Canada Revenue Agency / Agence du revenu du Canada

INCOME TAX
INTERPRETATION BULLETIN

NO.: **IT-270R3** DATE: November 25, 2004

SUBJECT: INCOME TAX ACT
Foreign Tax Credit

REFERENCE: Subsections 126(1), (2) and (2.1) and the definitions of "business-income tax", "non-business-income tax" and "tax for the year otherwise payable under this Part" in subsection 126(7) (also sections 3, 110.5, 115.1, 122.3, 127.5, 127.54 and subsections 4(3), 20(11), 20(12), 126(6) and 180.1(1.1) of the *Income Tax Act* (the "Act"))

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Application

This bulletin cancels and replaces:

- IT-270R2, *Foreign Tax Credit*, dated February 11, 1991;
- IT-194, *Foreign Tax Credit – Part-time Residents*, dated January 6, 1975; and
- IT-183, *Foreign-Tax Credit – Member of a Partnership*, dated October 28, 1974.

Summary

Section 126 of the Act makes a foreign tax credit available to a taxpayer who is a resident of Canada at any time in a year (references in this bulletin to a "year" mean a "taxation year"). A foreign tax credit is a deduction from the

taxpayer's Canadian tax otherwise payable that may be claimed in respect of foreign **income or profits tax** paid by the taxpayer for the year. A foreign tax credit can provide relief from double taxation on certain income, i.e., relief from the taxpayer's having to otherwise pay full tax to both Canada and another country on that income.

The taxpayer must make separate foreign tax credit calculations for:

- foreign non-business-income tax; and
- foreign business-income tax.

Furthermore, within each of these categories, a separate foreign tax credit calculation is required for each foreign country.

The maximum amount of each foreign tax credit that the taxpayer may claim with respect to either foreign non-business-income tax or business-income tax is essentially equal to the lesser of two amounts:

- the applicable foreign income or profits tax paid for the year; and
- the amount of Canadian tax otherwise payable for the year that pertains to the applicable foreign income.

A third limitation, which occurs only in the calculation of a foreign tax credit for foreign **business-income** tax, ensures that the taxpayer's foreign tax credit claims for the year for foreign **non-business-income** taxes have been deducted first. This ordering rule is designed to allow the taxpayer to maximize foreign tax credit claims over the years, taking into account a rule that only the portion of foreign **business-income** taxes that is not deductible as a foreign tax credit for the year can be carried over for purposes of a foreign tax credit in other years.

This bulletin does not describe the complete details of the foreign tax credit provisions, as the main purpose of the bulletin is to give interpretations with respect to some of the requirements contained in these provisions. For the full details of the provisions referred to in the bulletin, please refer to the Act.

This bulletin also briefly refers to the following:

- the special foreign tax credit that can apply if the taxpayer is subject to the minimum tax;
- a provision which, if needed, can enable a corporation to maximize its foreign tax credits for the year by means of an addition to taxable income for the year, with a corresponding amount of non-capital loss being created for use in other years; and
- the deferral of taxation in Canada in certain situations in order to provide relief from double taxation that could otherwise occur if Canada would otherwise tax the income resulting from a particular transaction in the year it occurs while another country defers its taxation with respect to that transaction.

It should be noted that the primary subject of this bulletin is the foreign tax credit provisions in Canada's domestic income tax law. While there are also comments regarding certain provisions in tax treaties between Canada and other countries, the bulletin does not purport to deal with all treaty provisions that could apply.

The following topics are also outside the scope of this bulletin:

- the "no economic profit" and "short-term security acquisitions" rules in the foreign tax credit provisions;
- the modifications to the foreign tax credit rules that apply to authorized foreign banks; and
- the modifications to the foreign tax credit rules that apply to resource companies.

Other relevant Interpretation Bulletins are the current versions of the following:

- IT-506, *Foreign Income Taxes as a Deduction From Income*;
- IT-395, *Foreign Tax Credit – Foreign-Source Capital Gains and Capital Losses*; and
- IT-173, *Capital Gains Derived in Canada by Residents of the United States*.

