounting work and tax filings as a result of the deemed year-end.[32] In many cases, without any immediate clear benefit, many taxpayers may be reluctant to spend money on this endeavour.

Lastly, could unwinding a structure hurt a future GAAR challenge?[33] One of the reasons cited in *Gladwin* for its corporate continuance to the British Virgin Islands, for example, was to limit directors' liability concerns. The continuance of a corporation back to Canada in response to a change in tax law could make the strength of that type of an argument appear less compelling.

The Case for Unwinding a Structure

There are also a number of compelling reasons why a taxpayer may wish to unwind a substantive CCPC. These include (1) the complexity of administering a substantive CCPC, as described above, and (2) the possibility of being subject to additional disclosures under the new mandatory tax disclosure rules.

Where a decision is made to transition a non-CCPC/substantive CCPC to a CCPC, care should be taken to avoid any unintended tax consequences. In particular, the impact of certain provisions within the CDA regime that could result in the loss of integration should be considered.

Mandatory Reporting Rules

The Department of Finance released draft legislation introducing a new "notifiable transaction" regime under section 237.4 on February 4, 2022.[34] Under these rules, certain enumerated transactions and transactions that are "substantially similar" to the enumerated transactions are the subject of enhanced disclosures. To help explain the meaning of "substantially similar," Finance provided a number of examples that included transactions designed to manipulate a corporation's CCPC status.[35] The notifiable transaction regime is proposed to be effective January 1, 2022, although penalties should not apply until the legislation receives royal assent.

The question becomes whether transactions that affect the status of a CCPC would be included as notifiable transactions given the introduction of the substantive CCPC regime. One could hope that they would not be included, given that most non-CCPC planning has likely ceased since the introduction of the new substantive CCPC regime. However, the relatively short time frame between the release of the notifiable transaction explanatory notes and the announcement of the substantive CCPC regime (approximately two months), and the government's general desire to have taxpayers provide more information,[36] may suggest that one would hope in vain.

Working on the assumption that non-CCPC and similar types of arrangements are going to be subject to the proposed notifiable transaction regime, taxpayers may be well served to unwind their structures prior to the enactment of this legislation. Doing so may avoid the requirement to report relevant transactions, which would presumably include the dismantlement of a non-CCPC structure, and as a result would reduce the risk of penalties associated with a failure to report.[37]

Corporations Controlled by a Non-Resident

Where a non-CCPC structure is to be unwound, special care should be taken where a corporation was controlled in fact or in law by a non-resident person, in order to avoid an unexpected reduction in a corporation's CDA balance. Under subclause 89(1)(a)(i)(C)(II) of the definition of CDA, the portion of any gain realized on the disposition of a property that can reasonably be regarded as having accrued while the property, or a property for which it was substituted, was property of a corporation controlled directly or indirectly in any manner whatever by one or more non-resident persons is *excluded* from the corporation's CDA account once it becomes a CCPC. This would mean, for example, if a non-CCPC repurchased voting control shares from a non-resident shareholder in order to become a CCPC (and cease to be a substantive CCPC), any accrued gains on property held by that corporation at that time would not be included in the corporation's CDA balance when the property was disposed of. This would cause a dramatic degree of underintegration when the capital gain was ultimately realized, since the non-taxable part of the gain could not be distributed as a tax-free capital dividend.

Moreover, subsection 89(1.1) could affect an existing CDA balance. This provision will apply where a corporation that was a private corporation controlled by one or more non-resident persons becomes a CCPC otherwise than through a change in the residence of one or more of its shareholders. Where this occurs, any CDA balance of the corporation at the time that control is acquired would be eliminated. The intention behind this rule is to prevent CDA attribute trading between non-residents and residents.

With regard to the examples above, one way to mitigate any exposure to subclause 89(1)(a)(i)(C)(II) and subsection 89(1.1) is to ensure that any unrealized gains are realized and paid prior to any transaction that would result in a non-resident ceasing to control the relevant corporation. Care should be taken to ensure that, among other things, subsection 83(2.1) does not apply.

Planning Opportunities

Corporation Controlled by a Non-Resident

There will continue to be situations in which a corporation resident in Canada is controlled by a non-resident person or persons and where no Canadian residents exercise de facto control. Where this occurs, a corporation could still benefit from the non-CCPC planning described above, subject to the anti-avoidance rule in proposed subsection 248(43).

The practical problem for a taxpayer planning to do so, however, is the wide interpretation and possible application of proposed subsection 248(43). As discussed above, this provision can apply where it can be shown that "one of the purposes" of a transaction was not to achieve a result that has occurred. We are not the first to struggle with the meaning of this language, which can also be found in subsections 55(2.1) and 55(4).[38]

There are many instances where control of a CCPC will be acquired by a non-resident with a material value non-controlling interest being held by Canadian residents. Consider a non-resident strategic investor who acquires a controlling interest in a Canadian corporation with a number of Canadian-resident investors, or where voting control shares of a CCPC are transferred to a non-resident beneficiary of an estate. These all-too-common situations could now be subject to scrutiny with regard to the correct tax consequences and face the risk of a CRA challenge based on subsection 248(43), although it should still be possible to achieve the advantages of the non-CCPC plans described above.

Other Opportunities

Other opportunities for planning remain but are generally fact-specific. One example would be to consider opportunities to characterize investment income as "active business income."[39] An "active business" is defined in subsection 248(1) as "any business carried on by the taxpayer other than a specified investment business or a personal services business."[40]

A "specified investment business" is defined under subsection 125(7) as

> [a business] carried on by a corporation in a taxation year . . . (other than a business carried on by a credit union or a business of leasing property other than real or immovable property) the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property but, except where the corporation was a prescribed labour-sponsored venture capital corporation at any time in the year, does not include a business carried on by the corporation in the year where
>
> (a) the corporation employs in the *business throughout the year more than 5 full-time employees*, or
>
> (b) *any other corporation associated with the corporation provides, in the course of carrying on an active business, managerial, administrative, financial, maintenance or other similar services to the corporation in the year and the corporation could reasonably be expected to require more than 5 full-time employees* if those services had not been provided [emphasis added].

The five full-time employees exception in the definition of a specified investment business can be particularly helpful where it can be shown that more than five full-time employees worked in the business responsible for generating investment income. In those types of instances, in addition to avoiding the application of the refundable tax regime, a CCPC could benefit from the small business deduction on the first $500,000 of its active business income. This would provide a better result than an equivalent non-CCPC plan from a corporate tax perspective.

Amendments to the RTF, CDA, and GRIP and Their Impact on the Integration of Foreign Income and Gains Earned by FAs and CFAs

Proposed Amendments To Prevent Deferral of Tax on FAPI and Non-Exempt Dividends from FAs

Under existing rules, Canadian corporate taxpayers can fully shelter FAPI with foreign accrual tax (FAT) to the extent that foreign income or profits tax paid by the FA is at least 25 percent of the FAPI income. This is because the FAT deduction in subsection 91(4) is generally the foreign income or profits tax paid multiplied by the "relevant tax factor" (RTF),[41] which for a corporation (or for a partnership all the members of which, other than non-resident persons, are corporations) is the reciprocal of the basic corporate tax rate less the general rate reduction:[42]

> 1/(percentage set out in paragraph 123(1)(a) − general rate reduction percentage in section 123.4)

Under current tax rates, the RTF for corporations and partnerships with corporate partners is 1/(38% − 13%), or 4. As a result, 25 percent foreign income tax paid on foreign income subject to FAPI treatment multiplied by an RTF of 4 yields a FAT deduction that fully offsets 100 percent of such FAPI income.

In other words, as long as the FAPI of a controlled foreign affiliate (CFA) has been subject to foreign income tax that approximates what a Canadian corporation would have paid as corporate income tax before the provincial abatement on general active business income—that is, 25 percent—there should be no net income inclusion in respect of FAPI for a shareholder that is a corporation or a partnership with exclusively corporate partners. There should be no further incidence of Canadian tax until the underlying income is paid by the corporation to its individual shareholders.

Since a CCPC or a substantive CCPC that earns AII is subject to the refundable tax regime, which in most provinces and territories results in immediate corporate taxation that approximates 50 percent, the non-imposition of Canadian corporate tax when foreign tax on a CFA's investment income reaches merely 25 percent represents an inconsistency. In some cases, a CCPC was able to reduce the immediate tax burden on its investment activities simply by moving its investable assets into a CFA, trading the AII regime for the FAPI regime.

The RTF is also used in paragraph 113(1)(b) to gross up underlying foreign tax applicable to dividends received by a Canadian corporate shareholder from an FA to the extent that the dividend is paid from the FA's taxable surplus. The taxable surplus of an FA consists mostly of the FA's FAPI or the FA's active business income not earned from a designated treaty country, net of foreign tax paid. To account for the fact that foreign income used to pay foreign income tax cannot fund the taxable surplus dividends, the multiplication factor used in paragraph 113(1)(b) is the RTF minus 1—thus, under existing rules, the paragraph 113(1)(b) deduction for all corporations is the underlying foreign tax applicable multiplied by 3, up to the amount of the taxable dividend received.

Therefore, if an FA's non-designated treaty country foreign business income has been subject to at least 25 percent foreign income tax, so that only 75 percent of the earnings is left to distribute as dividends to its Canadian-resident shareholder, the multiplication factor of 3 generally ensures that the Canadian-resident shareholder is not subject to further Canadian tax on the taxable surplus dividend received.

Paragraph 113(1)(c) provides a further deduction for non-business-income tax paid by the Canadian corporate shareholder on a taxable surplus dividend, equal to the non-business-income tax paid (which is typically the source-country withholding tax on the dividend) multiplied by the RTF of 4. Where a dividend is paid out of an FA's hybrid surplus, a multiplication factor of RTF minus 0.5—that is, 3.5—is used to gross up foreign tax paid on the taxable half of the hybrid surplus dividend, with the objective of providing full shelter to a hybrid surplus dividend where at least 25 percent foreign tax has been paid relative to half of the underlying capital gain that generated the hybrid surplus.

In almost all cases, this proposed change to the RTF will drastically increase the Canadian corporate taxation of a CCPC's or substantive CCPC's FAPI, taxable surplus dividend, and hybrid surplus dividend incomes.

Proposed Amendment To Reduce the RTF to 1.9, and Its Impact on FAT and Section 113 Deductions

The proposed amendment to the definition of "relevant tax factor" in subsection 95(1) would prevent a CCPC or a corporation that is a substantive CCPC at any time in the year from accessing the RTF of 4. Instead, their RTF would be 1.9. Under the existing rules, only individuals, trusts, and partnerships with non-corporate members are subject to an RTF of 1.9. If the proposed amendment is enacted, the definition of "relevant tax factor" for taxation years that begin on or after April 7, 2022 will read as follows:

> **relevant tax factor**, of a person or partnership for a taxation year, means
>
> (a) in the case of a corporation (*other than a Canadian-controlled private corporation or a corporation that is a substantive CCPC at any time in the year*), or of a partnership all the members of which, other than non-resident persons, are corporations (*other than Canadian-controlled private corporations or corporations that are substantive CCPCs at any time in the year*), the quotient obtained by the formula [emphasis in original]
>
> $$1/(A - B)$$
>
> where
>
> A is the percentage set out in paragraph 123(1)(a), and
>
> B is
>
> (i) in the case of a corporation, the percentage that is the corporation's general rate reduction percentage (as defined by section 123.4) for the taxation year, and
>
> (ii) in the case of a partnership, the percentage that would be determined under subparagraph (i) in respect of the partnership if the partnership were a corporation whose taxation year is the partnership's fiscal period, and
>
> (b) in any other case, 1.9.

With an RTF limited to 1.9, a CCPC, a substantive CCPC, or a partnership with *any* CCPC or substantive CCPC members is going to be subject to Canadian corporate income tax on FAPI unless the foreign income tax applicable to the underlying income equals or exceeds 52.63 percent.[43] Also, because the FA dividend deductions under paragraphs 113(1)(a.1), (b), and (c) use the RTF to gross up underlying foreign income tax and foreign withholding taxes paid, this reduction in the RTF diminishes the section 113 shelter against dividend income received from FAs. These proposed changes are best illustrated using numerical examples.

Example 1(a): FAPI in Respect of Income from Property

Canco is a CCPC operating in Ontario. Canco owns 100 percent of the shares of USco, which is a US C corporation that owns a rental property in the United States. For 2023, Canco determines its FAPI in respect of USco's rental income for the year to be $100, calculated pursuant to the rules of paragraph 95(2)(f), which requires income from property to be calculated as if USco is resident in Canada at all times (in other words, FAPI is calculated using Canadian tax rules). USco paid $26 of combined US federal and state income tax on this rental income. Both Canco and USco have December 31 fiscal and taxation year-ends.

Note that the details in the following paragraphs are summarized in table 5.

