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The Foreign Affiliate Fresh Start Rules

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This article discusses the policy behind the fresh start rules and reviews the proposed amendments to the rules. If the recommendations of the Advisory Panel on Canada's System of International Taxation are adopted, the characterization of income as foreign accrual property income or active business income likely will receive increased attention, prompting even greater focus on the application of the fresh start rules. Some of the issues and anomalies are highlighted, along with suggested changes to the proposed amendments.

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INTERNATIONAL TAX PLANNING

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

THE FOREIGN AFFILIATE FRESH START RULES

*Jerry Mahnger and Susan McKilligan****

This article discusses the policy behind the fresh start rules and reviews the proposed amendments to the rules. If the recommendations of the Advisory Panel on Canada's System of International Taxation are adopted, there should be a greater focus on the characterization of income as foreign accrual property income or active business income, resulting in an even greater focus on the application of the fresh start rules. The authors highlight some of the issues and anomalies contained in the proposed amendments and suggest further changes to address these matters.

KEYWORDS: FOREIGN AFFILIATES ■ INVESTMENT INCOME ■ FAPI ■ BUSINESS ■ ACTIVE ■ AMENDMENTS

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INTRODUCTION

This article reviews the fresh start rules in paragraphs 95(2)(k) through (k.6)¹ of the February 27, 2004 draft legislation (as amended).² Generally, the fresh start rules govern the tax consequences when a foreign affiliate's foreign business changes from an active business to an investment business (or a business other than an active business) or vice versa. This article comments on the background and policy behind the fresh start rules, summarizes key provisions of the draft legislation, provides examples of the application of the draft legislation, and makes some recommendations for further changes to the legislation to deal with issues raised by the amendments as currently drafted.

This article may be timely in light of the announcement in the 2009 federal budget³ that the government will consider the recommendations of the Advisory Panel on Canada's System of International Taxation⁴ ("the advisory panel") before proceeding with the remaining foreign affiliate measures announced in February 2004. If the advisory panel's recommendations are adopted, they will inevitably lead to a greater focus, in legislation and enforcement, on the characterization of income as sourced from an active business or from a passive business, and on the tax consequences of business activities (and the assets, gains, losses, and profits) that shift between the two different income sources.

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

2 Canada, Department of Finance, *Legislative Proposals and Draft Regulations Relating to Income Tax* (Ottawa: Department of Finance, February 2004). Although the fresh start rules are draft legislation, the amended provisions in paragraphs 95(2)(k) through (k.6) generally apply to taxation years of a foreign affiliate that begin after December 20, 2002 (or after 1994 if the fresh start election in section 95 has been filed). Transitional rules with respect to specific provisions defer the effective date to February 27, 2004.

3 Canada, Department of Finance, 2009 Budget, Canada's Economic Plan, January 27, 2009.

4 Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's Competitive Tax Advantage* (Ottawa: Department of Finance, December 2008).

BACKGROUND

CURRENT LEGISLATION

In 1995, the foreign affiliate rules were amended to expand the circumstances in which foreign accrual property income (FAPI) could arise in a foreign affiliate. This was achieved principally by introducing the definition of an investment business⁵ and by expanding the circumstances in which a foreign affiliate could have a business other than an active business.⁶

Paragraph 95(2)(k) was introduced at that time and applied when a foreign affiliate carried on an investment business or a business other than an active business and did not carry on that business in the preceding year. Specifically, paragraph 95(2)(k) was intended to provide a “fresh start” to a business that was brought into the FAPI regime because of the introduction of the definition of an investment business and paragraphs 95(2)(a.1) through (a.4). Among other things, the rules in paragraph 95(2)(k) ensured that income or loss accruing from carrying on the business in the first and subsequent taxation years of the foreign affiliate in which the foreign affiliate was not carrying on an active business

- excluded the income or loss accruing from carrying on the business in prior periods;⁷ and
- was calculated as if the foreign affiliate had disposed of and reacquired all of its assets at fair market value immediately before the beginning of the first taxation year.⁸

POLICY BEHIND PROPOSED AMENDMENTS

Technical issues surfaced with the fresh start regime created by paragraph 95(2)(k). The amendments in proposed paragraphs 95(2)(k) through (k.6) deal with many of these technical issues by, among other things,

- ensuring that the fresh start rules apply to a business carried on by a foreign affiliate as a member of a partnership;⁹
- expanding the application of the rules to circumstances where the income from a business carried on by the foreign affiliate is determined to be income

5 Subsection 95(1).

6 Paragraphs 95(2)(a.1) through (b).

7 Subparagraph 95(2)(k)(iii).

8 Subparagraph 95(2)(k)(v) and paragraph 138(11.91)(e). The deemed disposition of the foreign affiliate's assets would not trigger FAPI because the assets should qualify as excluded property at the time of the deemed disposition at the end of the prior taxation year. FAPI, or a foreign accrual property loss (FAPL), would be triggered on any increase (or decrease) in value between this time and a future disposition of the assets, because the “freshly started” business would not be an active business. Under the definition of FAPI in subsection 95(1), taxable capital gains realized on dispositions of excluded property are not FAPI.

