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 REFDATE 130122  
 SUBJECT Computation of "earnings" of a foreign affiliate  
 SECTION Reg. 5907(1); Proposed reg. 5907(2.03) (Bill C-48)

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PRINCIPAL ISSUES: Would proposed subsection 5907(2.03) of the Regulations result in a foreign affiliate being required to deduct in taxation year X and subsequent taxation years, amounts that it had previously deducted in computing its earnings in taxation years preceding taxation year X for which its calculation of earnings had been made in accordance with the income tax law of its foreign jurisdiction?

POSITION: No

REASONS: It is our view that in applying proposed subsection 5907(2.03) of the Regulations in respect of the active business of a foreign affiliate for the particular taxation year referred to in that subsection, any deduction claimed by the foreign affiliate in computing its earnings or loss from that business, in any taxation year of the affiliate that began on or before the commencement of the particular taxation year and for which its earnings or loss from that business had been determined under subparagraph (a)(i) or (ii) of the definition "earnings" in subsection 5907(1) of the Regulations, would be considered to have been actually claimed under the Act and to be within the maximum amount deductible.

XXXXXXXXXX

2012-046012

January 22, 2013

Dear XXXXXXXXXXXX

RE: Computation of "earnings" of a foreign affiliate

This is in reply to your letter of August 2, 2012, requesting our view in reference to the computation of the "earnings", as defined in subsection 5907(1) of the Income Tax Regulations (the "Regulations"), of a foreign affiliate ("FA") of a corporation resident in Canada in the following circumstances:

- 1) FA is resident in and carries on an active business in a country other than Canada ("Forland").
- 2) In every taxation year of FA since the commencement of its active business operations, FA was required by the income tax law in Forland to compute its income or profit from that active business.
- 3) In taxation year X, FA's circumstances changed such that it became

subject to tax in Forland based on a flat rate of tax applied to its gross revenue and, as a result, was no longer required to compute its income or profit from its active business under the income tax law of Forland.

4) As a consequence, pursuant to subparagraph (a)(iii) of the definition of "earnings" in subsection 5907(1) of the Regulations, in taxation year X and all subsequent taxation years, FA must compute its earnings from its active business in accordance with Part I of the Act (subject to the modifications described in subparagraph (a)(iii)), as if the business were carried on in Canada and FA were resident in Canada.

You drew our attention to proposed subsection 5907(2.03) of the Regulations which, as it appears in Bill C-48 tabled in Parliament on November 21, 2012, reads as follows:

The determination - under subparagraph (a)(iii) and paragraph (b) of the definition "earnings", and paragraph (b) of the definition "loss", in subsection (1) - of the earnings or loss of a foreign affiliate of a taxpayer resident in Canada for a particular taxation year from an active business is to be made as if the affiliate

(a) had, in computing its income or loss from the business for each taxation year (referred to in this paragraph as an "earnings or loss year") that is the particular year or is any preceding taxation year that ends after August 19, 2011,

(i) claimed all deductions that it could have claimed under the Act, up to the maximum amount deductible in computing the income or loss from the business for that earnings or loss year, and

(ii) made all claims and elections and taken all steps under applicable provisions of the Act, or of enactments implementing amendments to the Act or its regulations, to maximize the amount of any deduction referred to subparagraph (i); and

(b) had, in computing its income or loss from the business for any preceding taxation year that ended on or before August 19, 2011, claimed all deductions, if any, that it actually claimed under the Act, up to the maximum amount deductible, and made all claims and elections, if any, and taken all steps, if any, under applicable provisions of the Act, or of enactments implementing amendments to the Act or its regulations, that it actually made.

In light of proposed subsection 5907(2.03) of the Regulations, you requested our view as to whether FA, in the circumstances described above, would be required to deduct, in taxation year X and subsequent taxation years, amounts that it had previously deducted in computing its earnings in taxation years preceding taxation year X for which its calculation of earnings had been made in accordance with the income tax law of Forland.

For example, the cost of a depreciable capital property used by FA in its active business may have already been fully claimed in computing FA's earnings prior to taxation year X under subparagraph (a)(i) of the definition of "earnings" in subsection 5907(1) of the Regulations. However, as it is not clear that any portion of such cost would have been claimed under the Income Tax Act (the "Act"), you are concerned that the

cost of the same asset would be required to be claimed again in computing the earnings, under subparagraph (a)(iii) of the definition of "earnings" in subsection 5907(1) of the Regulations, in taxation year X and subsequent taxation years of FA pursuant to proposed subsection 5907(2.03) of the Regulations.

Our comments

It is our view that in applying proposed subsection 5907(2.03) of the Regulations in respect of the active business of a foreign affiliate for the particular taxation year referred to in that subsection, any deduction claimed by the affiliate in computing its earnings or loss from that business, in any taxation year of the affiliate that began on or before the commencement of the particular taxation year and for which the earnings or loss from that business had been determined under subparagraph (a)(i) or (ii) of the definition "earnings" in subsection 5907(1) of the Regulations, would be considered to have been actually claimed under the Act and to be within the maximum amount deductible.

We trust our comments will be of assistance.

Yours truly,

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