The $26 is the FAT applicable to Canco's $100 of FAPI income, since it is the amount reasonably regarded as applicable to the $100 of FAPI and the amount is paid by USco.[44] Accordingly, Canco may make a FAT deduction under subsection 91(4) equal to the product of the $26 FAT applicable multiplied by its RTF, which will be 1.9 if the proposed changes are enacted. This results in a FAT deduction of $49.40 against Canco's $100 of FAPI, which leaves $50.60 of FAPI unsheltered in Canco. Since FAPI income is includible in income "as income from the share" of the capital stock of the CFA by virtue of subsection 91(1), FAPI income should generally be considered income from property and part of AII.[45] As a result, the $50.60 is subject to the CCPC refundable tax regime; in Ontario, the current combined federal and provincial corporate income tax rate on AII is 50.2 percent. Therefore, unless Canco pays a non-eligible taxable dividend to its shareholder in the same year to recover NERDTOH, Canco's Canadian corporate income tax with respect to the FAPI is $25.40. In total, the immediate Canadian and US corporate income taxation on the rental income is $51.40. (However, note that as illustrated in example 1(b) below, the dividend repatriation by USco to Canco generates a net deduction that may partially offset the FAPI inclusion.)

The $51.40 approximates the top marginal income tax rate for individuals (which, in Ontario, is currently 53.5 percent). This is consistent with the amendment's objective of preventing tax deferral on FAPI and imposing a similar quantum of immediate taxation on FAPI to other types of AII earned by a CCPC or substantive CCPC, irrespective of whether the profits are repatriated back to Canada.

Example 1(b): Repatriation of FAPI Income from USco to Canco

Following on from example 1(a) above, in the same year of the FAPI inclusion (2023), USco distributes its after-tax income of $74 to Canco as a dividend. Assume that the limitation-on-benefits clause in the Canada-US tax treaty does not prevent Canco from claiming benefits under article X of the treaty, so US withholding tax on the dividend is reduced to 5 percent of the $74 dividend amount—that is, $3.70.[46] Other than FAPI, USco does not have any surplus or deficit balances in

Table 5 Canadian and US Income Tax, Before Repatriation of FAPI Income to Canco

USco's rental income	$100.00
US income tax paid	$26.00
Computation of Canco's taxable income for 2023	
FAPI of USco	$100.00
Participating percentage	100%
Income inclusion (subsection 91(1))	$100.00
Foreign accrual tax applicable	$26.00
RTF	1.9
FAT deduction (subsection 91(4))	$49.40
Net income inclusion	$50.60
Combined federal and Ontario corporate tax rate on AII	50.2%
Canadian corporate income tax on FAPI	$25.40
Combined Canadian and US income tax	$51.40
Global ETR with no repatriation	51.4%

FAPI = foreign accrual property income; RTF = relevant tax factor; FAT = foreign accrual tax; AII = aggregate investment income; ETR = effective tax rate.

respect of Canco. Also assume that the $74 dividend is not paid in the course of a liquidation and dissolution of USco.

Note that the details in the following paragraphs are summarized in table 6.

Since the $74 dividend from USco is not paid in the course of a liquidation and dissolution of USco, the $74 amount is includible in Canco's income under subsections 90(2) and 90(1). Where a Canadian corporate shareholder has currently or previously reported FAPI in respect of a CFA and receives a taxable surplus dividend from it, a combination of deductions against the dividend income is available under section 113 and subsection 91(5). In accordance with the ordering rule embedded in paragraph 91(5)(a), it is necessary to first determine the amount deductible under paragraph 113(1)(b).

Paragraph 113(1)(b) provides for a deduction in respect of the portion of the dividend prescribed to have been paid out of USco's taxable surplus ("the taxable surplus dividend"). According to the definition section in regulation 5907(1), an FA's taxable surplus includes its taxable earnings;[47] taxable earnings of an FA include its net earnings for the year in respect of its FAPI;[48] and net earnings in respect of FAPI are generally the amount of FAPI less the foreign income tax paid in respect of the FAPI.[49] In this case, since USco's FAPI for 2023 is $100 and it paid foreign tax of $26 on the FAPI, $74 is added to USco's taxable surplus for 2023.

Since USco has no surplus balances other than the $74 of taxable surplus, the whole $74 dividend should be considered to have been paid out of USco's taxable surplus per regulations 5901 and 5900. Note that even if USco paid the $74 dividend during 2023 and it did not have any taxable surplus balances at the beginning of the year, the dividend still accesses the $74 added to taxable surplus for the year if the dividend is paid more than 90 days after the commencement of the 2023 taxation year.[50]

Since the entire $74 dividend is paid out of USco's taxable surplus, Canco is permitted a deduction under paragraph 113(1)(b), which is calculated by multiplying the foreign tax prescribed to be applicable to the taxable surplus dividend by the amount by which the RTF exceeds 1. Prior to the proposed legislative amendment, this equated to multiplying the foreign tax applicable by 3.[51] However, if the proposed amendment is enacted, the paragraph 113(1)(b) deduction claimable by Canco (a CCPC) will be the foreign tax applicable multiplied by 0.9, since 0.9 is the amount by which the RTF of 1.9 exceeds 1.

Regulation 5900(1)(d) prescribes the foreign tax applicable to a taxable surplus dividend, and the definitions of "underlying foreign tax applicable" (UFTA) and "underlying foreign tax" (UFT) are contained in regulation 5907(1). UFTA is the proportion of the FA's UFT that the portion of the amount of the taxable surplus dividend is of the FA's taxable surplus at the time the dividend is paid (with an ability to elect to have a disproportionate amount of an FA's UFT included in the amount of UFTA for the whole dividend under paragraph (b) of that definition). UFT is generally the foreign income tax paid that can reasonably be regarded as having been paid in respect of the taxable earnings (which is the FAPI amount in this case).[52] Here, UFT should be the $26 of US income tax paid. Given that the whole taxable surplus balance of $74 is paid out as taxable surplus dividend, the UFTA should be $26 × 100%—that is, $26—without any need to make a disproportionate UFTA election under paragraph (b) of the UFTA definition.

Therefore, the paragraph 113(1)(b) deduction available under the amended RTF definition will be $23.40, which is the $26 UFTA multiplied by 0.9.

Where the Canadian-resident shareholder has reported FAPI in respect of a share of a CFA and the shareholder receives a taxable surplus dividend on that share, subsection 91(5) may provide an additional deduction.

Pursuant to subsection 92(1), a Canadian shareholder's adjusted cost base (ACB) of shares in a CFA is increased by the amount of FAPI included in the shareholder's income, and reduced by the amount of subsection 91(4) deduction claimed by the shareholder in respect of those shares. To prevent a double income inclusion of the underlying income already taxed as FAPI, subsection 91(5) allows the shareholder to claim this net addition to ACB against a taxable surplus dividend received on the same share, to the extent that the amount of the taxable surplus dividend exceeds the paragraph 113(1)(b) deduction available. In this example, since the FAPI was $100 and the FAT deduction allowed under subsection 91(4) was $49.40, the net addition to the ACB of the USco shares was $50.60. This is also the amount by which the $74 taxable surplus dividend exceeds the $23.40 paragraph 113(1)(b) deduction. As a result, Canco can claim a subsection 91(5) deduction of $50.60, thus reducing the income inclusion from the taxable surplus dividend to nil. (Claiming the subsection 91(5) deduction then correspondingly reduces the shareholder's ACB of shares in the CFA, per subparagraph 92(1)(b)(ii).)

The analysis does not stop here, however. Despite a nil net income inclusion in respect of this taxable surplus dividend, Canco should be entitled to a further deduction under paragraph 113(1)(c) as a result of the US withholding tax paid by Canco on the taxable surplus dividend. The deduction provided by paragraph 113(1)(c) is the lesser of

1) \$7.03, being the non-business-income tax paid by Canco (\$3.70) in respect of the taxable surplus dividend, multiplied by the RTF of 1.9; and
2) \$50.60, being the amount by which the \$74 taxable surplus dividend exceeds the \$23.40 deduction under paragraph 113(1)(b).

Therefore, Canco claims a deduction of \$7.03 under paragraph 113(1)(c). Section 113 does not limit the total deduction to the taxpayer's income in respect of the dividend received from the FA, and therefore there is a net reduction to income in the amount of \$7.03 with respect to the receipt of this dividend. This net loss can be used to shelter Canco's other income, or, if Canco has a net loss in the year and the FAPI was within the carryback period, Canco may be able to carry that loss back to offset previous years' FAPI. Finally, note that Canco cannot deduct US withholding tax as a foreign tax credit because paragraph 126(1)(a) explicitly prohibits the claiming of non-business-income tax where the taxpayer is a corporation and the tax is paid in respect of a share of an FA of the taxpayer. This result is appropriate because the non-business-income tax is already being deducted under paragraph 113(1)(c).

According to the global integration calculation above, the total tax burden on the \$100 of underlying rental income is 51.6 percent. This is again close to the 53.53 percent top personal marginal tax rate in Ontario.

It is important to note that this effective rate is premised on Canco being able to utilize the \$7.03 net deduction arising from its receipt of the dividend from USco (this is the deduction for foreign withholding tax under paragraph 113(1)(c)). Therefore, Canco should plan either to have other income to absorb the \$7.03 deduction or, where possible, to time the receipt of the USco dividend within the three-year carryback period from the year of the FAPI income inclusion.

Under the existing rule with an RTF at 4, the paragraph 113(1)(c) deduction is often nil because where underlying foreign tax rate paid by the foreign affiliate equals or exceeds 25 percent, an RTF of 4 generally provides a paragraph 113(1)(b) deduction that fully offsets the taxable surplus dividend amount, which in turn means that the paragraph 113(1)(c) deduction is limited to nil because of the "lesser of" mechanics in the paragraph. This will no longer be the case if the RTF is amended to 1.9, and the available net deduction resulting from paragraph 113(1)(c) will need to be considered each time foreign withholding tax is paid on a taxable surplus dividend from an FA or CFA.

Table 6 Repatriation of FAPI Income from USco to Canco

Net earnings, taxable earnings, and taxable surplus of USco			
FAPI			$100.00
Foreign income tax paid on FAPI			−$26.00
			$74.00
UFT: US income tax paid			$26.00
UFTA: UFT × (taxable surplus dividend ÷ taxable surplus)			$26.00
Paragraph 113(1)(b) deduction			
UFTA		$26.00	
Multiplied by (RTF − 1)		0.9	$23.40
Additions to and deductions from Canco's ACB in shares of USco per subsection 92(1), before the dividend so received			
FAPI for the year			$100.00
Subsection 91(4) deduction claimed			−$49.40
			$50.60
Subsection 91(5) deduction equal to the lesser of			
(a) Taxable surplus dividend that exceeds amount deductible under paragraph 113(1)(b)			$50.60
(b) Net addition to ACB per subsection 92(1)			$50.60
Paragraph 113(1)(c) deduction equal to the lesser of			
(a) Non-business income tax paid on taxable surplus dividend		$3.70	
Multiplied by RTF		1.9	$7.03
(b) Taxable surplus dividend that exceeds amount deductible under paragraph 113(1)(b)			$50.60
Computation of income of Canco			
Foreign dividend income (subsection 90(1))			$74.00
Less paragraph 113(1)(b) deduction			−$23.40
Less subsection 91(5) deduction			−$50.60
Less paragraph 113(1)(c) deduction			−$7.03
Net deduction in respect of dividend received from USco			−$7.03
Global tax integration: Underlying income earned			$100.00
US corporate income tax paid		$26.00	
US FDAP withholding tax paid		$3.70	
Canadian corporate income tax paid on FAPI[a]		$25.40	
Canadian tax savings from claiming of net deduction on receipt of USco dividend			
Net loss	−$7.03		
AII tax rate	50.2%	−$3.53	
Global income and withholding tax burden			$51.57
Global effective tax rate upon repatriation to Canco			51.6%

FAPI = foreign accrual property income; UFT = underlying foreign tax; UFTA = underlying foreign tax applicable; ACB = adjusted cost base; RTF = relevant tax factor; FDAP = fixed, determinable, annual, and periodic; AII = aggregate investment income.

a See table 5.

Proposed Amendment for CDA and GRIP Definitions Relating to FAPI and Section 113

We now turn our attention to Canco's tax attributes arising from the FAPI and the USco dividends, how they affect repatriation, and how the Department of Finance has proposed to amend the legislation in relation to these attributes.

Under existing paragraph (b) of variable E of the definition of "general rate income pool" in subsection 89(1), all amounts deductible under section 113 for the particular taxation year are added to GRIP. In most cases, any dividends received by a CCPC from an FA are added to GRIP, thus allowing the amounts to be paid up the corporate chain to the ultimate individual shareholders as eligible taxable dividends.