9 Proposed paragraphs 95(2)(k) and (k.2).

from a business other than an active business by virtue of paragraph 95(2)(b) or income from property by virtue of paragraph 95(2)(l);¹⁰

- clarifying that the rules do not apply in the first year of operation of the particular affiliate;¹¹
- amending the provisions defining the income subject to the fresh start rules, from “computing the income of the affiliate from the investment business”¹² to “computing the operator’s income or loss from the foreign business, and . . . computing the operator’s capital gain or capital loss from the disposition of property,”¹³ so that capital gains and losses are also subject to the fresh start rules; and
- perhaps most significantly, expanding the rules to apply when a foreign affiliate carries on a business that is not an active business and in a subsequent year either the foreign affiliate ceases to carry on the business or the business becomes an active business.¹⁴

IMPLICATIONS OF ADVISORY PANEL RECOMMENDATIONS

Although the foreign affiliate fresh start regime is already relevant to Canada’s current international tax system, it may become even more important if the minister of finance adopts certain recommendations of the advisory panel, as indicated in the 2009 budget.

The advisory panel’s recommendations include adopting a full exemption system for both foreign-source active business income earned by foreign affiliates and capital gains and losses realized on the disposition of shares of a foreign affiliate when the shares derive all or substantially all of their value from active business assets.¹⁵ If these recommendations are adopted, the Canadian tax system will shift to a territorial taxation system with respect to active business income earned by a foreign affiliate, while retaining a worldwide taxation system with respect to passive income earned by a foreign affiliate. The characterization of foreign affiliate income as sourced from an active business or from a passive business will be the deciding factor in whether foreign affiliate earnings are immediately taxed in Canada as FAPI or are exempt from tax both when realized and when distributed to Canadian taxpayers.

10 Proposed clauses 95(2)(k)(iii)(B) and (C), and 95(2)(k.2)(iii)(B) and (C). Paragraph 95(2)(b) defines the circumstances in which income from services provided to or by an affiliate are deemed to be income from a separate business that gives rise to FAPI. Paragraph 95(2)(l) provides that income from property includes, subject to certain exceptions, income from a business (other than an investment business) the principal purpose of which is to derive income from the trading or dealing in indebtedness (which includes the earning of interest).

11 Proposed clause 95(2)(k)(iv)(A) and subparagraph 95(2)(k.2)(i).

12 Paragraph 95(2)(k).

13 Proposed paragraphs 95(2)(k.1) and (k.3).

14 Proposed paragraphs 95(2)(k.2) and (k.3).

15 See *supra* note 4, at 26 (recommendation 4.1) and 30 (recommendation 4.3).

Fresh start rules will be an important part of any legislation designed to implement the advisory panel's recommendations and to fairly allocate the source of earnings between active and passive businesses.

OVERVIEW OF THE PROPOSED AMENDMENTS

TRANSITION FROM ACTIVE BUSINESS TO PASSIVE BUSINESS

The fresh start rules of proposed paragraph 95(2)(k.1) (“the active fresh start rules”) provide the results that occur when a foreign affiliate of a taxpayer changes its business from an active business to a passive business, specifically an investment business, a business other than an active business, or a business the income from which is included by paragraph 95(2)(l) in computing the affiliate's income from property.¹⁶

For the active fresh start rules to apply in respect of a taxation year (“the specified taxation year”) of a foreign affiliate or of a partnership of which a foreign affiliate is a member¹⁷ (“the operator”), the following four conditions must be met:¹⁸

1. the operator carries on a business (a “foreign business”) in the specified taxation year;
2. the foreign business is not, at any time in the specified taxation year, a “taxable Canadian business”;¹⁹
3. in the specified taxation year, the foreign business is any passive business; and
4. in the taxation year of the affiliate immediately preceding the specified taxation year, the affiliate carried on the foreign business and the foreign business was not a taxable Canadian business or any passive business.

When the active fresh start rules apply in a specified taxation year of an operator, a number of events are deemed to take place in computing the operator's income or loss from the foreign business and in computing the operator's capital gain or capital loss from the disposition of property used or held in the course of carrying on the foreign business.

First, the operator is deemed to have begun carrying on the foreign business in Canada at the beginning of the specified taxation year and throughout each subsequent year in which the foreign business is carried on by the operator.²⁰ Consequently,

16 Proposed clauses 95(2)(k)(iii)(A) through (C).

17 The amendments ensure that the active fresh start rules will apply if the particular business is carried on by a partnership of which a foreign affiliate is a member; however, for purposes of this article, we will not focus on the application of the rules in these circumstances.

18 Proposed paragraph 95(2)(k).

19 Generally, a “taxable Canadian business” is defined in proposed subsection 95(1) to mean a business carried on in Canada the income from which would not be exempt from Canadian income tax as a result of a tax treaty.

20 Proposed subparagraph 95(2)(k.1)(i).

the operator will compute its income from the foreign business as if it were carrying on the foreign business in Canada.

Second, if the foreign business is a business that the operator would, if the operator were a corporation carrying on the foreign business in Canada, be required by law to report to, and be subject to the supervision of, the superintendent of financial institutions or a similar authority of a province, the operator is deemed to be subject to such conditions.²¹ This deeming rule is intended to permit the operator to claim certain insurance reserves.

