

# In Print

## British Columbia's Tax Refund Regime: International Financial Activities

by Lincoln Schreiner

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By providing a refund of provincial income tax paid in respect of qualifying activities carried out in British Columbia, the province's international financial activity (IFA) regime enables corporations to shift pre-tax income from higher rate jurisdictions to its more moderate system. This article discusses ways in which non-financial corporations use the IFA regime to reduce effective income tax and improve cash flow.

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## INTERNATIONAL TAX PLANNING

Co-Editors: Lincoln Schreiner\* and Michael Maikawa\*\*

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### BRITISH COLUMBIA'S TAX REFUND REGIME: INTERNATIONAL FINANCIAL ACTIVITIES

*Lincoln Schreiner\*\*\**

Global tax planning includes shifting pre-tax income from a high tax rate jurisdiction to a lower tax rate jurisdiction. In British Columbia, a Canadian corporation can apply for a refund of BC corporate income tax paid on the profit associated with prescribed international financial activities. Registration for the BC regime is simple, no special business corporation licence is required, and there are no onerous restrictions on business conduct, location in the province, or the number of employees. The regime enables corporations carrying on certain types of business activity ("prescribed international financial activities") to shift pre-tax income from a high tax rate jurisdiction (country) outside Canada into British Columbia's moderate tax rate regime.

This article speaks to the more popular uses of British Columbia's international financial activity (IFA) regime by non-financial corporations, based on personal experience and interpretation letters and rulings issued by the provincial ministry that administers the regime. If commercial pressure requires that corporate international financial activities be carried on within Canada, rather than in a foreign country such as Ireland, Switzerland, or Barbados, carrying on those activities in British Columbia could produce a refund of BC corporate income tax paid on the profit associated with the prescribed activities, thereby reducing the corporation's effective income tax and increasing the free flow of cash.

**KEYWORDS:** INTERNATIONAL ■ FINANCIAL ■ CORPORATE INCOME TAXES ■ BRITISH COLUMBIA

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**INTRODUCTION**

Once in a while something hits your desk that makes you say, “Wow, look at this!” and pause to take a closer look. This article discusses one of those things—British Columbia’s international financial activity (IFA) regime.

Essentially, the IFA regime may provide a refund of BC corporate income tax paid in respect of certain qualifying activities.<sup>1</sup> The regime has been in place since September 1, 2004. It operates through a statute, the IFA Act,<sup>2</sup> regulations thereunder,<sup>3</sup>

1 As explained below, where a corporation qualifies for a refund of BC income tax paid on the profits from prescribed activities, the combined federal and provincial tax rate will approximate (or equal) the federal rate. Under proposals in the 2007 federal budget, the federal corporate tax rate will be reduced to 18.5 percent starting January 1, 2011: Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007.

2 International Financial Activity Act, SBC 2004, c. 49, effective September 1, 2004, as amended (herein referred to as “the IFA Act”).

3 International Financial Activity Regulations, BC Reg. 327/2004, OC 704/2004, deposited July 8, 2004, effective September 1, 2004, as amended (herein referred to as “the IFA Regulations”).

and administrative positions<sup>4</sup> issued by the provincial ministry responsible for administering the regime.<sup>5</sup> The genesis and history of this incentive tax legislation has been covered admirably in a Canadian Tax Foundation conference paper.<sup>6</sup>

The original IFA regime was changed to permit a corporation of a non-financial nature to register. As well, the list of qualifying activities was expanded to accommodate greater use of the regime by non-financial corporations. These changes spawned greater interest in the IFA regime.

Quebec also has a regime that provides for exemption from provincial income tax on certain qualifying activities.<sup>7</sup> To date, no other province has introduced a similar type of regime.<sup>8</sup>

The financial benefit of the IFA regime can be illustrated by a simple example. Imagine a Canadian corporation that earns business profit *entirely* from prescribed international financial activities (discussed below) that are *entirely* carried on by employees working in offices in British Columbia. The financial result is that the *entire* amount of BC corporate income tax paid by the Canadian corporation becomes refundable to the corporation. This gives the Canadian corporation an effective income tax rate equal to Canada's federal income tax rate. Although the (net) Canadian federal income tax rate is still much higher than the profit tax rate potentially achievable by carrying on some international financial activities in countries such as Ireland, Switzerland, and Barbados, corporate and employee issues often require those activities to be carried on within Canada.