Because of the proposed reduction in the RTF, a CCPC's or substantive CCPC's income associated with FAPI and non-exempt dividends from FAs will be subject to immediate foreign and Canadian tax totalling approximately 50 percent, if not more. If the distribution of this income to the ultimate individual shareholders attracts personal income taxation in the form of taxable dividends (even if they are eligible taxable dividends), the result will be significant underintegration of tax.[53] To address this outcome, the proposed legislation will allow the CCPC or substantive CCPC to elect to pay such already highly taxed amounts to its shareholders as tax-free capital dividends. In other words, these amounts will be added to the CDA balance of the CCPC or substantive CCPC, and will no longer be added to GRIP.

For taxation years that begin on or after April 7, 2022, new component (h) will be added to the CDA definition in subsection 89(1):

> (h) the total of all amounts each of which is, if the corporation was a Canadian-controlled private corporation throughout the year or a substantive CCPC at any time in the year,
>
> (i) an amount deductible under paragraph 113(1)(a.1) in computing the taxable income of the corporation for the particular taxation year in respect of a dividend received on a share of the capital stock of a foreign affiliate less the amount determined under sub-subclause 113(1)(a.1)(ii)(A)(II)1 in respect of the dividend, and
>
> (ii) the total of the amounts deductible under paragraphs 113(1)(b) and (c) in computing the taxable income of the corporation for the particular taxation year in respect of a dividend received on a share of the capital stock of a foreign affiliate less the amount determined under clause 113(1)(c)(i)(A) in respect of the dividend.[54]

Proposed subparagraph (h)(i) adds to CDA the deductible amount under paragraph 113(1)(a.1) in respect of a dividend paid out of an FA's hybrid surplus, less the amount described in sub-subclause 113(1)(a.1)(ii)(A)(II)1, which is the non-business-income tax paid by the Canadian corporate shareholder with respect to the hybrid surplus dividend. Hybrid surplus is generated when an FA realizes a capital gain on the disposition of shares of another FA or partnership interests that qualify as excluded property, or certain hedging instruments relating to such properties. Further below, this paper walks through an example illustrating a hybrid surplus dividend flowing through to the CDA under proposed subparagraph (h)(i).

Proposed subparagraph (h)(ii) adds to the CDA the deductible amount under paragraphs 113(1)(b) and (c) in respect of a taxable surplus dividend, less the amount described in clause 113(1)(c)(i)(A), which is the foreign withholding tax paid on the taxable surplus dividend.

Essentially, the general concept of both subparagraphs (h)(i) and (ii) is that when a CCPC or substantive CCPC receives a taxable surplus or hybrid surplus dividend, its CDA is increased by the tax-sheltered portion of such dividends and reduced by the foreign withholding tax paid thereon (because an amount paid as withholding tax would no longer be available to it to be distributed as capital dividends).

As a corollary to this, the amounts deductible under paragraph 113(1)(a.1) or paragraphs 113(1)(b) and (c) can no longer be added to GRIP of a CCPC. Without such an amendment, there would be a double dipping of the benefits of CDA and GRIP. Complicating this technical amendment to GRIP are other substantive amendments to the GRIP definition that are included in this legislative proposal:

1) An addition to GRIP in respect of exempt surplus dividends (that is, dividends deductible under paragraph 113(1)(a)) is to be reduced by foreign withholding tax paid on such dividends. This is proposed likely because GRIP is supposed to represent retained earnings that have been subject to a "general" level of tax—in this case, foreign active business income previously subject to the tax regime of a designated treaty country. Amounts paid to a foreign government as withholding tax are no longer retained and should not be part of GRIP.
2) An addition to GRIP should no longer include dividends that are deductible under paragraph 113(1)(d) and subsection 113(2). Paragraph 113(1)(d) provides a deduction for dividends paid out of the pre-acquisition surplus of an FA, and subsection 113(2) provides for a deduction based on the ACB of the FA shares at the end of 1975, so that pre-1976 investment in the FA can essentially be distributed as a return of capital. The Department of Finance's technical notes explained that this is because such dividends represent "de facto returns of capital rather than true dividends."[55] This change is not surprising, especially because allowing paragraph 113(1)(d) into GRIP permits the artificial generation of GRIP simply by returning capital from an FA when those amounts may have never been subject to foreign tax.

The first of the amendments described above applies to taxation years that begin on or after April 7, 2022. However, the second of these amendments applies only to taxation years that begin on or after August 9, 2022. The reason for this later implementation date is presumably because the exclusion of paragraph 113(1)(d) from GRIP was not mentioned in the Budget 2022 announcement in April.

The amendment also addresses a similar GRIP addition for a deposit insurance corporation in respect of amounts deductible under section 113.[56] Discussion of amendments as they relate to a deposit insurance corporation is beyond the scope of this paper.

As a result, where the relevant taxation year begins between April 7 and August 8, 2022, subparagraph (b)(i) of variable E of the definition of "general rate income pool" in subsection 89(1) is proposed to read as follows:

> (b)(i) a Canadian-controlled private corporation, an amount deductible under paragraphs 113(1)(a) or (d) or subsection 113(2) in computing the taxable income of the corporation for the particular taxation year in respect of a dividend received on a share of the capital stock of a foreign affiliate less the amount of non-business income tax (within the meaning of subsection 126(7)) paid by the corporation to the government of a country other than Canada in respect of the dividend . . .[57]

Where a taxation year begins on or after August 9, 2022, subparagraph (b)(i) is further revised to remove amounts deductible under paragraph 113(1)(d) and subsection 113(2):

> (b)(i) a Canadian-controlled private corporation, an amount deductible under paragraph 113(1)(a) in computing the taxable income of the corporation for the particular taxation year in respect of a dividend received on a share of the capital stock of a foreign affiliate less the amount of non-business income tax (within the meaning of subsection 126(7)) paid by the corporation to the government of a country other than Canada in respect of the dividend . . .[58]

Note that there is no GRIP amendment for substantive CCPCs because it is unnecessary. A substantive CCPC does not have GRIP, so the new CDA additions for section 113 deductible amounts should not create any double dipping of benefits.

Example 1(c): Dividend Distributions by Canco of Repatriated FAPI Income

Following on from example 1(b) above, Canco now wishes to dividend up to its shareholders the after-tax amount of the USco dividend it received. Table 7A summarizes Canco's Canadian corporate tax liability from the FAPI and the USco dividend received.

Because of the proposed amendments to the GRIP definition, none of the $74 of the USco taxable surplus dividend received by Canco would be added to Canco's GRIP. Instead, $26.73 will be added to Canco's CDA in respect of this dividend from USco pursuant to new subparagraph (h)(ii) of the CDA definition, as follows:

- $23.40 + $7.03, being the "total of the amounts deductible under paragraphs 113(1)(b) and (c) in computing the taxable income of the corporation for the particular taxation year in respect of a dividend received on a share of the capital stock of a foreign affiliate";[59]
- less the US withholding tax borne by Canco in the amount of −$3.70, being the "amount determined under clause 113(1)(c)(i)(A) in respect of the dividend."[60]

Table 7B sets out a summary of Canco's tax attributes.

Table 7A Canco's 2023 Income with Respect to FAPI and USco Dividend

		Reference
FAPI income (subsection 91(1))	$100.00	Table 5
Foreign dividend income (subsection 90(1))	$74.00	Table 6
Less subsection 91(4) FAT deduction	−$49.40	Table 5
Less paragraph 113(1)(b) UFTA deduction	−$23.40	Table 6
Less subsection 91(5) deduction for previously taxed FAPI	−$50.60	Table 6
Less paragraph 113(1)(c) withholding tax deduction	−$7.03	Table 6
Net income inclusion as AII	$43.57	
AII tax rate, combined federal and Ontario	50%	
Corporate income tax before NERDTOH refund	$21.87	

FAPI = foreign accrual property income; FAT = foreign accrual tax; UFTA = underlying foreign tax applicable; AII = aggregate investment income; NERDTOH = non-eligible refundable dividend tax on hand.

Table 7B Canco's Addition to NERDTOH and CDA

NERDTOH (30.67% of AII)*	$13.36
Net addition to CDA	
Paragraph 113(1)(b) deduction	$23.40
Paragraph 113(1)(c) deduction	$7.03
Less clause 113(1)(c)(i)(A) withholding tax	−$3.70
	$26.73
* Non-taxable dividend required for NERDTOH refund	$34.86

NERDTOH = non-eligible refundable dividend tax on hand; CDA = capital dividend account; AII = aggregate investment income.

Therefore, assuming a full NERDTOH recovery by virtue of Canco paying at least $34.86 of non-eligible taxable dividend, the amount that Canco has available to distribute is $61.79, computed as shown in table 7C. This distribution can be paid out partly as a tax-free capital dividend from Canco's CDA and partly as a non-eligible taxable dividend.

At the end, individual shareholders each receive $45.05 of after-tax funds. This represents a fully distributed global effective tax rate of 54.95 percent, a result that is slightly underintegrated compared to the top marginal tax rate on ordinary income in Ontario, which is 53.53 percent. The global tax burden is summarized in table 7D.

Integration of Non-Capital-Gain FAPI Income Across Canada

Table 8 replicates examples 1(a), (b), and (c) across all of Canada's provinces and territories to illustrate integration in each jurisdiction for FAPI income that is not a capital gain.

Table 7C Dividend Distributions from Canco

Canco's available funds for distribution	
Dividend received from USco	$74.00
Less US withholding tax	−$3.70
Less Canadian corporate tax before NERDTOH refund	−$21.87
Plus NERDTOH refund	$13.36
	$61.79
Distribution to individuals to consist of	
Capital dividend from CDA	$26.73
Remainder as non-eligible taxable dividend	$35.06
Combined federal and Ontario effective rate on non-eligible taxable dividend	47.74%
Personal income tax on non-eligible taxable dividend	$16.74

NERDTOH = non-eligible refundable dividend tax on hand; CDA = capital dividend account.

Table 7D Global Tax Burden on Full Distribution

US corporate income tax	$26.00
US withholding tax	$3.70
Canadian corporate income tax, after NERDTOH refunded	$8.51
Canadian personal income tax on non-eligible taxable dividend	$16.74
Global tax burden	$54.95
Global effective tax rate on full distribution	54.95%

NERDTOH = non-eligible refundable dividend tax on hand.

There is underintegration for all provinces and territories, particularly for taxpayers in Saskatchewan, Prince Edward Island, Yukon, and Nunavut. The bottom row of table 8 summarizes the foreign plus Canadian corporate tax paid or payable if the earnings are retained inside Canco and not paid out as dividends to the individual shareholders. Note that this is over 50 percent across the country, reflecting the Department of Finance's objective of preventing deferral on FAPI income.

Impact of Amendments on Hybrid Surplus Dividends

When an FA realizes a capital gain, the taxable portion of the capital gain is treated as FAPI if the property disposed of is not an excluded property of the FA,[61] or if the gain arose from a disposition to which one of the foreign affiliate reorganization provisions in paragraph 95(2)(c), (d), or (d.1), subparagraph 95(2)(e)(i), or paragraph 88(3)(a) applies.[62] However, where a capital gain is not includible in FAPI, and the capital gain arises from the disposition of a share of another FA, a partnership interest, or certain hedging instruments relating to such shares and partnership interests (such as an FA selling shares of another FA that are excluded property), the whole amount of the capital gain less any foreign income tax paid in respect of the gain is added to the FA's hybrid surplus.[63]

Table 8 Integration of Non-Capital Gain FAPI Income Across Provinces and Territories

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
USco's rental income	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
US income tax paid	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**	**$26.00**
USco dividend to Canco	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00	$74.00
US withholding tax paid	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**	**$3.70**
Canco's AII (table 8)	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57	$43.57
AII tax rate	50.7%	46.7%	50.7%	50.7%	50.2%	50.2%	52.7%	52.7%	54.7%	53.7%	50.7%	50.2%	50.7%
NERDTOH refund	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%
Canco's corporate tax	**$8.71**	**$6.97**	**$8.71**	**$8.71**	**$8.50**	**$8.50**	**$9.59**	**$9.59**	**$10.46**	**$10.02**	**$8.71**	**$8.50**	**$8.71**
Canco capital dividend	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73	$26.73
Canco non-eligible taxable dividend	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06	$35.06
ETR on non-eligible taxable dividend	48.9%	42.3%	41.8%	46.7%	47.7%	48.7%	47.8%	48.3%	47.0%	49.0%	44.1%	36.8%	37.8%
Personal tax on dividend	**$17.14**	**$14.83**	**$14.66**	**$16.36**	**$16.74**	**$17.07**	**$16.74**	**$16.92**	**$16.49**	**$17.17**	**$15.44**	**$12.91**	**$13.25**
Global tax	**$55.55**	**$51.50**	**$53.08**	**$54.78**	**$54.93**	**$55.27**	**$56.03**	**$56.21**	**$56.65**	**$56.89**	**$53.86**	**$51.10**	**$51.66**
Global ETR	**55.6%**	**51.5%**	**53.1%**	**54.8%**	**54.9%**	**55.3%**	**56.0%**	**56.2%**	**56.6%**	**56.9%**	**53.9%**	**51.1%**	**51.7%**
Comparison													
Top rate on ordinary income	53.5%	48.0%	47.5%	50.4%	53.5%	53.3%	53.3%	54.0%	51.4%	54.8%	48.0%	47.1%	44.5%
Underintegration	**2.1%**	**3.5%**	**5.6%**	**4.4%**	**1.4%**	**2.0%**	**2.7%**	**2.2%**	**5.3%**	**2.1%**	**5.9%**	**4.1%**	**7.2%**
Immediate tax payable without dividend to individual	*$51.78*	*$50.03*	*$51.78*	*$51.78*	*$51.56*	*$51.56*	*$52.65*	*$52.65*	*$53.52*	*$53.08*	*$51.78*	*$51.56*	*$51.78*

FAPI = foreign accrual property income; AII = aggregate investment income; NERDTOH = non-eligible refundable dividend tax on hand; ETR = effective tax rate.