Third, the active fresh start rules provide that, with certain modifications, paragraphs 138(11.91)(c) through (e) (“the restart provisions”) apply to the operator for the specified taxation year in respect of the foreign business.²² Generally, the restart provisions apply when a non-resident insurer commences carrying on business in Canada, so as to ensure the proper measurement and characterization of income or loss. In the context of the fresh start rules, the provisions are modified and apply to the operator whether or not the operator is in the insurance business. The consequences where the restart provisions apply are as follows:

- The operator is deemed to have a taxation year-end immediately before the specified taxation year.²³
- The operator is deemed to have carried on the business in Canada in the year prior to the specified taxation year and to have claimed the maximum amount of certain reserves in that year.²⁴ As a result, such reserves are included in determining the operator’s income from the foreign business for the specified taxation year.
- The operator is deemed to have carried on the business in Canada in the year prior to the specified taxation year and to have included in computing its income for that year amounts that would have been prescribed in respect of the operator for the purposes of paragraphs 138(4)(b) and 12(1)(e.1) with respect to insurance policies of the foreign business.²⁵ This provision applies to an operator that carries on an insurance business, and it allows the operator to claim a deduction for such amounts in the specified taxation year.²⁶

21 Moreover, if the operator is a life insurer and the foreign business is a life insurance business, the life insurance policies issued are deemed to be life insurance policies in Canada: proposed subparagraph 95(2)(k.1)(ii).

22 Proposed subparagraph 95(2)(k.1)(iii).

23 Paragraph 138(11.91)(c).

24 Specifically, paragraph 138(11.91)(d) treats the operator as having maximized its reserves for the preceding taxation year under paragraphs 20(1)(l) and (l.1) and 20(7)(c), and subparagraphs 138(3)(a)(i), (ii), and (iv).

25 Paragraph 138(11.91)(d.1).

26 The deductions would be claimed pursuant to subsection 20(22) and subparagraph 138(3)(a)(ii.1).

- The operator is deemed to have disposed, immediately before the beginning of the specified taxation year, of each property that is used or held by it in the specified taxation year in the course of carrying on the foreign business. The proceeds of disposition are deemed to be equal to the fair market value of the property at that time, and the property is deemed to have been reacquired at the beginning of the specified taxation year at a cost equal to the proceeds of disposition.²⁷

Finally, the active fresh start rules provide for a deferral of recognition of any income, gains, or losses (“the deferred amount”) arising on a deemed disposition of a particular property (a “particular disposition”) as a result of applying the restart provisions. The deferred amount is included in computing the foreign affiliate’s income, gain, or loss only for its tax year in which the property is later disposed of in a transaction other than the particular disposition.²⁸ The portion of income taxes paid by the foreign affiliate that may reasonably be considered to relate to the deferred amount is not to be included in determining income taxes paid in respect of any other income, gain, or loss of the affiliate.²⁹ Accordingly, income taxes paid in respect of the deferred amount would not be included in computing the foreign affiliate’s “foreign accrual tax” (FAT).³⁰

TRANSITION FROM PASSIVE BUSINESS TO ACTIVE BUSINESS/CESSATION OF BUSINESS

The fresh start rules of proposed paragraph 95(2)(k.3) (“the passive fresh start rules”) apply when a foreign affiliate changes its business from a passive business (as described above in the context of the active fresh start rules) to an active business or ceases to carry on its passive business. Similar to the active fresh start rules, the passive fresh start rules apply in a taxation year (“the specified taxation year”) of a foreign affiliate or of a partnership of which a foreign affiliate is a member³¹ (“the operator”) if the following four conditions are met:³²

1. the operator carries on a business (a “foreign business”) in the taxation year prior to the specified taxation year (“the preceding taxation year”);
2. the foreign business was not, at any time in the preceding taxation year, a “taxable Canadian business”;

27 Paragraph 138(11.91)(e).

28 Proposed clause 95(2)(k.1)(iv)(A).

29 Proposed clause 95(2)(k.1)(iv)(B).

30 Defined in subsection 95(1).

31 As in the case of the active fresh start rules, the passive fresh start rules apply if the particular business is carried on by a partnership of which a foreign affiliate is a member. Again, for purposes of this article, we will not focus on the application of the rules in these circumstances.

32 Proposed paragraph 95(2)(k.2).

3. in the preceding taxation year, the foreign business was any passive business; and
4. either
 - a. at any time in the specified taxation year, the operator carries on the foreign business and the foreign business is an active business that is not taxable in Canada or all or substantially all of the fair market value of the property of the operator used or held by it in the course of carrying on the foreign business is attributable to excluded property; or
 - b. the operator does not carry on the foreign business at any time in the specified taxation year.

If the passive fresh start rules apply in a specified taxation year of an operator, a number of events are deemed to have taken place in computing the operator's income or loss from the foreign business and in computing the operator's capital gain or capital loss from the disposition of property used or held in the course of carrying on the foreign business.

First, the operator is deemed to have ceased to carry on the foreign business in Canada at the beginning of the specified taxation year.³³ Accordingly, for that year and subsequent taxation years, the operator should not compute its income from the foreign business as if it were carrying on the foreign business in Canada. Regulation 5907 will apply in determining the active business earnings of the operator.