If the international financial activities must be carried on in Canada, locating them in British Columbia allows the corporation to use the IFA regime to reduce the tax rate on consolidated accounting profits and increase the free flow of corporate cash by shifting the income associated with prescribed international financial activities

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- 4 The British Columbia Ministry of Small Business and Revenue issues three types of publicly posted documents: administrative interpretations by private letter to taxpayers requesting such guidance; advance rulings by private letter to taxpayers requesting additional comfort with respect to the application of the IFA regime to proposed events; and information bulletins. To date, two information bulletins have been issued: *Bulletin IFA 001*, "International Financial Activity Act Overview," issued December 2004, revised February 2006; and *Bulletin IFA 002*, "Life Science Patents," issued September 2005, revised April 2006 (online: <http://www.sbr.gov.bc.ca/>).
  - 5 The IFA regime is administered by the BC Ministry of Small Business and Revenue, Income Taxation Branch (herein referred to as "the provincial ministry") (online: <http://www.sbr.gov.bc.ca/>).
  - 6 Nojan Abrary, "International Financial Activity Act," in *2004 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2004), tab 8B.
  - 7 For a detailed discussion of the international financial centre legislation in Quebec, see Alain Orvoine and Michel Ostiguy, "Les Centres financiers internationaux : Où en sommes-nous?" in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 45:1-59.
  - 8 It is my understanding that at least one province has investigated whether such a regime might be worthy of adoption into provincial tax policy; however, no further developments have yet been announced.

from a high tax rate jurisdiction outside Canada into the moderate tax rate regime of British Columbia.

The 2007 BC budget indicates that the provincial government continues to support the IFA regime; it shows \$25 million budgeted annually for IFA Act refunds (to both corporations and employees) through to the budget year of March 2010.<sup>9</sup>

## MEANING OF INTERNATIONAL FINANCIAL BUSINESS

In considering the availability of the IFA regime to a Canadian corporation, the starting point is to determine whether a business being carried on by the corporation meets the statutory definition of an “international financial business” in section 1 of the IFA Act:

a *business*

- (a) that is *carried on* by a corporation
  - (i) through a fixed place of business in British Columbia, and
  - (ii) as part of an *active business* of the corporation, and
- (b) all the activities of which are international financial activities [emphasis added].

The key terms “business” and “active business” are defined by the IFA Act to have the same meaning as in subsection 248(1) of the federal Income Tax Act.<sup>10</sup> The term “carried on” is not defined by the IFA Act and presumably retains its common-law meaning.

“Active business” is the term to be most wary of, because the federal Act excludes a “specified investment business” from the active business definition. Under subsection 125(7) of the federal Act, a “specified investment business” carried on by a corporation means

a business (other than . . . a business of leasing property other than real property) the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property but . . . 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.

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9 British Columbia, Ministry of Finance, 2007 Budget, Budget and Fiscal Plan: 2007/08–2009/10, February 20, 2007 (online: <http://www.bcbudget.gov.bc.ca/>).

10 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the federal Act”), and Income Tax Regulations, CRC 1978, c. 945, as amended (herein referred to as “the federal Regulations”).

The more than five full-time employee threshold in the specified investment business definition may be problematic for some businesses. Imagine the situation where one or more particular activities being carried on within a corporation are sufficiently disconnected from the core active business that those activities might be considered a separate business for income tax purposes.<sup>11</sup> If a separate business exists and the principal purpose of the business is to derive income from property (such as interest and royalties), there must be more than five full-time employees who are actively involved in that separate business in order to avoid the application of the specified investment business definition.<sup>12</sup> By definition, an international financial business for purposes of the IFA Act cannot be a specified investment business.

Practically speaking, a separation of businesses happens in one of two ways: the commercial facts and circumstances of the businesses suggest such a conclusion, or the particular activities are commercially isolated (separated) from the core business by transfer into a partnership or another corporation.

The provincial ministry is reviewing its current policy on the concept of an active business in relation to the federal five full-time employee threshold test. The provincial ministry has issued a consultation paper requesting public input as to whether the federal meaning of active business (and the associated employee threshold test) should dominate, and what are the commercial impediments under the federal meaning of active business for corporations seeking to access the financial benefits provided by the IFA Act.<sup>13</sup>

An international financial business can be carried on in partnership form, and a corporation that is a member of a partnership may ask for the provincial tax refund benefit provided by the IFA Act.<sup>14</sup>

## MEANING OF INTERNATIONAL FINANCIAL ACTIVITIES

The next step in considering whether the IFA Act may apply to a business carried on by a Canadian corporation is to determine whether the activities of that business fall within the definition of “international financial activities” in section 2(2) of the Act. The appendix to this article lists all the activities included in the definition. There are two terms to be wary of in this list: “person,” which is defined to include a partnership, and “non-resident person,” which is defined to exclude a partnership unless all the partners are non-resident persons.<sup>15</sup>

11 *Interpretation Bulletin* IT-206R, “Separate Businesses,” October 29, 1979, paragraphs 2 and 3.

12 *Interpretation Bulletin* IT-73R6, “The Small Business Deduction,” March 25, 2002, paragraphs 10-16.

13 British Columbia, Ministry of Small Business and Revenue, “Consultation Paper: International Financial Activity Act,” September 2006 (online: <http://www.sbr.gov.bc.ca/itb/ifa/ifa.htm>). At the time of writing this article, the provincial ministry has not released any findings or modifications in policy in respect of this consultation paper.

14 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 2005-0008, January 6, 2006.