A Canadian corporate shareholder who receives a dividend from an FA's hybrid surplus is entitled to a deduction under paragraph 113(1)(a.1). The amount is the total of

(i) one-half of the portion of the dividend prescribed to have been paid out of hybrid surplus ("the hybrid surplus dividend"),[64] and
(ii) the lesser of
(A) the total of
(I) the hybrid underlying tax applicable (HUTA, which generally is the foreign tax paid by the FA on the foreign capital gain)[65] to the hybrid surplus dividend, multiplied by the amount that is the RTF minus 0.5, and
(II) the non-business-income tax paid by the Canadian corporate shareholder (that is, the foreign withholding tax) applicable to the hybrid surplus dividend, multiplied by the RTF, and
(B) one-half of the hybrid surplus dividend.[66]

With the existing RTF of 4, the mechanics above should typically allow for a paragraph 113(1)(a.1) deduction that fully offsets the hybrid surplus dividend where the foreign tax rate in respect of the capital gain had been one-half of the 25 percent notional Canadian tax rate—in other words, 12.5 percent. The proposed reduction in the RTF changes this result so that Canadian corporate tax will apply to the hybrid surplus dividend unless foreign taxes of at least one-half of 52.63 percent (26.32 percent) have been paid.

There has long been a significant underintegration problem with capital gains realized by FAs and CFAs. This is because, under existing rules, capital gains realized by an FA never generate CDA. Consequently, all of these gains, when repatriated to the ultimate Canadian shareholders, are treated as taxable dividends. The amendment to CDA and GRIP largely fixes this for an FA's capital gain that funds hybrid surplus dividends. Example 2 illustrates this integration under the proposed rules.

Example 2: Integration of Hybrid Surplus Dividends from FAs

Canco, a CCPC, owns 100 percent of USco, a US C corporation. USco owns 100 percent of USsub, which is also a US C corporation. Substantially all assets of USsub are assets used to carry on an active business in the United States, so the shares of USsub constitute excluded property to USco. During 2023, USco sold all the shares of USsub for a gain of $100, on which USco paid US corporate tax of $21. USco repatriated $79 of the after-tax proceeds to Canco, on which US withholding tax of $3.95 was remitted. Prior to the sale, neither USco nor USsub had any surplus or deficit balances in respect of Canco.

USco's hybrid surplus is increased by $79 because that is the amount of the capital gain minus foreign tax paid thereon. Canco has to report the $79 as income, but is entitled to a deduction under paragraph 113(1)(a.1). The deduction is calculated as the total of

(i) \$39.50, being one-half of the hybrid surplus dividend, and
(ii) the lesser of
(A) the total of
(I) \$29.40, being the \$21 HUTA in respect of the hybrid surplus dividend multiplied by 1.4, which is the proposed RTF minus 0.5, and
(II) \$7.51, being the \$3.95 non-business-income tax paid by Canco on the hybrid surplus dividend, multiplied by 1.9, the proposed RTF, and
(B) \$39.50, being one-half of the hybrid surplus dividend.

This formula provides for a paragraph 113(1)(a.1) deduction of \$76.41. It leaves \$2.60 of hybrid surplus dividend income unsheltered, which would be taxed as AII. This unsheltered portion arose under the formula because the US tax paid is slightly less than one-half of 52.63 percent. Under the proposed legislative amendment, there will be no GRIP addition for Canco. Canco's CDA will be \$72.46, which is the paragraph 113(1)(a.1) deduction of \$76.41 less the \$3.95 non-business-income tax paid by Canco on the hybrid surplus dividend.

Table 9 illustrates the integration result across all the provinces and territories assuming a full distribution to the individual shareholders of Canco.

For most provinces, the result is complete integration or slight overintegration—the integration in Ontario, British Columbia, Quebec, and New Brunswick is perfect. However, there is still material underintegration in Alberta, Saskatchewan, and the three territories. Overall, though, this amendment fixes the longstanding issue of the lack of integration of capital gains realized by FAs, at least as it relates to gains that result in hybrid surplus.

Impact of Amendments on Foreign Capital Gains Treated as FAPI

As illustrated above, the proposed rules mostly achieve integration with respect to capital gains that fund hybrid surplus dividends. Disappointingly, the amendments do not fully address the underintegration problem with respect to capital gains treated as FAPI. When a CFA realizes a FAPI capital gain, half of the gain is included in FAPI[67] and the other half (less the portion of foreign tax reasonably regarded as tax on the non-taxable half) is included in exempt surplus.[68] Since there is no CDA addition for the non-taxable half of the foreign gain, that half is ultimately subject to personal income tax when repatriated to the individual Canadian-resident shareholders. It would have been logical and practical for the Department of Finance to fix this integration problem concurrently with the proposed amendments, similar to the way in which one-half of the hybrid surplus dividend will be added to CDA even if no foreign tax is paid on the hybrid surplus capital gain. To create a similar integration result, the legislation could, for example, add the non-taxable half of a FAPI capital gain to CDA.[69] Unfortunately, this is not part of the proposed amendments. The amendments add to CDA the taxable surplus dividend deduction less foreign tax. While this improves the integration situation, the overall tax burden on FAPI capital gains is still significantly underintegrated, as example 3 illustrates.

Table 9 Integration of a Foreign Affiliate's Capital Gain Included in Hybrid Surplus

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
USco's capital gain	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
US income tax paid	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**
USco dividend to Canco	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
US withholding tax paid	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**
Dividend income	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
Paragraph 113(1)(a.1) deduction	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41	−$76.41
Canco's AII	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60	$2.60
AII tax rate	50.7%	46.7%	50.7%	50.7%	50.2%	50.2%	52.7%	52.7%	54.7%	53.7%	50.7%	50.2%	50.7%
NERDTOH refund	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%
Canco's corporate tax	**$0.52**	**$0.42**	**$0.52**	**$0.52**	**$0.51**	**$0.51**	**$0.57**	**$0.57**	**$0.62**	**$0.60**	**$0.52**	**$0.51**	**$0.52**
Canco capital dividend	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46	$72.46
Canco non-eligible taxable dividend	$2.08	$2.18	$2.08	$2.08	$2.09	$2.09	$2.02	$2.02	$1.97	$2.00	$2.08	$2.09	$2.08
ETR on non-eligible taxable dividend	48.9%	42.3%	41.8%	46.7%	47.7%	48.7%	47.8%	48.3%	47.0%	49.0%	44.1%	36.8%	37.8%
Personal tax on dividend	**$1.01**	**$0.92**	**$0.87**	**$0.97**	**$1.00**	**$1.02**	**$0.97**	**$0.98**	**$0.93**	**$0.98**	**$0.91**	**$0.77**	**$0.78**
Global tax	**$26.48**	**$26.29**	**$26.34**	**$26.44**	**$26.45**	**$26.47**	**$26.49**	**$26.50**	**$26.50**	**$26.53**	**$26.38**	**$26.23**	**$26.25**
Global ETR	**26.5%**	**26.3%**	**26.3%**	**26.4%**	**26.5%**	**26.5%**	**26.5%**	**26.5%**	**26.5%**	**26.5%**	**26.4%**	**26.2%**	**26.3%**
Comparison													
Top rate on capital gain	26.75%	24.00%	23.75%	25.20%	26.77%	26.66%	26.65%	27.00%	25.69%	27.40%	24.00%	23.53%	22.25%
Underintegration	**−0.3%**	**2.3%**	**2.6%**	**1.2%**	**−0.3%**	**−0.2%**	**−0.2%**	**−0.5%**	**0.8%**	**−0.9%**	**2.4%**	**2.7%**	**4.0%**

FAPI = foreign accrual property income; AII = aggregate investment income; NERDTOH = non-eligible refundable dividend tax on hand; ETR = effective tax rate.

Example 3: Underintegration of FAPI Capital Gains

Canco, a CCPC, owns 100 percent of USco, a US C corporation. USco owns a passive rental property that does not qualify as an excluded property of USco. USco sold the property for a gain of $100, on which USco paid US corporate income tax of $21. USco repatriated $79 of the after-tax proceeds to Canco, on which US withholding tax of $3.95 was remitted. Prior to the sale, USco had no surplus or deficit balances in respect of Canco.

The proposed rules apply in this situation similar to the way they apply to the non-capital-gain FAPI income in example 1, but here only half of the $100 gain ($50) is included in FAPI. Given that the US corporate income tax liability of $21 is calculated on the basis of the whole $100 gain, the questions that arise are how much of the US corporate income tax of $21 can be claimed as FAT, how it affects the surplus pools, and how much of it can be claimed as UFTA:

- the subsection 91(4) FAT deduction is the RTF multiplied by "the portion of any income or profits tax that may reasonably be regarded as applicable" to the amount included in $50 of FAPI;[70]
- the addition to taxable surplus is the $50 of FAPI, minus "the portion of any income or profits tax paid to the government of a country for the year by the affiliate that can reasonably be regarded as tax in respect of that income";[71]
- the addition to exempt surplus is the amount by which the gross capital gain of the FA exceeds the $50 taxable capital gain included in FAPI and "the portion of any income or profits tax paid to the government of a country for the year by the particular affiliate that can reasonably be regarded as tax in respect of the amount by which the capital gains of the particular affiliate for the year exceed the [taxable portion of the capital gain]";[72] and
- the paragraph 113(1)(b) deduction is the amount that is the RTF minus 1 multiplied by the "underlying foreign tax applicable to such potion of the dividend as is prescribed to have been paid out of the taxable surplus."[73]

It is the CRA's longstanding view that the foreign tax paid in respect of a capital gain that may reasonably be regarded as applicable to the FAPI income inclusion, and as having been paid in respect of taxable earnings of an FA, is the amount of such foreign tax as is required to eliminate the Canadian income tax that would otherwise be payable in respect of the FAPI gain or the repatriation of the taxable surplus resulting from the gain.[74] Therefore, applying this concept, the full $21 of US corporate income tax paid should be considered to be applicable to the $50 of FAPI, with the following results:

- The subsection 91(4) deduction should be $39.90, being $21 multiplied by RTF of 1.9.
- The addition to USco's taxable surplus should be $29, being $50 minus $21 of foreign tax applicable.

- The addition to USco's exempt surplus should be $50, being the amount by which USco's capital gain ($100) exceeds the taxable capital gain included in FAPI ($50) and the portion of foreign tax that can reasonably be regarded as tax in respect of the non-taxable portion of the capital gain ($0). The last element is $0 because the entire $21 foreign tax is considered to be applicable to the FAPI income—that is, the taxable portion of the capital gain—so no portion of it should be applicable to the non-taxable portion of the capital gain.
- Consequently, of the $79 dividend paid by USco to Canco, $50 should be exempt surplus dividend and $29 should be taxable surplus dividend.
- The paragraph 113(1)(a) deduction should be $50, fully offsetting the exempt surplus dividend amount.
- Canco can claim a paragraph 113(1)(b) deduction of $18.90, being $21 of UFTA multiplied by 0.9, which is the RTF minus 1.
- The subsection 91(5) deduction is $10.10, being the $50 FAPI income inclusion less the $39.90 FAT deduction.

It is not clear what portion of the US withholding tax of $3.95 relates to the $29 taxable surplus dividend versus the $50 exempt surplus dividend. To the extent that the withholding tax relates to the taxable surplus dividend, that amount multiplied by the RTF is deductible under paragraph 113(1)(c). The new addition to CDA is the amounts deductible under paragraphs 113(1)(b) and (c) less the amount determined under clause 113(1)(c)(i)(A). In other words, the CDA addition will be reduced by any withholding tax that is applicable to the taxable surplus dividend amount.

However, the wording for the proposed addition to GRIP is this: "[A]n amount deductible under paragraph 113(1)(a) in computing the taxable income of the corporation for the particular taxation year in respect of *a* dividend received . . . less the amount of non-business income tax . . . paid by the corporation . . . in respect of *the* dividend [emphasis added]." If this is read literally, the whole withholding tax should reduce the amount that the exempt surplus dividend adds to GRIP—even though a portion of that withholding tax has already reduced the amount that the taxable surplus dividend adds to CDA.