Second, the passive fresh start rules provide that, with certain modifications, the restart provisions (paragraphs 138(11.91)(c) through (e)) apply to the operator for the specified taxation year in respect of the foreign business.³⁴ The restart provisions operate under the passive fresh start rules as they do under the active fresh start rules; therefore, the consequences of applying those provisions are the same as discussed in the preceding section.

Finally, the passive fresh start rules provide an election allowing the taxpayer to defer any income, gain, or loss ("the deferred amount") arising on a deemed disposition of a particular property (a "particular disposition") as a result of applying the restart provisions.³⁵ The taxpayer may elect to exclude that income (loss) in computing the foreign affiliate's FAPI (or foreign accrual property loss [FAPL]) in respect of the specified taxation year and instead include it in computing FAPI (FAPL) for the taxation year in which the property is disposed of through a disposition other than the particular disposition. As illustrated in the example later in this article (see scenario 2 below), the mismatch between the year in which the deemed disposition arises (the preceding taxation year) and the year to which the election to exclude the income (loss) from FAPI (FAPL) applies (the specified taxation year) may mean that the taxpayer is unable to defer recognition of the FAPI (FAPL).

33 Proposed subparagraph 95(2)(k.3)(i).

34 Proposed subparagraph 95(2)(k.3)(ii).

35 Proposed subparagraph 95(2)(k.3)(iii). The requirements for making the election are outlined in proposed regulation 5918.

The portion of income taxes paid by the foreign affiliate that may reasonably be considered to relate to that FAPI is not to be included in determining income taxes paid in respect of any other income, gain, or loss of the affiliate.³⁶

TAXABLE CANADIAN BUSINESS

As discussed above, the active fresh start rules and the passive fresh start rules do not apply if the foreign business is, at any time in the specified taxation year, a taxable Canadian business. Generally, when an operator carries on a business both outside and inside Canada and income from the particular part of that business that is carried on inside Canada is income from a taxable Canadian business, that particular part is deemed to be a separate business.³⁷ Accordingly, the fresh start rules will apply only to the part of the business that is not a taxable Canadian business.

BUSINESS OTHER THAN AN ACTIVE BUSINESS

The active fresh start rules and the passive fresh start rules apply to a foreign business that changed to or from, respectively, a business whose activities *included* activities deemed by any of paragraphs 95(2)(a.1) through (b) to be a separate business, other than an active business, carried on by the affiliate. As a result, even though only a portion of the foreign business's activities may include activities deemed to be a business other than an active business, the fresh start rules would apply to the entire foreign business. To prevent the fresh start rules from applying to the entire foreign business, proposed paragraphs 95(2)(k.5) and (k.6) apply to carve out the activities deemed to be a business other than an active business.

Generally, if the activities deemed to be a business other than an active business are not all the activities of a particular business, that part of the particular business that consists of activities deemed by any of paragraphs 95(2)(a.1) through (b) to be a separate business, other than an active business, is deemed to be the operator's foreign business for purposes of applying the fresh start rules.

SURPLUS ADJUSTMENTS

Where the active fresh start rules apply, the regulations provide certain adjustments in computing the earnings³⁸ for surplus purposes of a foreign affiliate from an active business for the taxation year ending immediately prior to the specified taxation year. In general, the amounts added to the earnings of the foreign affiliate include the excess of actual reserves claimed over the maximum reserves permitted under proposed paragraph 95(2)(k.1), recapture in respect of depreciable property and accrued gains in respect of property other than capital property, eligible capital

36 Proposed clause 95(2)(k.3)(iii)(B).

37 Proposed paragraph 95(2)(k.4).

38 As defined by regulation 5907(1).

property, and resource property.³⁹ Generally, the amounts added to the loss⁴⁰ of the foreign affiliate include the excess of the maximum reserves permitted under proposed paragraph 95(2)(k.1) over the actual reserves claimed, the terminal loss in respect of depreciable property, accrued losses in respect of property other than capital property, eligible capital property, and resource property.⁴¹

The regulations trigger the adjustments to the surplus balances at the time of a deemed disposition even though no actual disposition has occurred. As illustrated in scenario 1 below, surplus is recognized in advance of a disposition other than the deemed disposition (that is, before a deferred amount is recognized).

Finally, the regulations provide that the deemed disposition and reacquisition resulting from the application of the fresh start rules are taken into account when calculating a foreign affiliate's surplus accounts for purposes of regulation 5907.⁴²

APPLICATION OF THE PROPOSED AMENDMENTS

SCENARIO 1: CHANGE FROM ACTIVE BUSINESS TO PASSIVE BUSINESS

The following example illustrates the application of the active fresh start rules and some of the related issues.

A controlled foreign affiliate ("Forco") of a Canadian company ("Canco") is in the real estate development business in the United States. In year 1, Forco develops a 100-unit condominium building ("building 1"). Each completed condo unit has a tax basis of \$150,000. During year 1, Forco sells 25 units for average proceeds of \$200,000 per unit. At the end of year 1, the fair market value of each condo unit is \$225,000. Throughout year 1, Forco has six employees working full time in the active conduct of its real estate development business. Forco is a calendar-year taxpayer.