15 IFA Act, section 1, definition of “person,” and section 2(1), definition of “non-resident person.”

A single corporation can carry on as many prescribed international financial activities as it likes. It is not required to carry on each activity as a distinct business. However, in purely financial terms, prescribed international financial activities of a patent nature (discussed in more detail below) probably should not be carried on within the same corporation as other prescribed activities. This is because the IFA Act allows a Canadian corporation to claim a refund for BC corporate income tax paid in respect of either activities of a patent nature or activities of a non-patent nature, but it cannot claim a refund for BC corporate income tax paid in respect of both types of activities. So it may make financial sense to carry on those activities through separate corporations.

A corporation is not required to carry on the prescribed international financial activities in any particular location in British Columbia in order to qualify for a provincial refund, nor is it required to employ a minimum number of employees dedicated to the conduct of the international financial business.

## **CALCULATION OF THE REFUND**

A corporation registered under the IFA regime is entitled to apply for a refund of BC corporate tax paid in respect of the taxation year on income from international financial activities, calculated from the date of registration issued by the provincial ministry. If a registration date is issued during a taxation year, the income amounts earned by the corporation must be prorated. A corporation may submit the refund application once it has received the federal notice of assessment showing the amount of taxable income reported and applicable BC income tax paid. The refund application must be filed within 18 months after the end of the taxation year, unless the provincial ministry has granted permission to file later.<sup>16</sup>

The BC tax recoverable is the amount paid net of applicable provincial tax credits. Two refund calculations are required, if applicable: one for prescribed international financial activities of a patent nature, and another for all other prescribed activities.

## **ACTIVITIES OF A PATENT NATURE**

The prescribed activities of a patent nature are listed in sections 2(2)(q.1) and (q.2) of the IFA Act (reproduced in the appendix and discussed below). Generally speaking, the amount of tax that may be recovered by a corporation is 75 percent of the BC income tax paid by the corporation for the taxation year, multiplied by a fraction where

- the numerator is the aggregate amount of incomes (determined by part I, division B, subdivision b of the federal Act) from prescribed international financial activity sources of a patent nature; and
- the denominator is the total income of the corporation (determined by section 3 of the federal Act).

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16 IFA Act, sections 24(1) and 28(4).

The amount of the refund in respect of prescribed activities of a patent nature, either alone or in combination with each other, is limited to a maximum of \$8 million for any particular year.<sup>17</sup> The annual refund maximum must be shared among associated corporations as defined under the federal Act.

### **ALL OTHER ACTIVITIES**

For prescribed international financial activities of a non-patent nature, the 75 per cent reduction factor does not come into play, and the numerator of the multiplier is restricted to income from prescribed international financial activity sources of a non-patent nature. No annual refund maximum is imposed on any particular corporation under this calculation.

### **TRANSFER PRICING**

The IFA Act does not preclude a tax refund for transactions with non-arm's-length persons and related persons. A corporation can become eligible for the provincial tax refund even if the profit earned by an international financial business is entirely generated from transactions with Canadian and non-resident corporations within the same control group of companies. Transactions with non-arm's-length parties must use fair market value pricing.<sup>18</sup> Documentation prepared in compliance with subsection 247(4) of the federal Act is acceptable for the IFA Act.<sup>19</sup>

### **SOME POSSIBLE SCENARIOS UNDER THE IFA REGIME**

This section presents some examples of commercial scenarios of particular interest to Canadian corporations not otherwise within a regulated financial industry (such as banking, securities trading, and insurance). These examples are derived from personal experience and from technical interpretations and advance rulings issued by the provincial ministry.<sup>20</sup> They focus on intragroup activities involving transactions with related non-resident persons, which are permitted under the IFA Act. Other scenarios are possible, and those presented here are greatly simplified.<sup>21</sup>

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17 The refund for patent-type international financial activities only applies for the number of days in the taxation year after 2005 that the corporation was registered under the IFA Act.

18 IFA Act, section 20.

19 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 2005-0007, December 8, 2005.

20 The technical interpretations and advance tax rulings were obtained under the BC Freedom of Information and Protection of Privacy Act, RSBC 1996, c. 165, as amended. However, all of these documents are now posted online: see *supra* note 4.

21 Notably, the scenarios presented here ignore the many nuances of commercial law, financial accounting, and Canadian transaction taxes (federal goods and services tax and provincial sales taxes) that must be considered in a real situation. In addition, consideration must be given to (1) whether the particular international financial activity is part of an existing core active business

## FACTORING WITHIN A CONTROL GROUP

Factoring (dealing in trade receivables) where the payer is a non-resident person may appeal to a Canadian company. The definition of an international financial activity in section 2(2) of the IFA Act includes

- (o) collecting trade accounts that
  - (i) are receivable from a non-resident person, and
  - (ii) have been bought outright from the seller and without recourse to the seller.