We believe that a double grind against both CDA and GRIP does not appear to be a reasonable interpretation based on the context and purpose of these proposed rules, and would likely be prevented by the double-counting provision of subsection 248(28). As a result, in our illustration, we presume that the portion of the US withholding tax applicable to the taxable surplus dividend will reduce the CDA addition, while only the portion of the US withholding tax applicable to the exempt surplus dividend will reduce the GRIP addition. We hope that the CRA will clarify this if these rules are to be enacted.

Furthermore, in our illustration, we took the approach of prorating the $3.95 withholding tax between the $50 exempt surplus dividend and the $29 taxable surplus dividend, as follows:

- The paragraph 113(1)(c) deduction for foreign withholding tax on the taxable surplus dividend is assumed to be $2.76, being the $1.45 ($3.95 foreign withholding tax prorated by $29 over $79) multiplied by the RTF of 1.9.
- The addition to CDA should be $20.21, being the $18.90 deductible under paragraph 113(1)(b) plus $2.76 deductible under paragraph 113(1)(c), less $1.45 as the amount used in clause 113(1)(c)(i)(A).
- On the basis of our interpretation, the addition to GRIP should be $47.50, being the $50 of paragraph 113(1)(a) deduction less $2.50 ($3.95 foreign withholding tax prorated by $50 over $79).

Table 10 puts all of this together, for each province and territory across Canada.

While the CDA addition for the paragraph 113(1)(b) and (c) deductions has improved integration from the existing regime, the result is still significant under-integration on FAPI capital gains across all provinces and territories. For instance, in Alberta, a foreign capital gain realized in the form of FAPI will be taxed on a fully distributed basis at almost twice the rate that a gain realized by an individual personally would be taxed (45 percent compared to 24 percent).

Impact of Amendments on Taxable Surplus Dividends Derived from Active Business Income

An FA's exempt surplus includes income earned from an active business carried on by it in a designated treaty country, provided that none of the rules in paragraphs 95(2)(a.1) to (b) applies to recharacterize such income, and provided that the FA's Canadian common-law residency is consistent with its residency under a tax treaty with Canada.

The residency requirement is based on paragraph (d) of the "exempt earnings" definition, which requires that the FA, throughout the year, be resident in a designated treaty country in order for it to accumulate its active business income carried on in a designated treaty country as exempt earnings.[75] It is the CRA's longstanding view that Canadian common-law principles apply in determining whether a foreign affiliate is resident in a designated treaty country. Furthermore, regulation 5907(11.2) deems a foreign affiliate not to be resident in a designated treaty country unless one of the requirements in regulations 5907(11.2)(a), (b), (c), and (d) is satisfied.[76]

This can be generally summarized as a two-prong test:

- First, the FA must be resident in a designated treaty country under Canadian common-law principles: a company is resident in the country in which its central management and control (CMC) is exercised.[77]
- Second, the FA must satisfy one of the treaty residency requirements in regulations 5907(11.2)(a), (b), (c), and (d). Most commonly, it is the requirement in regulation 5907(11.2)(a) that applies: "[T]he affiliate is, at that time, a resident of that country for the purpose of the agreement or convention."

Table 10 Example 3: Underintegration of FAPI Capital Gain

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
USco's capital gain	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
US income tax paid	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**
USco dividend to Canco	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
US withholding tax paid	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**
FAPI	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00	$50.00
Dividend income	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
Paragraph 113(1)(a) deduction	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00	−$50.00
Subsection 91(4) FAT deduction	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90	−$39.90
Paragraph 113(1)(b) deduction	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90
Subsection 91(5) deduction	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10	−$10.10
Paragraph 113(1)(c) deduction	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76	−$2.76
Canco's AII	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35	$7.35
AII tax rate	50.7%	46.7%	50.7%	50.7%	50.2%	50.2%	52.7%	52.7%	54.7%	53.7%	50.7%	50.2%	50.7%
NERDTOH refund	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%	−30.7%
Canco's corporate tax	**$1.47**	**$1.18**	**$1.47**	**$1.47**	**$1.43**	**$1.43**	**$1.62**	**$1.62**	**$1.76**	**$1.69**	**$1.47**	**$1.43**	**$1.47**

(Table 10 is concluded on the next page.)

Table 10 Concluded

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Canco capital dividend	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21	$20.21
Canco eligible taxable dividend	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50	$47.50
Canco non-eligible taxable dividend	$5.88	$6.17	$5.88	$5.88	$5.91	$5.91	$5.73	$5.73	$5.58	$5.66	$5.88	$5.91	$5.88
ETR on eligible taxable dividend	36.5%	34.3%	29.6%	37.8%	39.3%	40.1%	33.5%	41.6%	34.2%	46.2%	28.9%	28.3%	33.1%
ETR on non-eligible taxable dividend	48.9%	42.3%	41.8%	46.7%	47.7%	48.7%	47.8%	48.3%	47.0%	49.0%	44.1%	36.8%	37.8%
Personal tax on dividend	**$20.23**	**$18.91**	**$16.54**	**$20.69**	**$21.51**	**$21.93**	**$18.65**	**$22.52**	**$18.89**	**$24.71**	**$16.33**	**$15.63**	**$17.93**
Global tax	**$46.65**	**$45.03**	**$42.96**	**$47.11**	**$47.89**	**$48.31**	**$45.22**	**$49.08**	**$45.60**	**$51.35**	**$42.74**	**$42.02**	**$44.35**
Global ETR	**46.6%**	**45.0%**	**43.0%**	**47.1%**	**47.9%**	**48.3%**	**45.2%**	**49.1%**	**45.6%**	**51.4%**	**42.7%**	**42.0%**	**44.4%**
Comparison													
Top rate on capital gain	26.8%	24.0%	23.8%	25.2%	26.8%	26.7%	26.7%	27.0%	25.7%	27.4%	24.0%	23.5%	22.3%
Underintegration	**19.9%**	**21.0%**	**19.2%**	**21.9%**	**21.1%**	**21.7%**	**18.6%**	**22.1%**	**19.9%**	**24.0%**	**18.7%**	**18.5%**	**22.1%**
Immediate tax payable without dividend to individual	*$28.67*	*$28.38*	*$28.67*	*$28.67*	*$28.63*	*$28.63*	*$28.82*	*$28.82*	*$28.97*	*$28.89*	*$28.67*	*$28.63*	*$28.67*

FAPI = foreign accrual property income; AII = aggregate investment income; NERDTOH = non-eligible refundable dividend tax on hand; ETR = effective tax rate.

To the extent that an FA's active business income is not includible in exempt surplus, either because the business is not carried on in a designated treaty country or because its CMC is found to be exercised in a jurisdiction different from its treaty residency jurisdiction, that active business income would be accumulated in the FA's taxable surplus.[78]

The proposed amendments to the RTF and the definitions of GRIP and CDA will significantly increase the immediate taxation imposed on taxable surplus dividends for CCPCs and substantive CCPCs, and change the integration results. Example 4 illustrates this.

Example 4: Integration of Active Business Income Includible in Taxable Surplus

Canco, a CCPC, owns 100 percent of Forco. Forco is a corporation that resides and carries on an active business in a country that is not a designated treaty country. Forco earned active business income of $100, and it paid foreign income tax of $21 on this income. Forco repatriated $79 of the after-tax income to Canco. Forco's country of residence imposes a 5 percent withholding tax ($3.95) on the dividend. Aside from surplus relating to this $100 of business income, Forco had no surplus or deficit balances in respect of Canco.

Because of the reduced RTF, Canco will have corporate income tax payable, at AII rates, upon receiving a dividend from Forco. Table 11A illustrates the global tax burden, before Canco declares dividends to its shareholders to recover NERDTOH.

Table 11B illustrates the result when Canco distributes the after-tax proceeds from the Forco dividend to its shareholders, making use of the CDA arising from the paragraph 113(1)(b) and (c) deductible amounts (reduced by the foreign withholding tax on the taxable surplus dividend), and distributes the rest as non-eligible taxable dividends. The illustration assumes full recovery of the NERDTOH balance.

A meaningful measure is to compare the result if Forco's active business income had qualified as exempt surplus. The exempt surplus dividend deduction in paragraph 113(1)(a) is unaffected by the proposed change to the RTF, since the deduction under paragraph 113(1)(a) equals the whole exempt surplus dividend amount. The paragraph 113(1)(a) deduction is not included in the amended CDA definition, and the amount will be added to GRIP (the whole paragraph 113(1)(a) amount in the existing rules, but reduced by foreign withholding tax paid in accordance with the proposed GRIP definition). Tables 12A and 12B illustrate the tax result if Forco's active business income had qualified as exempt surplus.

The most significant implication of Forco's active business income being treated as taxable surplus is Canadian corporate tax (at AII rates) applying to the Forco dividend when it is received by Canco. Under the existing regime, where the RTF is 4, this often does not have a material tax impact to the extent that Forco operates in a jurisdiction with corporate income tax of 25 percent or higher. However, with the RTF proposed to be reduced to 1.9, the global tax burden is doubled on this corporate-to-corporate taxable surplus repatriation compared to when the business

Table 11A Corporate Repatriation of Active Business Income Includible in Taxable Surplus

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Forco's income	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
Foreign income tax paid	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**
Forco dividend to Canco	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
Foreign withholding tax paid	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**
Dividend income	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
Paragraph 113(1)(b) deduction	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90	−$18.90
Paragraph 113(1)(c) deduction	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51	−$7.51
Canco's AII	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60	$52.60
AII tax rate	50.7%	46.7%	50.7%	50.7%	50.2%	50.2%	52.7%	52.7%	54.7%	53.7%	50.7%	50.2%	50.7%
Canco's corporate tax	**$26.65**	**$24.54**	**$26.65**	**$26.65**	**$26.39**	**$26.39**	**$27.70**	**$27.70**	**$28.75**	**$28.23**	**$26.65**	**$26.39**	**$26.65**
Global tax	**$51.60**	**$49.49**	**$51.60**	**$51.60**	**$51.34**	**$51.34**	**$52.65**	**$52.65**	**$53.70**	**$53.18**	**$51.60**	**$51.34**	**$51.60**
Global ETR	**51.6%**	**49.5%**	**51.6%**	**51.6%**	**51.3%**	**51.3%**	**52.7%**	**52.7%**	**53.7%**	**53.2%**	**51.6%**	**51.3%**	**51.6%**

FAPI = foreign accrual property income; AII = aggregate investment income; ETR = effective tax rate.

Table 11B Integration of Active Business Income Includible in Taxable Surplus, with Amounts Fully Distributed to Shareholders as Dividends

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
NERDTOH refund to Canco, adding to distributable cash	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13	−$16.13
Distributable cash	*$64.53*	*$66.63*	*$64.53*	*$64.53*	*$64.79*	*$64.79*	*$63.48*	*$63.48*	*$62.43*	*$62.95*	*$64.53*	*$64.79*	*$64.53*
Canco capital dividend	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46	$22.46
Canco non-eligible taxable dividend	$42.08	$44.18	$42.08	$42.08	$42.34	$42.34	$41.02	$41.02	$39.97	$40.50	$42.08	$42.34	$42.08
ETR on non-eligible taxable dividend	48.9%	42.3%	41.8%	46.7%	47.7%	48.7%	47.8%	48.3%	47.0%	49.0%	44.1%	36.8%	37.8%
Personal tax on dividend	**$20.57**	**$18.69**	**$17.60**	**$19.64**	**$20.21**	**$20.62**	**$19.59**	**$19.80**	**$18.80**	**$19.83**	**$18.53**	**$15.59**	**$15.90**
Global tax	**$56.04**	**$52.05**	**$53.07**	**$55.11**	**$55.42**	**$55.83**	**$56.11**	**$56.32**	**$56.38**	**$56.87**	**$54.00**	**$50.80**	**$51.37**
Global ETR	**56.0%**	**52.1%**	**53.1%**	**55.1%**	**55.4%**	**55.8%**	**56.1%**	**56.3%**	**56.4%**	**56.9%**	**54.0%**	**50.8%**	**51.4%**
Comparison													
Top rate on ordinary income	53.5%	48.0%	47.5%	50.4%	53.5%	53.3%	53.3%	54.0%	51.4%	54.8%	48.0%	47.1%	44.5%
Underintegration	**2.5%**	**4.1%**	**5.6%**	**4.7%**	**1.9%**	**2.5%**	**2.8%**	**2.3%**	**5.0%**	**2.1%**	**6.0%**	**3.7%**	**6.9%**

NERDTOH = non-eligible refundable dividend tax on hand; ETR = effective tax rate.