Discussion and Interpretation

The Foreign Tax Credit for Full-Year Residents of Canada

¶ 1. The amount of foreign tax credit that is available under subsection 126(1)—for **non-business-income tax** paid by a taxpayer resident in Canada throughout the year to a particular country other than Canada—is equal to the lesser of two amounts, which are identified in this bulletin as follows:

- FTP(NBIT), and
- CTOP(FNBI).

The first amount, FTP(NBIT), means (in this bulletin) the **foreign tax** paid—but restricted to non-business-income tax. More specifically, FTP(NBIT) is such part as the taxpayer may claim of any "non-business-income tax" (as defined in subsection 126(7)) paid by the taxpayer for the year to the applicable foreign jurisdiction (including the taxpayer's share, if any, of any such tax paid by a partnership), excluding any such tax that may reasonably be regarded as having been paid by a corporate taxpayer in respect of income from a share of the capital stock of a foreign affiliate of the taxpayer.

The second amount, CTOP(FNBI), means (in this bulletin) that portion of the Canadian tax otherwise payable that pertains to the applicable foreign non-business income (from the applicable foreign country). The CTOP(FNBI) is determined as follows:

$$\text{CTOP(FNBI)} = \frac{\text{FNBI}}{\text{WI(1)}} \times \text{CTOP(1)}$$

In the above formula for CTOP(FNBI), the variables are as follows:

FNBI is the **numerator** in the above fraction. FNBI is the total of the taxpayer's foreign non-business income for the year from sources in the applicable foreign country (including the taxpayer's share, if any, of any such income of a partnership) as calculated in accordance with subparagraph 126(1)(*b*)(i).

WI(1) is the **denominator** in the above fraction. It essentially represents the taxpayer's worldwide income for the year, subject to the adjustments contained in subparagraph 126(1)(*b*)(ii).

CTOP(1) is the Canadian tax otherwise payable for the year as calculated under paragraph (*a*) of the subsection 126(7) definition of the term "tax for the year otherwise payable under this Part."

Corporations claiming a foreign tax credit under subsection 126(1) should use the T2 Schedule 21, *Federal Foreign Income Tax Credits and Federal Logging Tax Credit*. Other taxpayers should use form T2209, *Federal Foreign Tax Credits*.

¶ 2. The amount of foreign tax credit that is available under subsection 126(2)—for foreign **business-income tax** paid by a taxpayer resident in Canada throughout the year in respect of businesses carried on in a particular country other than Canada (the "foreign business country")—is equal to the least of three amounts, which are identified in this bulletin as follows:

- FTP(BIT);
- CTOP(FBI); and
- X.

The first amount, FTP(BIT), means (in this bulletin) the **foreign tax** paid—but restricted to business-income tax. More specifically, FTP(BIT) is such part as the taxpayer may claim of the total "business-income tax" (as defined in subsection 126(7)) paid by the taxpayer for the year in respect of businesses carried on by the taxpayer in the foreign business country (including the taxpayer's share, if any, of any such tax paid by a partnership), plus the taxpayer's eligible "unused foreign tax credits" (if any) in respect of that country (see the current version of IT-520, *Unused Foreign Tax Credits – Carryforward and Carryback*).

The second amount, CTOP(FBI), means (in this bulletin) that portion of the Canadian tax otherwise payable that pertains to the foreign business income, i.e., from the foreign business country. The CTOP(FBI) is determined as follows:

$$\text{CTOP(FBI)} = \left[\frac{\text{FBI}}{\text{WI(2)}} \times \text{CTOP(2)} \right] + \text{Y}$$

In the above formula for CTOP(FBI), the variables are as follows:

FBI is the **numerator** in the above fraction. FBI is the total of the taxpayer's income for the year from **businesses carried on in** the foreign business country (including the taxpayer's share, if any, of any such income of a partnership) as calculated in accordance with subparagraph 126(2.1)(a)(i).

WI(2) is the **denominator** in the above fraction. It essentially represents the taxpayer's worldwide income for the year, subject to the adjustments contained in subparagraph 126(2.1)(*a*)(ii).

CTOP(2) is the Canadian tax otherwise payable for the year as calculated under paragraph (*c*) of the subsection 126(7) definition of the term "tax for the year otherwise payable under this Part."

Y is the proportion (as determined under paragraph 126(2.1)(*b*)) of any subsection 120(1) tax for the year (on income that is not "income earned in a province") that pertains to income from businesses carried on in the foreign business country.