Imagine a Canadian corporation with an office in British Columbia that purchases, from its Canadian and foreign subsidiaries, trade debt accounts receivable without recourse at a discount from their face amount, and then collects the full face amount from customers. This factoring activity generates a profit to the extent that the amount collected exceeds the amount paid out to purchase the book of trade receivables. The IFA Act requires that a Canadian corporation engaged in factoring assume all credit risk and foreign exchange risk from the seller of the trade receivables. Trade accounts receivable from any non-resident person are eligible; that is, the debtor may be related to the Canadian factoring company. The seller of the trade receivables also may be a Canadian or a non-resident person, and may be related to the Canadian company. If the accounts receivable included in the factoring activity are payable by both non-resident and Canadian-resident persons, the profit earned from the entire factoring activity must be allocated in a reasonable manner for purposes of determining the amount of BC corporate tax that may be recovered.

The provincial ministry's administrative positions in respect of a factoring business activity include the following:

- Where active business income includes a non-arm's-length factoring arrangement, documentation is required confirming that the transaction was undertaken on terms comparable to arm's-length transactions carried out on a regular and ongoing basis.<sup>22</sup>
- Gains and losses on foreign-currency contracts may be included as profit or loss from an international financial business if foreign-currency trade receivables are hedged with forward foreign-currency contracts.<sup>23</sup>

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or might itself be a separate business, (2) the allocation of taxable income among provinces, and (3) any foreign taxes applicable to the transactions that might become payable when income on transactions is shifted from a foreign non-resident person to a Canadian corporation.

- 22 British Columbia, Ministry of Small Business and Revenue, ruling IFA 2005-0006, July 4, 2005. This document confirms that the provincial ministry has adopted the Canada Revenue Agency's administrative position (CRA document no. 2001-0063925, March 26, 2001) that, although the determination is a question of fact, a factoring business using fewer than six full-time employees can be considered an active business and not be tainted by the specified investment business definition.
- 23 British Columbia, Ministry of Small Business and Revenue, ruling IFA 2005-0004 (revised), June 27, 2005.

- The expression “without recourse” means that the purchaser of the factored trade receivable assumes the financial risk of insolvency and non-payment of the receivable, with appropriate latitude made for the common industry practice of not assuming risk for defective products and incorrect invoicing.<sup>24</sup>

### **TREASURY AND ADMINISTRATIVE SUPPORT WITHIN A CONTROL GROUP**

The following prescribed international financial activities are potentially of interest to a Canadian corporation that has a global treasury group located in Canada:

- (b) making deposits in any currency
  - (i) with a non-resident person . . .
- (c) making loans in any currency
  - (i) to a non-resident person . . .
- (d) borrowing in any currency
  - (i) from a non-resident person . . .
- (e) guaranteeing the payment of a debt if all of the debtors or creditors are non-resident persons . . .
- (r) providing, to a non-resident person, administrative support services, other than prescribed administrative support services [call centres, marketing, advertising], that are directly related to a *financial* activity of the non-resident person . . .
- (t) any other prescribed financial activity that is conducted *exclusively for* non-resident persons and from which the corporation earns fee or commission income.<sup>25</sup>

Consider a treasury group associated with a Canadian head office that is responsible for

- investing excess cash during the positive cash flow cycles of the business;
- making short-term loans (with interest) to foreign subsidiaries of the Canadian parent company to fund periodic negative working capital situations;
- guaranteeing the payment of lending facilities provided by a foreign banking syndicate to foreign subsidiaries of the Canadian parent company to fund long-term capital expansion needs; and
- collecting trade receivables on behalf of foreign subsidiaries.

Nearly all of the prescribed activities listed above are functions commonly carried on by a Canadian treasury group; the exceptions are those in paragraphs (r) and (t).

The prescribed activities in paragraphs (r) and (t) have potential application for a treasury group engaged in the collection of trade accounts receivable for foreign subsidiaries of the Canadian corporation. Operational benefits that flow from a

24 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 2005-0001, April 6, 2005.

25 IFA Act, section 2(2) (emphasis added).

consolidation of global trade receivable collection functions (paragraph (r)) in one BC location are a reduced number of global employees resulting in reduced payroll costs, and greater ability by the Canadian treasury group to manage the periodic global cash-sweep (for external banking facility needs) and currency risk. The global tax benefit flows from the shifting of a “sliver of profit” from a potentially high tax rate country where the foreign subsidiary carries on its business (and creates the trade accounts receivable) into a Canadian corporation with a (net) profit tax rate equal to the Canadian federal income tax rate. The “sliver of profit” shifted might be slightly increased by administrative support services in relation to the collection of the trade receivables of foreign subsidiaries under paragraph (r). Because the provincial ministry interprets the meaning of “financial” as “[requiring] a relationship to the management of money and other assets of a business system, including the acquisition and allocation of those resources,”<sup>26</sup> an accounting service can be an administrative support service under paragraph (r) when it directly supports a financial activity such as the collection of trade accounts receivable for foreign subsidiaries.