Table 12A Corporate Repatriation of Active Business Income Includible in Exempt Surplus

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Forco's income	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
Foreign income tax paid	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**	**$21.00**
Forco dividend to Canco	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
Foreign withholding tax paid	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**	**$3.95**
Dividend income	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00	$79.00
Paragraph 113(1)(a) deduction	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00	−$79.00
Canco's AII	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
AII tax rate	50.7%	46.7%	50.7%	50.7%	50.2%	50.2%	52.7%	52.7%	54.7%	53.7%	50.7%	50.2%	50.7%
Canco's corporate tax	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**	**$0.00**
Global tax	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**	**$24.95**
Global ETR	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**	**25.0%**

AII = aggregate investment income; ETR = effective tax rate.

Table 12B Integration of Active Business Income Includible in Exempt Surplus, with Amounts Fully Distributed to Shareholders as Dividends

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL	YT	NT	NU
Distributable cash	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*	*$75.05*
Canco capital dividend	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Canco eligible taxable dividend	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05	$75.05
ETR on eligible taxable dividend	36.5%	34.3%	29.6%	37.8%	39.3%	40.1%	33.5%	41.6%	34.2%	46.2%	28.9%	28.3%	33.1%
Personal tax on dividend	**$27.42**	**$25.75**	**$22.24**	**$28.36**	**$29.52**	**$30.10**	**$25.15**	**$31.21**	**$25.69**	**$34.67**	**$21.70**	**$21.26**	**$24.83**
Global tax	**$52.37**	**$50.70**	**$47.19**	**$53.31**	**$54.47**	**$55.05**	**$50.10**	**$56.16**	**$50.64**	**$59.62**	**$46.65**	**$46.21**	**$49.78**
Global ETR	**52.4%**	**50.7%**	**47.2%**	**53.3%**	**54.5%**	**55.1%**	**50.1%**	**56.2%**	**50.6%**	**59.6%**	**46.7%**	**46.2%**	**49.8%**
Comparison													
Top rate on ordinary income	53.5%	48.0%	47.5%	50.4%	53.5%	53.3%	53.3%	54.0%	51.4%	54.8%	48.0%	47.1%	44.5%
Underintegration	**−1.1%**	**2.7%**	**−0.3%**	**2.9%**	**0.9%**	**1.7%**	**−3.2%**	**2.2%**	**−0.7%**	**4.8%**	**−1.3%**	**−0.8%**	**5.3%**

ETR = effective tax rate.

income is treated as exempt surplus. Also, on a fully distributed basis, the global effective tax rate is slightly lower in most provinces and territories if the business income qualifies as exempt surplus rather than taxable surplus.

In the past, the active business income of an FA could be treated as FAPI if the business was carried on in a "non-qualifying country."[79] At the time of writing, however, there are no non-qualifying countries remaining, so we will not analyze the impact of the proposed amendment on such businesses.

The next part of this paper discusses the planning and compliance implications of these proposed amendments to RTF, GRIP, and CDA.

Future Planning Considerations as a Result of Amendments to RTF, CDA, and GRIP

Existing FAPI Tax-Deferral Structures

Prior to the proposed amendments, a CCPC could avoid the refundable tax regime on AII, which imposes immediate corporate taxation of close to 50 percent, by holding investments in a CFA that is subject to foreign tax at or near 25 percent. With an RTF of 4, there would generally be no Canadian corporate tax due on the FAPI or on dividend income paid by the CFA to the Canadian corporate shareholder.

The proposed amendment to the RTF eliminates the tax-deferral benefits of such a structure. These structures carry significant compliance burdens, such as foreign tax reporting for the CFA and the computation of FAPI and surplus balances. Since the maintenance of such structures will yield no Canadian tax benefits if the proposed amendments are enacted, it may be advisable to unwind them. However, it is important to consider any foreign and Canadian tax and non-tax considerations before doing so. For example, where the assets in the CFA have appreciated in value, a disposition and/or repatriation of these assets will likely trigger foreign income tax and foreign withholding tax and have Canadian FAPI, dividend income inclusion, and capital gain implications. Given the significant foreign exchange fluctuations we have experienced over the last several years, there may be material accrued foreign exchange gains to consider even where the underlying assets have not appreciated in value in the CFA's local currency. Furthermore, some foreign jurisdictions may have domestic laws that require certain types of local assets, such as real estate, to be held by an entity residing in that country.

Where a CCPC or substantive CCPC will earn FAPI or taxable/hybrid surplus dividend income *and* the CCPC or substantive CCPC has non-resident shareholders, the overall tax result could be onerous. This is because, despite the inclusion of paragraph 113(1)(a.1), (b), and (c) deductible amounts in CDA, a non-resident shareholder does not benefit from CDA. Capital dividends that are paid to non-resident shareholders are subject to part XIII withholding tax, and non-resident shareholders will often be subject to taxation on the dividends in their local jurisdiction. This could result in an overall tax burden far in excess of 50 percent for these non-resident shareholders in respect of income caught by these new proposals.

Unwinding FAPI structures in these situations will likely be important, and if the situation cannot be rectified, it is conceivable that non-resident shareholders might prefer to completely exit their position in the CCPC or substantive CCPC.

Financing/Service/Captive Insurance CFA Structures

Large CCPCs (or substantive CCPCs) that operate internationally may have CFAs outside Canada that provide centralized financing, service, or insurance functions to active subsidiaries around the world. Provided that the payers are other FAs in which the CCPC has a qualifying interest, and the amounts paid are for expenditures deductible by the payer FAs against earnings from their active business, the amounts should generally be treated as income from an active business for the CFA that provides such financing, service, or insurance functions. As long as CMC of the CFA is aligned with its treaty residency, this income should be treated as exempt surplus of the CFA.[80]

Where the CFA also provides the same centralized financing, service, or insurance functions to the CCPC or other Canadian entities within the group, the profit therefrom is generally treated as FAPI and taxable surplus.[81] However, despite this tax result, this situation often arises in these international structures because commercially it made sense for the corporate group to globally centralize their financing, service, or insurance functions in the CFA, rather than duplicate the same function in the Canadian entities.

The proposed reduction in the RTF to 1.9 will make the FAPI arising from these structures significantly more costly. CCPCs or substantive CCPCs that are in these international structures and currently reporting FAPI should consider this increased Canadian tax cost of FAPI, and compare this to the commercial cost of moving the Canadian portion of the financing, service, or insurance functions back to its Canadian entities. This may be particularly attractive if these functions can be moved to a province in Canada that has lower provincial corporate income tax rates (such as Alberta).

Avoiding Taxable Surplus Dividends if ACB on FA Shares Is Available

As illustrated above, if the proposed amendments are enacted, a CCPC or substantive CCPC that receives a taxable surplus dividend will most likely not have sufficient paragraph 113(1)(b) and (c) deductions to fully shelter the dividend income, and the net income inclusion will most likely be subject to close to 50 percent immediate corporate taxation as AII. The same applies, but to half the extent, for hybrid surplus dividends.

Where an FA has no exempt surplus and only taxable surplus or hybrid surplus, it may be possible to "skip" the taxable surplus or hybrid surplus pool through either a qualifying return of capital (QROC) or a preacquisition surplus election under regulation 5901(2)(b). A QROC is a return of capital by an FA where a subsection 90(3) election is timely filed.[82] A QROC is not considered income, and it reduces the recipient shareholder's ACB in the shares of the FA.[83] Alternatively, a dividend from an FA that is otherwise, in whole or in part, paid out of exempt surplus, hybrid surplus, or taxable surplus can instead be deemed to have been paid out of the preacquisition surplus of the FA if an election is properly filed under regulation 5901(2)(b). A dividend paid out of an FA's preacquisition surplus can be fully sheltered by the Canadian corporate shareholder claiming a paragraph 113(1)(d) deduction. The shareholder's ACB in the shares of the FA is reduced by the amount deductible under paragraph 113(1)(d), less any foreign income tax paid by the shareholder on the preacquisition dividend, such as foreign withholding tax.[84] Note that pursuant to the proposed amendment to the GRIP definition, paragraph 113(1)(d) deductions will no longer be added to GRIP for taxation years that begin on or after August 9, 2022.

Therefore, both the QROC and the regulation 5901(2)(b) election allow the Canadian corporate shareholder of an FA to avoid Canadian corporate taxation on taxable surplus or hybrid surplus dividends, and instead have the amount grind their ACB in the FA shares. For structures where a CCPC or substantive CCPC has sufficient ACB in the shares of its FA, either the QROC or the regulation 5901(2)(b) election should be an effective strategy of deferring tax for managing FA repatriations.

What if the ACB grind exceeds the ACB of the FA shares? A "negative" ACB triggers a deemed gain from a disposition of property under subsection 40(3). Does that mean that a QROC or regulation 5901(2)(b) election allows taxable surplus and hybrid surplus to be skipped over in favour of realizing a capital gain in the hands of the Canadian corporate shareholder that is only 50 percent includible in income, with the other 50 percent added to CDA? No, and this is because of the anti-avoidance rule in subsection 93(1.1).

According to paragraph 93(1.1)(b), where a corporation would be deemed by subsection 40(3), because of a QROC election or a regulation 5901(2)(b)(i) election, to have realized a gain from the disposition of an FA share, the corporation is deemed to have made an election under subsection 93(1) and to have designated the FA's "net surplus" amount under the election.[85] Unless an FA has any exempt, hybrid, or taxable deficits, the FA's "net surplus" is the total of its exempt surplus, hybrid surplus, and taxable surplus in respect of the Canadian corporate shareholder.[86] As a result, if the FA has a positive taxable or hybrid surplus balance, and the Canadian shareholder incurs a capital gain because a QROC or regulation 5901(2)(b) election exceeded the ACB of the FA share, the shareholder will be required to report the taxable surplus or hybrid surplus dividend income to the extent of the balance of those surplus accounts, rather than a capital gain.[87]

While it is not possible to skip over surplus accounts to trigger a capital gain via a QROC or regulation 5901(2)(b) election for the reasons given above, it may be possible to do so on the dissolution or liquidation of the FA, or on a redemption of the shares of the FA. A distribution made in the course of such corporate actions of the FA is carved out of the dividend income treatment rule in subsection 90(2), and there is no deemed subsection 93(1) election to recharacterize the disposition. Furthermore, a qualifying liquidation and dissolution under subsection 88(3.1) may provide for further tax deferral. Depending on the amount of any available section 113 deduction, CCPCs and substantive CCPCs that have FAs with positive taxable and or hybrid surplus balances may want to consider repatriating the FAs' profits using these methods. For example, an FA with taxable surplus in respect of a Canadian corporate shareholder may first pay an amount of taxable surplus dividend where, with a disproportionate UFT election provided by paragraph (b) of the UFTA definition in regulation 5907(1), the shareholder can fully shelter the taxable surplus dividend amount with paragraph 113(1)(b) and (c) deductions based on the reduced RTF. Then, the remaining value of the FA can be repatriated to the Canadian corporate shareholder using share redemptions or corporate liquidation. Of course, any foreign income or withholding tax implications or other non-tax implications must also be considered.

Structures That Avoid FAPI

The proposed amendments significantly increase Canadian corporate tax on FAPI for CCPCs and substantive CCPCs. At best, the tax result would be equivalent to AII earned directly by the CCPCs or substantive CCPCs, but with the added complication of FAPI and taxable surplus computations. Therefore, some Canadian taxpayers may be considering structures that avoid FAPI altogether.

The reporting of FAPI is required only when a CFA of the taxpayer earns the FAPI. Generally, there are two ways to avoid having CFAs while investing abroad. The first is to invest through an FA that falls outside any of the control criteria in the CFA definition. The second is to not invest through any entity that could be considered a non-resident corporation under the Act.

In accordance with its definition in subsection 95(1), an FA is a CFA only if it is controlled by the taxpayer, or if it would be controlled by the taxpayer if the taxpayer also owned all the shares owned by

- persons not dealing at arm's length with the taxpayer;
- any four (or fewer) other Canadian-resident persons (each of whom is referred to as a "relevant Canadian shareholder"); and
- persons not dealing at arm's length with any "relevant Canadian shareholders."

"Control" for the purpose of this definition refers to de jure or legal control.[88] Given this, it may be tempting to set up an artificial control arrangement where, say, an unrelated non-resident person owns the controlling shares of a foreign corporation while the Canadian-resident taxpayer holds non-controlling participating shares, and with an understanding that the non-resident controlling shareholder will simply "rubber-stamp" all of the Canadian-resident taxpayer's decisions in respect of the foreign corporation. If such an arrangement is relied on for a filing position that the foreign corporation is not a CFA (so that the taxpayer does not have to report FAPI and can defer Canadian taxation until repatriation from the foreign corporation), there could be various ways for the CRA to attack this. For example, the CRA could argue:

- The non-resident controlling person is not dealing at arm's length with the Canadian-resident taxpayer on a factual basis.[89] In that case, that person's shares are counted in determining control, and hence the foreign corporation is a CFA of the Canadian-resident taxpayer.
- The non-resident controlling person is merely an agent or a bare trustee holding the shares for the Canadian-resident taxpayer. In that case, the Canadian-resident taxpayer is considered to own the controlling shares and the corporation is its CFA.
- The non-resident controlling person acquired the controlling shares of the foreign corporation, and it can reasonably be considered that the principal purpose of this acquisition was to permit the Canadian-resident taxpayer to avoid, reduce, or defer tax otherwise payable under the Act. In that case, subsection 95(6) would deem the acquisition to not have taken place, in which case the Canadian-resident taxpayer would control the foreign corporation and that foreign corporation would be its CFA.[90]
- Emboldened by the recent decision of the Supreme Court of Canada in *Deans Knight*, which involved a transaction carefully structured to avoid de jure control, the CRA will likely assert that the arrangement frustrates the object, spirit, or purpose of the CFA definition and the FAPI provisions and that GAAR applies.[91]
- The arrangement is merely a sham.[92]

Beyond these arguments, there would also be the commercial risk of issuing controlling shares to someone, and that may be the biggest risk to these types of arrangements.