In year 2, Forco acquires additional land and commences the development of another 100-unit condominium building ("building 2"). Between January 1 and November 30 of that year, Forco sells the remaining 75 units of building 1 for average proceeds of \$250,000. Also on November 30, Forco completes the development of building 2. On December 1, Forco reduces its staff to five employees working full time in the active conduct of its business. At that time, the tax basis of building 2 is \$10 million and the fair market value is \$15 million. In year 3, Forco sells all of the units of building 2 for a profit of \$5 million.

39 Proposed regulation 5907(2.9)(a) (which includes new rules in respect of eligible capital property and resource property).

40 As defined by regulation 5907(1).

41 Proposed regulation 5907(2.9)(b) (which also includes new rules in respect of eligible capital property and resource property).

42 Proposed regulation 5907(2.91).

Application of Fresh Start Rules

With respect to year 1, Forco should be considered to carry on an active business, because throughout that year it employed more than five employees full time in the active conduct of its real estate development business.⁴³ With respect to year 2, however, because Forco reduced its staff to five full-time employees, it would be considered to be carrying on an investment business throughout that taxation year (even though Forco met the full-time employee requirement in every month except December). Therefore, technically, a change of business has occurred in year 2, and a determination must be made as to whether that change triggers the application of the fresh start rules.

For the active fresh start rules to apply, Forco must meet all four conditions in proposed paragraph 95(2)(k). The results, based on the facts, are as follows:

1. In year 2 (the specified taxation year), Forco carried on its business of developing real estate for sale (the foreign business).
2. Forco's real estate business is undertaken in the United States and is not a business carried on in Canada; therefore, its business is not, at any time in year 2, a taxable Canadian business.
3. In year 2, Forco's real estate development business is considered to be an investment business, for the reason cited above.
4. In year 1, Forco carried on the foreign business and the foreign business was not a passive business.

As a result, the active fresh start rules will apply to Forco in respect of year 2 and subsequent years in computing Forco's income or loss from the foreign business and in computing its capital gain or capital loss from the disposition of property used or held in the course of carrying on the foreign business.

Under the active fresh start rules, Forco is deemed to have begun to carry on its business in Canada at the beginning of year 2 and throughout each subsequent year; therefore, Forco will compute its income for year 2 and subsequent taxation years as if it were carrying on the business in Canada.⁴⁴

In addition, Forco is deemed to have a taxation year-end immediately before the beginning of year 2.⁴⁵ At that time, Forco is deemed to have disposed of building 1 at fair market value and deemed to have reacquired building 1 at the beginning of year 2 at a cost equal to the deemed proceeds of disposition.⁴⁶ Accordingly, Forco

43 Subsection 95(1), the definition of "active business" and subparagraph (c)(i) of the definition of "investment business."

44 Paragraph 95(2)(k.1)(i).

45 Paragraph 138(11.91)(c).

46 Paragraph 138(11.91)(e).

will have a “deferred amount” of \$5.625 million⁴⁷ and a stepped-up tax basis in respect of each unit of building 1 of \$225,000. There will not be a deemed disposition in respect of building 2 because it was not an asset of Forco at the end of year 1.

Forco’s deferred amount of \$5.625 million is not included in computing Forco’s income for year 1. Instead, it must be included in computing Forco’s income in the year the property is actually disposed of—that is, in year 2.⁴⁸ In addition, Forco will have income in year 2 of \$1.875 million from the sale of the remaining 75 units of building 1, being the proceeds from the sale of those units less the stepped-up tax basis as a result of applying the active fresh start rules.⁴⁹

FAPI Implications

Year 1

As noted above, throughout year 1, Forco should be considered to be carrying on an active business and not an investment business. Therefore, Forco’s income of \$1.25 million from the sale of 25 units in that year should not be considered FAPI.

Year 2

As discussed above, in year 2 Forco should be considered to have carried on an investment business throughout the year. Accordingly, Forco’s income of \$1.875 million from the sale of the remaining 75 units of building 1 should be attributable to Cancos as FAPI in respect of year 2.

The deferred amount of \$5.625 million, which is also included in computing Forco’s income for year 2, should be active business income; however, the active fresh start rules do not say explicitly that such amount should be included in computing the affiliate’s income from an active business. The relevant provision (proposed subclause 95(2)(k.1)(iv)(A)(I) addresses only the timing of the income inclusion. On the other hand, the corresponding provision with respect to the passive fresh start rules (subclause 95(2)(k.3)(iii)(A)(I) explicitly says that the deferred amount “is to be included in computing the foreign affiliate’s foreign accrual property income” in the year of the disposition (other than the deemed disposition).

The portion of foreign income taxes paid by Forco in year 2 that relates to the deferred amount is not to be included in determining income taxes paid in respect of the \$1.875 million of income included in computing FAPI.⁵⁰

47 Pursuant to paragraph 95(2)(k.1)(iv), in general, the deferred amount is equal to the accrued gain on building 1 as at the end of year 1 [75 units × (\$225,000 – 150,000) = \$5,625,000].

48 Proposed subclauses 95(2)(k.1)(iv)(A)(I) and (II).

49 Based on the average sales proceeds of \$250,000 less the fair market value at the end of year 1 (the stepped-up tax cost) of \$225,000 for each of the 75 units sold in year 2.