The provincial ministry appears to apply the ordinary meaning of terms such as “making deposits” and “making loans.” This may create some practical difficulty for a treasury group in respect of the types of near-money investments that it uses to invest excess cash on hand. For example, the economic profit that a BC-based treasury group of a Canadian corporation makes by investing temporary cash on hand in a portfolio of US federal treasury bills might not satisfy the ordinary meaning of making a deposit or making a loan. This seems harsh compared to the treatment of a BC-based treasury group that lends excess cash to (or places excess cash on deposit with) a wholly owned non-resident subsidiary corporation, which in turn uses the borrowed cash (or deposited cash) to purchase the same portfolio of US treasury bills and then uses the profit made on the investment to pay interest on the loan (or deposit) owing to the Canadian treasury group. In this example, the interest income flowing to the BC treasury group on the loan (or deposit) made with the non-resident subsidiary corporation would clearly be an international financial activity as a loan to (or a deposit made with) a non-resident person.

If it is a tax policy goal of the BC government to have treasury staff situated in the province, the difficulty with investing excess cash in near-money investments such as treasury bills and banker’s acceptances needs to be resolved. This matter has been brought to the attention of the provincial ministry for its consideration.

In the case of a Canadian company guaranteeing debt of a non-resident person (say, a foreign subsidiary of the Canadian corporation), the provincial ministry has confirmed that either all the debtors must be non-resident persons or all the creditors must be non-resident persons, but it is not necessary that all debtors and all

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26 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 2006-0001, March 7, 2006.

creditors be non-resident persons.<sup>27</sup> A practical difficulty may exist with a syndicated loan scenario for a foreign subsidiary with multiple lenders. Even if there is a single nominal Canadian lender as part of the lending syndicate, the whole amount of the guarantee will not qualify as an international financial activity; that is, no allocation is possible. In such a case, the guaranteeing activity should still remain a prescribed international financial activity provided that the borrower (debtor) of the lending syndicate is a non-resident person, such as a foreign subsidiary of a Canadian corporation.

## INVESTMENT MANAGEMENT

The following prescribed international financial activities are of potential interest to a Canadian corporation providing investment fund management, financial advice, and financial information:

(g) acting . . .

(ii) if the corporation is not a securities corporation, as principal in making or offering to make with a non-resident person an agreement for acquiring or disposing of securities [other than securities of the Canadian corporation or a person affiliated with the Canadian corporation] for a prescribed purpose [managing a financial risk of a non-resident person other than a financial risk with respect to the change in value of a commodity] . . .

(i) providing financial advice, other than prescribed financial advice [legal, accounting, and tax advice by a corporation in the business of providing such advice], to non-resident persons; . . .

(k) managing, for a fee or commission, foreign exchange activities for non-resident persons;

(l) managing, for a fee or commission, investments for non-resident persons;

(m) managing, for a fee or commission and for persons resident in Canada, investments in securities that are issued by a non-resident person and that are not listed with a stock exchange prescribed in section 3200 of the Income Tax Regulations (Canada);

(n) preparing stock market or other financial research, other than prescribed financial research [legal, accounting, and tax research by a corporation in the business of providing such research], *for the exclusive use* of non-resident persons.<sup>28</sup>

This grouping of prescribed international financial activities presents many scenarios for consideration. Generally, the primary condition is that financial services and research must be provided to, and for use by, a non-resident person, and in some cases for the exclusive use of non-resident persons. Paragraph (m) is an exception: this activity is focused on fees earned from a Canadian person (say, a Canadian mutual

<sup>27</sup> Supra note 19.

<sup>28</sup> IFA Act, section 2(2) (emphasis added). The reference to a prescribed stock exchange in paragraph (m) is currently limited to three Canadian exchanges: the TSX Venture Exchange, the Montreal Stock Exchange, and the Toronto Stock Exchange: see regulation 3200 of the federal Regulations.

fund trust) on the condition that the investments owned by the Canadian person are issued by non-resident persons and are not listed on a prescribed Canadian stock exchange. This is unusual, because the payer is a Canadian person, but the subject matter does remain of a foreign nature. In addition, the provincial ministry says that the term “financial advice” used in paragraph (i) implies that a recommendation or an opinion is offered regarding a course of action.<sup>29</sup> If a recommendation or an opinion is not offered as part of the financial service, it may still qualify as financial research under paragraph (n).

Generally, an investment management business that includes both prescribed and non-prescribed activities must allocate profit earned by the whole business in a reasonable manner, because only the prescribed activities can produce a potential refund of BC tax.<sup>30</sup> As noted above, the definition of “non-resident person” in the IFA Act includes a partnership provided that all of the members of the partnership are non-resident persons. This definition raises practical difficulties, as in the case of a Canadian corporation that provides investment advice to a foreign investment fund organized as a partnership under foreign commercial law. The Canadian investment adviser needs to know if any member of that partnership is a Canadian-resident person. If a Canadian-resident partner exists, even if holding a nominal partnership interest, none of the income earned by the Canadian corporation from that particular foreign partnership can be included as income from a prescribed international financial activity. A submission has been made to the BC government requesting a review of the tax policy that leads to this result. The better approach is to prorate, on a reasonable basis, the income associated with prescribed international financial activities and non-prescribed activities provided to the foreign partnership—perhaps, for example, on the basis of the annual profit allocation of the partnership among the members for each fiscal year of the partnership.