While the example above is extreme and artificial, there are many commercially driven situations in which a Canadian taxpayer invests with unrelated foreign investors, and sometimes, as part of the commercial deal, is not granted de jure control of the foreign investment vehicle, so that CFA status cannot be achieved for the Canadian taxpayer. The CRA should not be able to attack such bona fide structures using the arguments above.

Another way to avoid having a CFA is to not invest through a foreign corporation. Instead, a Canadian taxpayer can invest through

- personal ownership;
- a Canadian or foreign partnership, which can be either a general or a limited partnership;
- a Canadian or foreign joint venture;
- a Canadian corporation owning an interest in a Canadian or foreign partnership or joint venture; or
- a Canadian corporation investing/operating in the foreign jurisdiction as a branch.

Among these alternatives, the only structure for which most foreign jurisdictions would provide limited liability is the limited partnership, and typically only in respect of a limited partner who is not engaged in the management of the partnership. However, there are Canadian tax "traps" to watch out for when a limited partnership is used. First, if the partnership is expected to receive any payments from Canadian-resident payers and the partnership is not a "Canadian partnership," part XIII tax applies to these payments if they fall into one of the types of income subject to part XIII (rents, interests, royalties, management fees, etc.).[93] In situations where this is a concern, the typical planning is to ensure that the partnership remains a "Canadian partnership" under subsection 102(1) by allowing only Canadian-resident partners to be members of the partnership; and, where foreign investors are involved, to have them invest through a Canadian corporation or unlimited liability company. Second, realizing a capital gain from the disposition of a partnership interest to a non-resident person can be subject to 100 percent inclusion in income, rather than the usual 50 percent inclusion, as a result of subsections 100(1) and (1.1). This is particularly important if a disposition of the partnership interest to an existing or future non-resident partner is contemplated as part of the Canadian taxpayer's exit plan from the structure.

Finally, the CRA's classification of a foreign entity for Canadian tax purposes follows the "two-step" method,[94] which may or may not result in a classification that aligns with the entity's foreign legal status. Therefore, an entity that is not a corporation in its organizational jurisdiction could potentially still be a corporation and a CFA for Canadian tax purposes.

Sometimes, bringing otherwise FAPI-investable assets back into the hands of the Canadian corporate parent could even avoid AII treatment. For example, AII treatment could be avoided where previously the CFA does not employ more than five full-time employees in its investment business, but once the investable assets are brought back to the Canadian parent, the Canadian parent employs more than five full-time employees in its overall investment business that now encompasses both the domestic and foreign investments (assuming that they are all one business and not separate businesses).[95] AII treatment could also be avoided for businesses that fall within the definition of "investment business" in subsection 95(1) but not the definition of "specified investment business" in subsection 125(7). For instance, a securities trading business or a land development business without more than five full-time employees is considered an "investment business" per its definition in subsection 95(1) because the principal purpose of the business is to profit from the disposition of "investment property,"[96] and income from such a business is therefore considered income from property for FAPI purposes. However, if a Canadian corporation carries on such activities, even if the activities are carried on outside Canada (for example, through a land development limited partnership of which the Canadian corporation is a limited partner), such activities are not a specified investment business because the principal purpose is not to derive income from property; as a result, income from such property is not AII and thus would be entitled to general corporate tax rates (and potentially even the small business tax rate if the foreign activity is part of an active business carried on in Canada).

Proper Housekeeping for FAPI, Surplus, and CMC now Paramount for CCPCs and Substantive CCPCs

In our experience, many small to mid-size CCPCs that carry on activities in foreign jurisdictions with relatively high corporate tax rates and a tax treaty with Canada (such as the United States) have not paid sufficient, or any, attention to the proper computation of FAPI, surplus balance, or the exercise of CMC of an FA in the FA's jurisdiction of residency. These housekeeping matters may have been dismissed as merely academic for many of these CCPCs, perhaps because most or all of their FAPI was effectively sheltered by FAT and because, even if CMC is misaligned with the FA's treaty residency and the foreign active business income is treated as taxable surplus, there would be a sufficient paragraph 113(1)(b) deduction to fully shelter most or all of the dividends repatriated from the FA. Even with the expanded disclosure introduced with the new T1134 forms that became applicable for taxation years beginning in the 2021 taxation year, many practitioners held onto these assumptions.

However, if the proposed amendments to the RTF are enacted, a complete change in mindset will be required. The reduction of the RTF for CCPCs and substantive CCPCs means that Canadian corporate tax will apply to any FAPI and taxable surplus dividends where the foreign income tax paid on the underlying income is less than 52.63 percent, and we are not aware of any foreign jurisdiction that imposes corporate income taxation at that level. It is probably fair to assert that, absent available deductions or exemptions, Canadian corporate tax will apply to substantially all FAPI and taxable surplus dividends earned by a CCPC or substantive CCPC for taxation years starting on or after April 7, 2022. Moreover, the Canadian corporate tax applicable will most likely be at the high AII rate.

Therefore, the following housekeeping items will be mandatory and paramount going forward: FAPI calculations; maintenance of exempt surplus, taxable surplus, and hybrid surplus balances; and ensuring that CMC of an FA is actually exercised in the country in which the FA resides. For small CCPCs, maintaining CMC of an FA in a foreign country can be practically challenging and sometimes impossible. Imagine a small business where all the decisions are made by the Canadian-resident owner and that business expanded to the United States through a US subsidiary. To truly maintain CMC of the US subsidiary in the United States, most or all strategic decisions relating to the US subsidiary need to be made physically inside the United States.

Recently, the CRA reiterated this CMC requirement and what it expects taxpayers to document to evidence this:

> In addition to surplus calculations, Canco is required to keep records that support that FA is resident in Country A under common law principles to substantiate that the condition under paragraph (d) of the definition of "exempt earnings" in subsection 5907(1) of the Regulations that the FA is "resident in a designated treaty country" is met. In order to do so, the information in those records needs to be detailed and complete enough to support that the central

> management and control of FA is exercised in the treaty country, and include information relating to the whole "course of business and trading" of the FA and, thus, *not be limited to the location of board meetings or where members of the board are resident*.[97]

It does not often make commercial sense for small CCPCs to employ local executive personnel for its foreign subsidiary. These CCPCs will likely have a difficult time substantiating that CMC was exercised in the country of its treaty residency. Going forward, there will be significantly adverse tax implications for these CCPCs of having the foreign income characterized as taxable surplus—a potential difference between tax-free exempt surplus dividends and taxable surplus dividends that are taxed at up to the 50 percent AII Canadian corporate tax rate.

Proposals to the Department of Finance and the CRA Regarding Surplus and FAPI

Given that it may be impossible or impractical for small CCPCs to maintain CMC of their FAs in the countries of their treaty residency, we strongly urge the Department of Finance to consider an amendment to regulation 5907(11.2) so that small to mid-size CCPCs do not have to comply with CMC requirements in order for their FA's active business income earned from a designated treaty country to be included in exempt surplus. Without this, Canadian small to mid-size businesses expanding their business abroad will be forced to incur unnecessary and sometimes prohibitive overhead and administrative costs, hurting their competitiveness. If such a broad change is unpalatable to the Department of Finance, we believe that the department should at least consider exempting FAs that are residents of the United States under the Canada-US tax treaty from the requirement that CMC must be exercised in the United States in order for their active business income to be included in exempt surplus. The United States is a high-tax jurisdiction with a highly developed and sophisticated enforcement regime. We do not see any mischief arising from exempting US corporate subsidiaries of Canadian taxpayers from the CMC requirement, and granting this exemption should resolve this pain point for a large majority of small to mid-size CCPCs expanding their business abroad.

As mentioned above, we believe that the Department of Finance should take advantage of this legislative overhaul to fix the significant underintegration problem with FAPI capital gains. For Canadians investing abroad, investing through a foreign corporation often makes the most sense from a commercial and asset-protection perspective. However, significant underintegration on future FAPI capital gains will sway many of them to choose a more convoluted structure that often makes less commercial sense. This is counter to the fundamental tax policy objective of neutrality.

We also note that since FAPI and taxable surplus dividends will be subject to significant taxation for CCPCs and substantive CCPCs, the CRA should consider including FAPI and surplus calculation schedules or worksheets as part of the corporate T2 tax returns. It is unreasonable to expect small CCPCs and their tax return preparers to correctly calculate FAPI and surplus balances with no forms to guide them. We appreciate that these rules are nuanced and complicated, and that it would be a monumental task for the CRA to design such a form or worksheet. However, given the proposed reduction of the RTF, we believe that the CRA no longer has the luxury of ignoring this.

Notes

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

2 Subsection 125(7).

3 An exception is provided where all or substantially all of the shares of a corporation are being sold to an arm's-length purchaser, the transaction is to close before 2023, and it occurred pursuant to a written purchase and sale agreement entered into before April 7, 2022.

4 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax and Other Legislation (Budget 2022 and Other Proposals)* (Ottawa: Department of Finance, August 2022), at 74-75.

5 Subsections 256(5.1) and (5.11).

6 Supra note 4, at 75 (emphasis added).

7 Canada, Department of Finance, *Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations (Budget 2022 and Other Proposals)* (Ottawa: Department of Finance, August 2022), at 141-42, examples 1 and 2.

8 Ibid.

9 The August 9, 2022 explanatory notes (ibid., at 137) on the proposed amendments to subsection 248(1) acknowledge this fact by commenting that because "the CCPC definition was designed to restrict certain tax benefits to 'true' Canadian-controlled private corporations, it is a restrictive definition. This has made the CCPC definition more susceptible to manipulation by taxpayers seeking to avoid the anti-deferral rules that apply to CCPCs."

10 *Silicon Graphics Ltd. v. The Queen*, 2002 DTC 7112 (FCA).

11 *Commissioners of Inland Revenue v. Duke of Westminster*, [1936] AC 1 (HL).

12 *Gladwin Realty Corporation v. The Queen*, 2019 TCC 62; aff'd 2020 FCA 142.

13 Ibid., at paragraph 17 (TCC).

14 Ibid.

15 Anthony Strawson and Andrew Bateman, "CDA Extraction After Deemed Gain Followed by Deemed Loss Held To Be Abusive" (2019) 19:3 *Tax for the Owner-Manager* 1-2.

16 Ibid.

17 Subsection 250(5.1).

18 Subsection 89(1).

19 Where a corporation is not deemed to be a resident of a jurisdiction owing to a tax treaty, for Canadian income tax purposes a corporation will be resident in the jurisdiction where its "central management and control" is exercised. See *De Beers Consolidated Mines Ltd. v. Howe*, [1906] AC 455, at 458 (HL).

20 Because Holdco is not a taxable Canadian corporation, dividends paid by Holdco are likely subject to paragraph 82(1)(d) and not paragraph 82(1)(b).

21 Canada, Department of Finance, supra note 4; and Canada, Department of Finance, supra note 7.

22 Subsection 249(3.1).

23 Canada, Department of Finance, supra note 4, at 73 (emphasis in original).

24 Ibid. (emphasis in original).

25 This may provide a limited opportunity during which in a taxation year a substantive CCPC could pay an eligible dividend, notwithstanding that it has earned AII in the year, because the LRIP addition under variable D does not take place until the following taxation year. This, however, may be of only limited practical benefit since a non-eligible dividend would need to be paid in the following taxation year to recover a NERDTOH balance.

26 Defined under subsection 89(1).

27 Subparagraph 129(4)(a)(ii).

28 Subject to the payment of the eligible dividend being considered an "excessive eligible dividend designation" under paragraph 89(1)(c). This would be the case if it was reasonable to consider that the eligible dividend was paid in a transaction or as part of a series of transactions, one of the main purposes of which was to artificially maintain or increase the corporation's GRIP, or to artificially maintain or decrease the corporation's LRIP.