50 Proposed clause 95(2)(k.1)(iv)(B).

Year 3

Assume that in year 3, Forco is still carrying on the business of real estate development and, throughout that year, does not employ more than five employees full time in the active conduct of the business, so that the business is still considered to be an investment business. Unfortunately, the application of the active fresh start rules did not result in a step-up of Forco's tax basis in respect of building 2, because Forco did not own the building prior to the specified taxation year (year 2). Therefore, all of the income (\$5 million) from the sale of the condo units in building 2 should be included in computing Forco's FAPI attributable to Canco.

Surplus Implications

As we have seen, the deemed disposition of building 1 at the end of year 1 creates income of \$5.625 million, which is deferred and included in computing Forco's income in the year the property is disposed of (year 2). The regulations include that deferred amount in computing the earnings of Forco in the year of the deemed disposition,⁵¹ resulting in the addition of \$5.625 million to Forco's surplus balance at the end of year 1.

This seems to be an unusual and anomalous result, because the recognition for surplus purposes occurs before the actual disposition of the property. That is, it appears that a gain or loss may be recognized for surplus purposes under the regulations in advance of income or loss recognition under the active fresh start rules. Moreover, there is no guidance on whether the subsequent recognition of the deferred amount as income or loss would create a second recognition of the same surplus adjustment—though, from a tax policy perspective, it should not.

Other Considerations***Accrued Active Income in the Specified Taxation Year***

As discussed above, Forco is technically considered to be carrying on an investment business throughout year 2 because it did not employ more than five employees full time in the active conduct of its business throughout the year. There could be other situations where a foreign affiliate carries on an active business for part of the specified taxation year. In such a case, any gain (loss) accruing during that portion of the specified taxation year in which the operator carried on an active business is still treated as FAPI (FAPL), because the fresh start happens at the beginning of that year regardless of when the transition event occurred. This seems to be an unjust result, but it remains a pitfall under the existing draft fresh start regime.

Cessation of Business

The active fresh start rules do not apply if a foreign affiliate carries on an active business and then ceases to carry on that business. As a result, any gain in respect of

51 Proposed regulation 5907(2.9)(a)(i)(C) and the definition of "earnings" in regulation 5907(1).

a property that may have accrued in the period during which the active business was carried on may not be considered to be active business income on the disposition of such property. This may be an unusual situation, and perhaps could be mitigated with foresight and appropriate planning. Nevertheless, it too may be a pitfall for the unwary. The passive fresh start rules preserve the treatment of such subsequent gains as FAPI.

SCENARIO 2: CHANGE FROM PASSIVE BUSINESS TO ACTIVE BUSINESS

The following example illustrates the application of the passive fresh start rules and some of the related issues.

A foreign affiliate (“IPCo”) of a Canadian company (“Canco”) holds intellectual property relating to the research and development of a pharmaceutical product. In year 1, IPCo licenses the worldwide rights to the intellectual property to an arm’s-length US company. By year-end, IPCo has earned \$400,000 in royalty income under the licensing agreement.

The agreement is to be renewed annually, subject to the parties’ agreement. However, attempts to negotiate a new licensing agreement prove unsuccessful, and four months into year 2, the licence expires. In the course of the negotiations, IPCo decides to retain the rights to the intellectual property, with the intention of manufacturing the product and selling it to arm’s-length customers in the United States and Europe. Later in the year, it commences manufacturing and sales operations.

In the first four months of year 2, before the expiry of the initial licensing agreement, IPCo earns \$200,000 in royalty income. In the last two months of the year, it sustains a \$300,000 loss relating to its manufacturing operations. In year 3, IPCo earns \$400,000 in income relating to the manufacture of goods for sale to arm’s-length foreign customers.

In years 1 and 2, IPCo employs no more than five full-time employees in the active conduct of its licensing business.

IPCo’s only asset is the intellectual property. The fair market value of that asset is \$750,000 at the end of year 1, \$500,000 at the time IPCo ceases to carry on the licensing business during year 2, and \$1.5 million at the end of year 2. IPCo’s adjusted cost base in the intellectual property is \$100,000. The following analysis assumes that a disposition of the intellectual property will be treated as a disposition on capital account and will not be treated as a disposition of an eligible capital expenditure.⁵²

52 For a discussion of the characterization of income realized on a disposition of intellectual property, see Nathalie Brouard and Marc D. Milgrom, “Exploiting Intellectual Property Rights: A Myriad of Opportunities and Tax Issues,” in *R & D: Credits Today, Innovation Tomorrow*, 1999 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1999), 14:1-52.

Application of Fresh Start Rules

In year 1 and the first four months of year 2, IPCo is considered to carry on an investment business, because the principal purpose of its business is to derive income (royalties) from property (intellectual property).⁵³ During year 2, IPCo ceases to carry on the investment business. In the final two months of year 2, and throughout year 3, IPCo carries on a manufacturing business, which is considered to be an active business.⁵⁴

For the passive fresh start rules to apply in year 3 (the specified taxation year), IPCo must meet all four conditions in proposed paragraph 95(2)(k.2). The results of applying this test are as follows:

1. In year 2 (the preceding taxation year), IPCo carried on the business of licensing intellectual property (the foreign business).
2. IPCo's business is not a business carried on in Canada; therefore, its business is not, at any time in year 2, a taxable Canadian business.
3. In year 2, IPCo's business is considered to be an investment business.
4. In year 3, IPCo must either
 - a. continue to carry on the foreign business but carry it on as an active business or as a company holding excluded property; or
 - b. no longer carry on the foreign business at any time in year 3.