The third amount, X, takes into account a rule that, if the taxpayer's FTP(NBIT) cannot be fully claimed as a subsection 126(1) foreign tax credit for the year (i.e., because CTOP(FNBI) is a lower amount—see ¶ 1), the unused portion of the FTP(NBIT) cannot be carried over and used for purposes of a subsection 126(1) foreign tax credit in another year. Any portion of FTP(BIT) that cannot be deducted as a subsection 126(2) foreign tax credit for the year, on the other hand, can qualify as a subsection 126(7) "unused foreign tax credit" for the year, which can be carried over for purposes of a subsection 126(2) foreign tax credit for certain other years (see the current version of IT-520, *Unused Foreign Tax Credits – Carryforward and Carryback*). The third amount, X, ensures that the taxpayer's subsection 126(1) foreign tax credit claims are deducted before the subsection 126(2) foreign tax credits. This ordering rule is designed to allow the taxpayer to maximize both the foreign tax credits deducted for the year and the amount of "unused foreign tax credit" for the year that can be carried over and used for purposes of a foreign tax credit in other years. Amount X is determined as follows:

$$\text{X} = \text{CTOP(3)} - \text{Z}$$

The variables in the above formula for X are as follows:

CTOP(3) is the Canadian tax otherwise payable for the year as calculated under paragraph (*b*) of the subsection 126(7) definition of the term "tax for the year otherwise payable under this Part."

Z is the total of all non-business foreign tax credit claims made for the year under subsection 126(1) (see ¶ 1).

Corporations claiming a foreign tax credit under subsection 126(2) should use the T2 Schedule 21, *Federal Foreign*

Income Tax Credits and Federal Logging Tax Credit. Other taxpayers should use form T2209, *Federal Foreign Tax Credits*.

The Foreign Tax Credit for Part-Year Residents

¶ 3. If an individual is resident in Canada throughout part of the year and non-resident throughout another part of the year, section 114 applies to the individual. If section 114 applies, the calculations in ¶ 1 and ¶ 2 are modified. For further particulars, see subsections 126(1) and 126(2.1).

Foreign Income or Profits Tax

¶ 4. In general terms, a **tax** is a levy of general application for public purposes enforceable by a governmental authority. Examples of payments that do not qualify as payments of a “tax” include the following:

- resource royalties;
- voluntary contributions to governmental authorities; and
- payments made to acquire a specific right or privilege.

¶ 5. To qualify for foreign tax credit purposes, a payment of tax:

- must be made to the government of a foreign country or to the government of a state, province or other political subdivision of a foreign country; and
- must be an “**income or profits tax**.”

In determining whether or not a particular foreign tax qualifies as an income or profits tax, the name given to the tax by the foreign jurisdiction is not the deciding factor. Rather, the basic scheme of application of the foreign tax is compared with the scheme of application of the income and profits taxes imposed under the Act. Generally, if the basis of taxation is substantially similar, the foreign tax is accepted as an income or profits tax. To be substantially similar, the foreign tax must be levied on net income or profits (but not necessarily as would be computed for Canadian tax purposes) unless it is a tax similar to that imposed under Part XIII of the Act. Since taxable capital gains are included in income for Canadian income tax purposes, a foreign tax on a capital gain is considered to be an income or profits tax for purposes of section 126. If a particular tax imposed by a foreign country is specifically identified, in an “elimination of double tax” article of an income tax treaty between Canada and that country, as a tax for which Canada must grant a deduction from Canadian taxes on profits, income or gains which arose in that other country and which gave rise to the foreign tax in question, the foreign tax will qualify as an income or profits tax when applying section 126 in conjunction with that treaty article. (See, for example, the U.S. taxes referred to in paragraph 2(a) of Article XXIV of the *Canada-United States Income Tax Convention (1980)*, as amended by the third protocol to that convention.) Examples of taxes that do **not** qualify as income or profits taxes for purposes of the section 126 foreign tax credit provisions include the following:

- sales, commodity, consumption or turnover taxes;
- succession duties or inheritance taxes;
- property or real estate taxes;
- franchise or business taxes;
- customs or import duties;
- excise taxes or duties;
- gift taxes; and
- capital or wealth taxes.