29 Canada, Department of Finance, supra note 4, at 74 (emphasis added). "Designated property" should not be relevant in most cases. This term is defined to mean (a) any property of a private corporation that last became a private corporation before November 13, 1981 and that was acquired by the corporation before November 13, 1981 or after November 12, 1981 pursuant to an agreement in writing entered into before that date; (b) property that was acquired from another private corporation that was not dealing at arm's length where the property was designated property of the other private corporation; (c) a share acquired by a private corporation to which section 51, subsection 85(1), or section 85.1, 86, or 87 applied in exchange for another share that was a designated property; or (d) replacement property (within the meaning under section 44) for a designated property.

30 As per the coming-into-force provision introducing the definition of a substantive CCPC.

31 Canada, Department of Finance, supra note 7, at 134.

32 Subsection 249(3.1).

33 We are aware of a number of cases that are in various stages of appeal at the Tax Court of Canada.

34 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax Act and Other Legislation* (Ottawa: Department of Finance, February 2022).

35 Canada, Department of Finance, *Explanatory Notes of the Legislative Proposals Relating to Income Tax Act and Other Legislation* (Ottawa: Department of Finance, February 2022), at 65-67.

36 For example, additional disclosures for controlled foreign affiliates required under the revised T1134 forms.

37 Reportable transactions must be reported to the CRA within 45 days of the earlier of the day the taxpayer becomes contractually obligated to enter into the transaction and the day the taxpayer enters into the transaction. A penalty of $500 per week will be imposed for each failure to report a notifiable transaction, up to the greater of $25,000 and 25 percent of the tax benefit; or, for corporations that have assets with a total carrying value of $50 million or more, $2,000 per week up to the greater of $100,000 and 25 percent of the tax benefit. Separate adviser and promoter penalties also exist equal to the total of 100 percent of fees changed, $10,000, and $1,000 for each day during which the failure to report continues, up to a maximum of $100,000.

38 See Angelo Nikolakakis, "Purpose," in *Report of Proceedings of the Seventy -First Tax Conference*, 2019 Conference Report (Toronto: Canadian Tax Foundation, 2019), 21:1-33.

39 For a more extensive discussion of a "specified investment business," see Andrew Plant, "A Review of Specified Investment Business Rules and the Taxation of Canadian Corporate Investment

Income," in *2019 Atlantic Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2019), 3B:1-26.

40 A "personal services business" is generally defined under subsection 125(7) as a business carried on by a corporation in a taxation year of providing services where "(a) an individual who performs services on behalf of the corporation (. . . the 'incorporated employee'), or (b) any person related to the incorporated employee is a specified shareholder of the corporation and the incorporated employee would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation." This definition is subject to two exceptions: where a corporation employs more than five full-time employees in the business throughout the year, and where the amount paid or payable to the corporation for services is received from a corporation with which it is "associated" in the year.

41 Subsection 91(4) has a lookback period of five taxation years so that foreign income or profits tax paid after the year of the FAPI income can be claimed. The amount of foreign income or profits tax relevant for this purpose is governed by the definition of "foreign accrual tax" in subsection 95(1).

42 See "relevant tax factor" as defined in subsection 95(1).

43 With 1.9 as the multiplication factor, to get to a 100 percent shelter for the foreign income, a foreign tax rate of 52.63 percent is needed because $52.63\% \times 1.9 = 100\%$.

44 See "foreign accrual tax" as defined in subsection 95(1).

45 The CRA confirms its view that FAPI should be included in AII in CRA document no. 2000-0037805, October 6, 2000. However, we note that paragraph (a) of the definition of "income" in subsection 129(4) states that income shall include "the income or loss from a specified investment business carried on by it in Canada other than income or loss from a source outside Canada." Therefore, should the facts and circumstances of the situation show that Canco's income in respect of its shares of USco is part of its specified investment business (as defined in subsection 125(7)), it *might* be possible to carve out the FAPI from inclusion in AII.

46 The United States considers a dividend to be fixed, determinable, annual, and periodic (FDAP) income. Internal Revenue Code of 1986, as amended, section 871, imposes tax of 30 percent on a non-resident alien who receives such amount. Article X(2) of the Canada-US tax treaty limits the United States' ability to tax this dividend to 5 percent where a 10 percent ownership threshold is met. Article XXIX A contains the limitation-on-benefit provisions of the treaty, which prevent entitlement to the benefits of the treaty in certain circumstances, such as where the Canadian company claiming treaty benefits is not owned ultimately by natural persons resident in Canada or other qualifying persons. Detailed discussion of the limitation-on-benefit provisions of the treaty is beyond the scope of this paper. For the Canada-US tax treaty, see the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US tax treaty").

47 Clause (ii) of variable A in the definition of "taxable surplus" in regulation 5907(1).

48 Subparagraph (b)(ii) of the definition of "taxable earnings" in regulation 5907(1).

49 Paragraph (b) of the definition of "net earnings" in regulation 5907(1).

50 Regulation 5901(2)(a) permits a dividend paid more than 90 days after the commencement of a year to have been paid out of the surplus pools that would otherwise be available if the dividend had been paid immediately after the end of that year.

51 The multiplication factor in paragraph 113(1)(b) is the amount by which RTF exceeds 1. Since the RTF under the existing rule is 4, the multiplication factor in paragraph 113(1)(b) would have been 3.

52 Clause (ii) of variable A in the definition of UFT in regulation 5907(1).

53 "Integration" has long been an overarching design objective of the Canadian income tax system. According to David Phillip Jones, "Corporations, Double Taxation and the Theory of Integration" (1979) 27:4 *Canadian Tax Journal* 405-27, integration means that the total tax paid by a corporation and its shareholders should equal the amount that would have been paid by the individual shareholders themselves had they carried on the economic activity themselves directly, and not through the intermediary of a corporation. In contrast, underintegration occurs when the total income tax burden is higher because the income has been earned through a corporate intermediary. Overintegration occurs when the total tax burden is lower by virtue of the income having been earned through a corporate intermediary.

54 Canada, Department of Finance, supra note 7, at 126-27.

55 Ibid., at 128.

56 "Deposit insurance corporation" is defined in subsection 137.1(5).

57 Canada, Department of Finance, supra note 4, at 72.

58 Ibid.

59 Ibid.

60 Ibid.

61 The definition of "excluded property" is contained in subsection 95(1).

62 Variable B of the definition of FAPI in subsection 95(1).

63 Clause (ii) of variable A and clause (iv) of variable B in the definition of "hybrid surplus" in regulation 5907(1).

64 Regulations 5900(1)(a.1) and 5901(1)(a.1) prescribe what portion of a dividend received from an FA is paid out of the FA's hybrid surplus.

65 See regulation 5900(1)(c.1), and the definitions of "hybrid underlying tax applicable" and "hybrid underlying tax" in regulation 5907(1).

66 The Department of Finance technical notes released on October 24, 2012 relating to paragraph 113(1)(a.1) contain a numeric example of its application.

67 Variable B of the definition of FAPI in subsection 95(1) includes income from capital gains on the disposition of non-excluded property or on dispositions subject to various foreign reorganization provisions. Paragraph 95(2)(f) requires that an FA compute capital gains as if it is a resident of Canada. Since 50 percent of capital gains are non-taxable under Canadian tax rules, only 50 percent of capital gains are includible in FAPI.

68 Paragraph (a) of the definition of "exempt earnings" in regulation 5907(1), generally speaking, adds to exempt earnings the non-taxable portion of the FAPI capital gain less the portion of foreign income tax paid that can reasonably be regarded as tax in respect of this non-taxable portion. Exempt earnings are then included in "exempt surplus" per its definition in regulation 5907(1).

69 Prior to the release of the draft legislative amendment, one of the authors and Henry Shew proposed such a CDA mechanism: see Henry Shew and Kenneth Keung, "Opportunity To Address Integration of FAPI Gains in Light of Budget 2022" (2022) 22:3 *Tax for the Owner-Manager* 1-3.

70 Subparagraph (a)(i) of the definition of "foreign accrual tax" in subsection 91(4) and the definition of "foreign accrual tax" in subsection 95(1).

71 Supra note 49.

72 See "exempt earnings," supra note 68.

73 Subparagraph 113(1)(b)(i) and the definitions of "underlying foreign tax" and "underlying foreign tax applicable" in regulation 5907(1).

74 CRA document nos. 5-1511, August 5, 1986, and 1991-231, September 1991.

75 Paragraph (d) of the definition of "exempt earnings" in regulation 5907(1).

76 CRA document no. 9619090, June 14, 1996; recently confirmed by the CRA in document no. 2022-0929501C6, May 17, 2022.

77 The leading case that decided that a company resides where its "central management and control" is actually exercised is the UK House of Lords case *De Beers Consolidated Mines*, supra note 19.

78 The definition of "taxable earnings" in regulation 5907(1) includes the FA's "net earnings" from active business carried on by it in a country, unless the amount has been included in exempt earnings. Paragraph (a) of the definition of "net earnings" in regulation 5907(1) defines these to be the FA's earnings from that active business carried on in that country minus any foreign tax paid thereon.

79 "Non-qualifying business" in variable A of the FAPI definition in subsection 95(1). "Non-qualifying business" and "non-qualifying country" are defined in subsection 95(1). See Organisation for Economic Co-operation and Development, "Jurisdictions Participating in the Convention on Mutual Administrative Assistance in Tax Matters Status—22 March 2023," March 22, 2023 (www.oecd.org/ctp/exchange-of-tax-information/Status_of_convention.pdf). As of 2022, there are no non-qualifying countries.

80 Typically, paragraph 95(2)(a) can be relied on to recharacterize income from property as income from an active business in these situations. Also, service income should be income from an active business unless it is recharacterized as income from other than an active business by paragraph 95(2)(b).

81 Paragraph 95(2)(b), and paragraph 95(2)(a) not applying to recharacterize the income from property because the payer is not an FA.

82 Subsection 5911(6) contains the prescribed rules for the filing of a subsection 90(3) election. According to CRA document no. 2011-0427001C6, December 6, 2011, the CRA takes a "two-step" approach to determining whether a distribution by a foreign corporation is a "return of capital." The first step is to determine the characteristics of the distribution under foreign corporate law (not tax law); the second step is to compare these characteristics with those of recognized categories of distributions under Canadian common law and corporate law in order to classify the distribution under one of those categories.

83 Subclause 53(2)(b)(i)(B)(II).

84 Subsection 92(2) and paragraph 53(2)(b).

85 Paragraph 93(1.1)(b) causes subsection 93(1.11) to apply. Subsection 93(1.11) deems the corporation to have made an election under subsection 93(1), designating the "prescribed amount" in respect of the disposed share. The "prescribed amount" is defined in regulation 5902(6), which requires the amount designated in the election be the lesser of (a) the capital gain otherwise determined and (b) the amount that would reasonably be expected to have been received in respect of the share if the FA had at that time paid dividends, on all its shares, equal to its "net surplus."

86 The definition of "net surplus" in regulation 5907(1).

87 Paragraph 93(1)(b) reduces the subsection 40(3) capital gain amount by the elected amount. Paragraph 93(1)(a) deems the elected amount to have been received as a dividend from the FA, and not to have been received as proceeds of disposition.

88 Although the Act does not define "control," it is well established in the jurisprudence that it refers to "effective control" over the affairs and fortunes of the corporation. This is manifested in the corporation's governing statute, its share register, and any limitation on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company in either the constating documents of the corporation or any unanimous shareholders' agreement (USA). Generally, ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors—that is, 50 percent + 1 of the voting shares of the company—confers "control." See *Duha Printers*

(Western) Ltd. v. Canada, [1998] 1 SCR 795. This concept of "control" is also referred to as de jure, or legal, control and is distinguished from a separate, broader control concept of de facto, or factual, control that is used elsewhere in the Act.

89 Paragraph 251(1)(c): finding of non-arm's-length dealing based on question of fact. As summarized by the CRA in paragraph 1.38 of *Income Tax Folio* S1-F5-C1, "Related Persons and Dealing at Arm's Length," the courts have generally used the following criteria in determining whether parties to a transaction are not dealing at arm's length:

- whether there is a common mind that directs the bargaining for both parties to a transaction;
- whether the parties to a transaction act in concert without separate interests; and
- whether there is de facto control.

90 In *Canada v. Lehigh Cement*, 2014 FCA 103, the Federal Court of Appeal interpreted subsection 95(6) narrowly, requiring that the principal purpose test be considered only in respect of the acquisition of the shares, and not of the series of transactions.

91 *Deans Knight Income Corp. v. Canada*, 2023 SCC 16.

92 In *Snook v. London & West Riding Investments Ltd.*, [1967] 2 QB 786 (CA), at 802, the English Court of Appeal described a sham as "acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create."

93 Paragraph 212(13.1)(b).

94 *Income Tax Technical News* no. 38, September 22, 2008.

95 In determining whether a business is a separate business, the CRA considers whether there is an interconnection, interlacing, or interdependence between the operations: *Interpretation Bulletin* IT-206R (Archived), "Separate Businesses," October 29, 1979.

96 The definition of "investment property" in subsection 95(1).

97 CRA document no. 2022-0929501C6, May 17, 2022 (emphasis added).