## LICENSING OF PATENTS

The following prescribed international financial activities are of potential interest to a Canadian corporation with a business involving life science patents:<sup>31</sup>

(q.1) selling, assigning or licensing to a non-resident person a patent within a prescribed class of patents;

(q.2) selling, to a non-resident person, a good or service in respect of which the sales revenue is principally derived from an invention for which a patent within a prescribed class of patents is owned by the corporation.<sup>32</sup>

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29 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 2006-0001, March 7, 2006.

30 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 001, November 9, 2004.

31 For a good overview of the prescribed class of life science patents, see *Bulletin IFA* 002, supra note 4.

32 IFA Act, section 2(2).

In the opinion of the provincial ministry, with respect to paragraph (q.1), only direct licensing of the patent will qualify as an international financial activity, and the licensing of distribution rights will not fulfill the requirement.<sup>33</sup> Also, with respect to paragraph (q.2), the Canadian corporation must own at least one qualifying patent that is used to produce the invention, and licensing a patent used to produce the invention will not fulfill the ownership requirement.<sup>34</sup>

These prescribed international financial activities probably have the greatest interest for Canadian companies in the life sciences sector that have achieved a level of success in their Canadian business that makes it fiscally expensive<sup>35</sup> to shift ownership of Canadian-developed patents to a foreign subsidiary corporation for exploitation in the global marketplace.

## **OTHER PLANNING CONSIDERATIONS**

### **ELECTION TO PREVENT INCLUSION OF THE REFUND IN INCOME**

By virtue of paragraph 12(1)(x) of the federal Act, the refund of BC corporate income tax is included in income for federal income tax purposes, and therefore also for purposes of the BC and other provincial income tax regimes. However, subsection 12(2.2) of the federal Act permits a corporation to make an annual election to exclude the refund from income for federal income tax purposes by applying the refund against the amount of BC tax paid. Making this election in respect of a refund of BC corporate income tax under the IFA Act has been considered favourably by the Canada Revenue Agency (CRA).<sup>36</sup>

### **CYCLICAL BUSINESSES**

Some industries (such as oil, gas, and mining) experience cycles of profits and losses over several years (at least historically speaking). If the Canadian corporation has a loss, there is no tax benefit to be gained from the IFA regime, because no BC corporate tax is paid out. Moreover, if a corporation splits up its core active business by transferring prescribed international financial activities into a Canadian wholly owned subsidiary corporation registered under the IFA Act, federal income tax paid out by the subsidiary cannot easily be recovered in a later year when the parent corporation sustains a non-capital loss (for income tax purposes) with respect to its

33 British Columbia, Ministry of Small Business and Revenue, technical interpretation IFA 2006-0002, August 31, 2006.

34 Ibid.

35 When a Canadian corporation transfers ownership rights of a patent to a foreign subsidiary for the purpose of global market exploitation, any gain or profit made by the Canadian corporation on the transfer of the ownership rights may be subject to Canadian income tax. The federal Act does not contain a tax rollover provision for non-share property that is transferred to a foreign subsidiary corporation.

36 CRA document 2004-0086361E5, September 8, 2004.

remaining core active business. If the federal income tax paid out by the subsidiary is not easily recoverable,<sup>37</sup> the Canadian corporation potentially has less consolidated free cash flow. In such cyclical businesses, it may be appropriate to retain the prescribed international financial activities as part of the core active business.

### **DILUTION OF REFUNDABLE TAX**

When a corporation has permanent establishments both within and outside British Columbia, the taxable income of the corporation that is allocated to British Columbia is determined by the federal taxable income allocation formula in part IV of the federal Regulations. The formula allocates taxable income to a particular province on the basis of the proportion of the total gross revenue and salaries and wages associated with a permanent establishment in that province. This could lead to a reduction of the amount of BC tax recoverable.

To illustrate, assume that a corporation carries on a single active business at two locations:

1. Very profitable prescribed international financial activities are carried on at an office located in British Columbia, but these account for a small proportion of the corporation's total gross revenue and salaries and wages.
2. Breakeven operations for non-prescribed business activities are carried on at a location in Ontario, and these account for a large proportion of the total gross revenue and salaries and wages.

In such a case, under the federal allocation formula, most of the corporation's taxable income for the year will be allocated away from British Columbia, leaving little BC income tax to be paid, and therefore not much of a refund to be recovered under the IFA regime. The corporation might consider splitting up the existing active business, so that the BC location can be owned by a separate corporation that has no office outside the province. The income earned by the BC office will then be taxed entirely within British Columbia, thus making a larger tax refund possible under the IFA regime.

### **INTERPROVINCIAL SHOPPING**

Could the list of prescribed international financial activities apply to mobile business activities, prompting an inappropriate shifting of tax revenue bases from a Canadian province with a relatively high tax rate to British Columbia? This concern is addressed in two ways by the interaction of the IFA Act and the federal Act.

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<sup>37</sup> Federal tax paid out by a Canadian wholly owned subsidiary of a Canadian parent company can be recovered by using the method (approved by the CRA) of borrowing to subscribe for preferred shares and thus transferring income from the taxable corporation to the loss corporation by way of the interest expense. However, this technique is cumbersome and requires careful planning and timing to make it work well.