IPCo ceased carrying on the licensing business after the fourth month of year 2, and therefore will meet the fourth condition.

If IPCo were instead considered to be carrying on the same foreign business in years 1 through 3 (treated as a passive business for all of year 1 and part of year 2, and then treated as an active business in part of year 2 and all of year 3), the passive fresh start rules would apply to IPCo in respect of year 2—one year earlier than if IPCo ceases to carry on the business in year 2. Because IPCo is considered to have ceased carrying on the foreign business, IPCo will not meet the fourth condition in proposed paragraph 95(2)(k.2) until year 3.

As a result of the application of the passive fresh start rules, IPCo's income, loss, capital gain, or capital loss for year 3 and each subsequent taxation year is calculated as if IPCo had ceased to carry on the foreign business in Canada at the beginning of year 3.⁵⁵

In addition, IPCo has a deemed taxation year-end immediately before the commencement of year 3.⁵⁶

53 It is assumed that IPCo also meets the other conditions set out in the definition of "investment business" in subsection 95(1).

54 Although the manufacturing business involves the exploitation of IPCo's intellectual property, it is neither an investment business nor a passive business under the deeming provisions in section 95.

55 Proposed subparagraph 95(2)(k.3)(i).

56 Paragraph 138(11.91)(c).

Finally, IPCo is deemed to have disposed of the intellectual property immediately before the beginning of year 3 for proceeds of disposition equal to the fair market value at that time, and to have reacquired the property at a cost equal to that fair market value.⁵⁷

FAPI Implications

Year 1

In year 1, IPCo is carrying on an investment business. Therefore, all of the income in that year from the licensing of the intellectual property (\$400,000) is considered FAPI of IPCo attributable to Canco.

Year 2

In the first four months of year 2, IPCo continues to carry on an investment business. Therefore, all of its income in that year from the licensing of the intellectual property (\$200,000) is considered FAPI of IPCo attributable to Canco. IPCo's manufacturing business is an active business and not an investment business. Thus, the loss that IPCo sustains during year 2 from its manufacturing business is not considered a FAPL and should not reduce the FAPI attributed to Canco from the licensing business.

In addition, IPCo is deemed to have disposed of the intellectual property immediately before the beginning of year 3 for proceeds of disposition equal to the fair market value at that time, and to have reacquired the property at a cost equal to that fair market value. Because the intellectual property was used in an active business (manufacturing) at the time of the deemed disposition, the gain of \$1.4 million realized on the deemed disposition should not result in FAPI attributed to Canco.⁵⁸ This result does not appear consistent with the policy objective behind the fresh start rules.

At the time IPCo ceases carrying on an investment business, it has an accrued gain in respect of the intellectual property of \$400,000. However, as a result of the deemed disposition of the intellectual property under the passive fresh start rules, Canco's FAPI inclusion is nil⁵⁹ (because the disposition is deemed to occur at the end of year 2, regardless of when the investment business ceases and the active business

57 Paragraph 138(11.91)(e).

58 Subject to later comments in this article regarding the ability of a taxpayer to make an election under paragraph 95(2)(k.3), if Canco elected to defer this gain pursuant to subparagraph 95(2)(k.3)(iii), the gain would not be treated as a gain arising on a disposition of excluded property and would instead be included in IPCo's FAPI under subclause 95(2)(k.3)(iii)(A)(I). In addition, if Canco had realized a loss rather than a gain on the disposition of the intellectual property, by making such an election, Canco could ensure that the loss would be treated as a FAPL rather than a loss arising on a disposition of excluded property.

59 Based on proceeds of \$1.5 million less the adjusted cost base of \$100,000 multiplied by the 50 percent capital gains rate.

commences). This result seems inappropriate, given that the \$400,000 gain accrued in the period during which IPCo carried on an investment business. Arguably, this accrued gain should be included in Canco's FAPI.

Year 3

Throughout year 3, the only business carried on by IPCo is the manufacture of goods for sale to arm's-length foreign customers. Since this is an active business, IPCo's income in year 3 is not considered FAPI.

Surplus Implications

Under regulation 5907(2.91), the deemed disposition and reacquisition of IPCo's intellectual property under paragraph 95(2)(k.3) takes place in the same manner and for the same amount as for surplus purposes. Because the intellectual property was being used to carry on an active business (manufacturing) at the time of the deemed disposition, the intellectual property is excluded property; therefore, 100 percent of the gain arising on the disposition of the intellectual property is included in IPCo's exempt surplus balance. Again, this result appears inconsistent with the policy behind the fresh start rules, which is to ensure that gains (losses) accruing when assets are used in a passive business are treated as gains (losses) arising on a disposition of property that is not excluded property.