First, there is the statutory condition in the IFA Act that the international financial activity must be associated with an active business, in conjunction with the federal rule that excludes a business as an active business if it is caught by the federal specified investment business definition (discussed above). This means that an international financial business generally requires substance and employment in order to carry out the prescribed international financial activities. Relocating people from one province to another consumes much time and energy, and relocation of a business generally entails downsizing office space, finding new office space, and often losing staff who choose not to relocate.

Second, as discussed immediately above, the high profit margin associated with prescribed international financial activities carried on within British Columbia may result in little BC corporate income tax when most of the total gross revenue and salaries and wages of a corporation is associated with one or more permanent establishments located outside British Columbia.

### **SPECIFIED FINANCIAL INSTITUTION STATUS**

Becoming registered under the IFA Act does not by itself create any type of financial institution status, as may be the case when a licence is granted to carry on a banking, lending, or insurance business. The IFA Act registration should not trigger automatic status of the corporation as a specified financial institution under the federal Act.<sup>38</sup> However, depending on the particular international financial activities carried on by the corporation,<sup>39</sup> specified financial institution status under the federal Act could result for the particular corporation and all corporate members within the control (related) group.

### **EMPLOYEE REFUND**

Certain employees of a Canadian corporation can register under the IFA Act and apply for a refund of up to 75 percent of BC tax paid on their employment income. There is no fee for registration. A registered employee may claim a refund in respect of a taxation year, up to a maximum of five years. The employee must be a specialist in international financial activities (some activities do not qualify) and a non-resident of Canada before accepting the employment offer; and at least 70 percent of the employee's duties must be dedicated to prescribed international financial activities.

### **ACCESSING THE IFA REGIME**

To apply for the IFA regime, a corporation must exist under Canadian corporate law and have a permanent establishment in British Columbia. The corporation must be

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38 Federal Act, subsection 248(1), definition of “specified financial institution,” paragraphs (a) through (e).

39 See, for example, *ibid.*, at paragraph (e).

registered with the provincial ministry<sup>40</sup> and must be a core member of the International Financial Centre British Columbia Society (IFC BC) (discussed below).

The application to the provincial ministry should describe the proposed international financial activities to be carried on by the applicant corporation and identify the proposed office location(s) within British Columbia. It should include copies of incorporation and corporate-law filings, a business plan describing how the international financial business will be carried on, and copies of the most recent financial statements and income tax returns.

The registration date is critical since it determines the effective date of eligibility for the refund. The registration date allocated to an application is the day the provincial ministry determines that the applicant has met the registration requirements; it cannot be earlier than the day the application is submitted. A one-time fee (currently \$5,000) is charged.

### MINISTRY GUIDANCE AVAILABLE

The provincial ministry has a policy of issuing guidance to taxpayers, in a private letter format, of a technical interpretation or advance ruling nature. There is no fee for either service. The provincial ministry aims to issue such documents within 90 days after submission of a request.

Technical interpretations are not binding on the provincial ministry. Advance rulings are intended to guide the taxpayer in deciding upon a particular course of action, by providing greater certainty about how the IFA Act will be applied. It appears that rulings are available only for proposed, rather than existing, business operations.<sup>41</sup> Rulings are binding on the provincial ministry, provided that (1) the facts upon which the ruling is based are materially correct, and (2) there are no subsequent changes in applicable common law, the IFA Act, or the IFA Regulations.

### IFC BC

The IFC BC is a non-profit organization with a mandate to promote the location of international financial business in British Columbia. As noted above, corporations applying to register under the IFA regime must be core members of the IFC BC. Members pay an initial application fee (currently \$1,000), plus 0.7 percent of annual international financial profits, to an annual maximum of \$150,000.<sup>42</sup> The IFC BC Web site displays those corporations that are core members.<sup>43</sup>

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40 The application form can be downloaded from the provincial ministry Web site at <http://www.sbr.gov.bc.ca/itb/ifa/ifa.htm>.

41 This conclusion is based on British Columbia, Ministry of Small Business and Revenue, ruling IFA 2006-0001, March 7, 2006.

42 The application form for membership and other information about the IFC BC can be downloaded from its Web site at <http://www.ifcbc.com/>.

43 See the IFC BC Web site, *ibid.*, under "Core Members."

Membership in the IFC BC helps corporations to understand the full potential of accessing the refund available under the IFA Act. The IFC BC Web site provides useful commentary on refund opportunities associated with particular activities, including treasury, factoring, administrative services, life science patents, financial activities, film distribution, captive insurance, and direct finance leasing.

## **CONCLUSION**

British Columbia has broadened the IFA regime to permit non-financial institutions to register, and has expanded the listing of prescribed international financial activities to enable qualifying non-financial institutions to access the refund. Canadian corporations that are not considered to be financial institutions may already be carrying on commercial activities that fit one or more categories of prescribed international financial activities, whether in Canada or through a foreign subsidiary. If the qualifying activities can be carried on at an office location in British Columbia, some or all of the applicable BC corporate income tax may be recoverable, so that the corporation's effective income tax rate may approach (or equal) the Canadian federal income tax rate. This will result in a lower income tax rate on global profits and greater consolidated free cash flow.

I acknowledge that the net Canadian tax rate on profits will still be higher than the tax rate that might be achieved by carrying on some of the international financial activities in another country with a favourable tax regime, such as Ireland, Switzerland, or Barbados. However, commercial realities (which often come into play) might dictate that the base for prescribed international financial activities remain in Canada or that prescribed activities currently carried on in a high tax rate foreign country be moved (shifted) to Canada. In these situations, a corporation may find it advantageous to locate the prescribed activities in British Columbia so as to benefit from the reduction of tax under the IFA regime.

## APPENDIX LIST OF INTERNATIONAL FINANCIAL ACTIVITIES

The prescribed financial activities for purposes of the IFA regime are listed in section 2 of the IFA Act. This list is subject to modifications introduced by sections 2(3) through 2(5) of the IFA Act and section 4 of the IFA Regulations, which are not reproduced here.<sup>44</sup>

- (2) . . . [A]ny of the following is an international financial activity of a corporation:
- (a) accepting deposits in any currency
    - (i) from a non-resident person, or
    - (ii) in respect of a prescribed business from a person carrying on the business;
  - (b) making deposits in any currency
    - (i) with a non-resident person, or
    - (ii) in respect of a prescribed business with a person carrying on the business;
  - (c) making loans in any currency
    - (i) to a non-resident person, or
    - (ii) in respect of a prescribed business to a person carrying on the business;
  - (d) borrowing in any currency
    - (i) from a non-resident person, or
    - (ii) in respect of a prescribed business, from a person carrying on the business;
  - (e) guaranteeing the payment of a debt if all of the debtors or creditors are non-resident persons;
  - (f) if the corporation is a savings institution,
    - (i) issuing and accepting letters of credit, or
    - (ii) handling documentary collections,in respect of a transaction of which not more than one party is resident in Canada;
  - (g) acting
    - (i) if the corporation is a securities corporation,
      - (A) as principal in making or offering to make with a non-resident person an agreement for acquiring, disposing of, subscribing for or underwriting securities, or
      - (B) as agent for a person resident in Canada in making or offering to make with a non-resident person an agreement for acquiring, disposing of, subscribing for or underwriting securities, except securities that are listed on a stock exchange prescribed in section 3200 of the Income Tax Regulations (Canada),
    - (ii) if the corporation is not a securities corporation, as principal in making or offering to make with a non-resident person an agreement for acquiring or disposing of securities for a prescribed purpose, or
    - (iii) as agent for a non-resident person in making or offering to make with a person resident in Canada or another non-resident person an agreement for acquiring, disposing of, subscribing for or underwriting securities;

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44 See supra notes 2 and 3.

- (h) insuring or reinsuring prescribed risks
  - (i) of, or relating to, non-resident persons, and
  - (ii) relating to property situated or events occurring outside of Canada;
- (i) providing financial advice, other than prescribed financial advice, to non-resident persons;
- (j) dealing in foreign exchange other than on the corporation's own account, if the corporation is
  - (i) a savings institution,
  - (ii) a corporation whose primary business is dealing in foreign exchange, or
  - (iii) a prescribed corporation;
- (k) managing, for a fee or commission, foreign exchange activities for non-resident persons;
- (l) managing, for a fee or commission, investments for non-resident persons;
- (m) managing, for a fee or commission and for persons resident in Canada, investments in securities that are issued by a non-resident person and that are not listed with a stock exchange prescribed in section 3200 of the Income Tax Regulations (Canada);
- (n) preparing stock market or other financial research, other than prescribed financial research, for the exclusive use of non-resident persons;
- (o) collecting trade accounts that
  - (i) are receivable from a non-resident person, and
  - (ii) have been bought outright from the seller and without recourse to the seller;
- (p) leasing property to a non-resident person by means of a direct financing lease, as defined in the Handbook of The Canadian Institute of Chartered Accountants, as amended from time to time;
- (q) selling, assigning or licensing rights to a non-resident person
  - (i) to distribute outside of Canada a film or television production, other than a prescribed production, or
  - (ii) to exploit outside of Canada any thing related to the production;
- (q.1) selling, assigning or licensing to a non-resident person a patent within a prescribed class of patents;
- (q.2) selling, to a non-resident person, a good or service in respect of which the sales revenue is principally derived from an invention for which a patent within a prescribed class of patents is owned by the corporation;
- (r) providing, to a non-resident person, administrative support services, other than prescribed administrative support services, that are directly related to a financial activity of the non-resident person;
- (s) providing, to a non-resident person, services, equipment and premises for continuing the business operations of the non-resident person if primary equipment or premises used by the non-resident person becomes temporarily non-operational;
- (t) any other prescribed financial activity that is conducted exclusively for non-resident persons and from which the corporation earns fee or commission income.

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