Other Considerations

Timing Issues

If, instead of ceasing to carry on the investment business, IPCo changed from an investment business to an active business partway through year 2, any income, gain, or loss earned by IPCo in that year before the commencement of the active business would be considered to be income or loss from an active business rather than FAPI or FAPL. The reason is that the fresh start would be deemed to occur at the beginning of year 2, regardless of when the actual change occurred. Arguably, this portion of IPCo's income should be included in Canco's FAPI. In addition, IPCo will be deemed to have disposed of the intellectual property at the end of year 1. Any gain realized by IPCo as a result of this disposition will be considered FAPI of IPCo attributable to Canco. Canco may not know that it has a FAPI inclusion at the time that its return for the preceding taxation year is due. For example, this would be case if the change to an active business occurred in the last six months of the specified taxation year.

Recognition of Deferred Amount

The election in subparagraph 95(2)(k.3)(iii) provides that when a particular property is deemed to have been disposed of in the *specified taxation year* by the foreign affiliate pursuant to the passive fresh start rules, the taxpayer can elect to defer recognition of income, gain, or loss (the deferred amount) derived from the deemed disposition until the taxation year in which the property is disposed of (other than

by the particular deemed disposition). This appears to be a drafting error. This provision is in contrast to the deferral rules in proposed subparagraph 95(2)(k.1)(iv) of the active fresh start rules, which apply in respect of dispositions in the *preceding taxation year*.

The restart rules deem the operator to have disposed of the intellectual property “immediately before the beginning of the particular taxation year,”⁶⁰ which would be in the *preceding* taxation year not the *specified* taxation year. Thus, contrary to the intention of the legislators, the election to defer recognition of income, gain, or loss is not applicable in any circumstance in which the passive fresh start rules apply.

If the legislation were drafted so that taxpayers were able to elect to have a deferred amount, the deferred amount would be triggered on a disposition. This disposition need not be made to an arm’s-length party. Thus, the deferred FAPI would be triggered by a reorganization or other transaction (such as a foreign merger under paragraph 95(2)(d.1) or another fresh start under paragraph 95(2)(k.1)) that would result in a disposition but would not otherwise trigger exempt surplus or FAPI. This could also lead to double taxation, because the foreign tax relief provided in subsections 91(1) and (4) will not provide relief in all circumstances.⁶¹ The draft legislation does not include a mechanism to defer the gain until an actual disposition occurs.

If a taxpayer elects under paragraph 95(2)(k.3) to defer the FAPI arising on the deemed disposition, the regulations do not appear to defer recognition of the exempt surplus and exempt deficit, because the election does not delay the timing of the disposition of the intellectual property by IPCo but merely delays Canco’s recognition of the FAPI. If surplus is intended to match realization of assets, the income should be recognized and recorded as earnings in the year in which the property is actually disposed of for fair market value consideration.

CONCLUSIONS

The proposed amendments to the fresh start rules address many of the legislative policy concerns regarding Canadian tax implications when a foreign affiliate’s foreign business changes from an active business to a passive business or vice versa. However, the mechanical complexity of the rules as drafted can produce tax consequences that do not appear intended by the legislators and are beyond the scope of the policy concerns.

To help rectify some of these unusual results, the Department of Finance should consider the following suggested amendments to the proposed rules:

60 Paragraph 138(11.91)(e).

61 Under subsection 91(4), FAT payable in respect of FAPI is deductible only when the FAPI was included in income for a taxation year or for any of the five immediately preceding taxation years. If the foreign tax on an actual disposition arises more than five taxation years after the taxation year in which FAPI is included in income under the fresh start rules, the taxpayer will not receive a FAT deduction for that portion of the foreign tax attributable to the previously taxed FAPI.

- Amend the legislation so that the deferred amount under subparagraph 95(2)(k.1)(iv), and the FAPI deferral under subparagraph 95(2)(k.3)(iii), are swept into income when there is a commercial disposition of the asset to a third party. This will ensure that an internal reorganization or other transaction that would not otherwise trigger exempt surplus or FAPI will not trigger the deferred amount or the FAPI deferral.
- Amend subparagraph 95(2)(k.3)(iii) so that the preamble refers to each property disposed of in the “preceding taxation year” rather than the “specified taxation year.” This will ensure that the FAPI deferral is available for the year in which the deemed disposition arose (the preceding taxation year).
- Amend subparagraph 95(2)(k.1)(iv) to clarify that the deferred amount is active income (loss) and not FAPI (FAPL) when it is brought into income on a subsequent disposition.
- Amend paragraph 95(2)(k.3) or (k.4) to clarify that the gain arising on the deemed disposition of assets on the cessation of a passive business will be characterized as FAPI and not as active business income.
- Amend the active fresh start rules so that they apply when a foreign affiliate carries on an active business and then ceases to carry on any business (active or passive).
- Amend the legislation so that the operator is deemed to have disposed of the foreign business assets and to have begun or ceased to carry on the foreign business in Canada at the time of the change in the business from active to passive (or vice versa), rather than at the beginning of the specified taxation year. This will ensure that active and passive income (loss) earned in the specified taxation year will be appropriately characterized as FAPI (FAPL) and active business income (loss). In addition, there will no longer be a risk that the Canadian taxpayer could have a FAPI inclusion in the preceding taxation year but be unaware of the inclusion until after the tax return for that year is due.
- Amend the regulations to ensure that the timing of recognition of exempt and taxable earnings (loss) for surplus purposes is consistent with the timing for recognition of income (loss) under paragraphs 95(2)(k.1) and (k.3).