A unitary tax of a state of the United States cannot be regarded as an income or profits tax if it is not computed on the basis of business income. The following are instances where a unitary tax does not qualify as an income or profits tax:

- The tax represents an annual minimum franchise tax.
- The tax is applicable even when there is no income.
- The calculation of the tax does not attempt to allocate income to the particular state.
- The tax is in the nature of a capital tax.

(However, a unitary tax that does not qualify as an income or profits tax for purposes of claiming a foreign tax credit would likely be deductible in computing the taxpayer’s income pursuant to subsection 9(1) as an expense for the purpose of earning income.) A decision as to whether a particular state’s unitary tax can be regarded as an income or profits tax for purposes of claiming a foreign tax credit can be made only after a review of the applicable state legislation. (See also the comments regarding a unitary tax in ¶ 7 and ¶ 13.)

¶ 6. Where it is clear that an amount of tax has been paid to a foreign government authority, a foreign tax levy based on net income established under a prescribed formula is considered to be an income or profits tax if the following conditions are met:

- it can be considered that the formula produces a reasonable approximation of actual net income in typical situations; and
- an attempt to compute actual net income would be significantly affected by arbitrary or estimated expense allocations.

It should also be noted that an amount which by nature is not an income or profits tax can nevertheless be deemed to have been paid as an income or profits tax to a foreign jurisdiction: see subsection 126(5), which (in conjunction with related definitions), deems certain foreign oil and gas levies to have been paid as an income or profits tax to a foreign jurisdiction.

Business-Income Tax

¶ 7. As indicated in ¶ 2, for purposes of claiming a subsection 126(2) foreign tax credit with respect to a particular foreign business country, FTP(BIT) with respect to that country primarily consists of such part as the taxpayer may claim of the taxpayer’s total “business-income tax” with respect to that country as defined in subsection 126(7).

Generally (subject to subsections 126(4.1) and (4.2), which concern the “no economic profit” and “short-term security acquisitions” rules, respectively), an income or profits tax paid by the taxpayer qualifies as “business-income tax” with respect to the foreign business country to the extent that:

- it is a tax that can reasonably be regarded as being in respect of income from any business carried on by the taxpayer in that country; and
- it is a tax paid to any foreign jurisdiction.

Note from the above that the foreign country containing the jurisdiction to which the tax is paid and the foreign business country (i.e., in respect of which the foreign tax credit is claimed) do not have to be the same country.

A foreign income or profits tax is recognized as “business-income tax” **only** to the extent that it pertains to income from a business carried on outside Canada. Whether or not (or the extent to which) the taxpayer is carrying on a business in or outside Canada is essentially a question of fact to be determined in each particular case. For purposes of deciding this question, consideration should be given to any relevant caselaw. See ¶ 23 for guidelines for purposes of determining where a business is carried on.

It may be possible for a unitary tax of a state of the United States to qualify as “business-income tax” if it is an income or profits tax (see ¶ 5) that is computed on a Canadian corporation’s net business income from carrying on a business in that state. In a case, however, where the Canadian corporation would not be liable to the unitary tax on its sales into the particular state if it were not for the activities of its U.S. affiliate or affiliates in that state, it would be arguable that the tax is in respect of the Canadian corporation’s investment in its U.S. affiliates rather than in respect of income from any business carried on by the Canadian corporation in the United States, in which case the tax would not qualify as “business-income tax”. See also the comments regarding a unitary tax in ¶ 5 and ¶ 13.

Certain taxes that would otherwise qualify as “business-income tax” are specifically excluded therefrom. One of these exclusions is any tax that may reasonably be regarded as relating to an amount received or receivable by any other person or partnership from the foreign jurisdiction to which the tax is paid. This excluded tax may qualify, however, as “non-business-income tax” for the purpose of a subsection 20(12) deduction (but not “non-business-income tax” for foreign tax credit purposes)—for further comments, see ¶ 8(d).

Non-Business-Income Tax

¶ 8. As indicated in ¶ 1 , for purposes of claiming a subsection 126(1) foreign tax credit with respect to a particular foreign country, FTP(NBIT) consists of such part as the taxpayer may claim of any “non-business-income tax” of the taxpayer with respect to that country (subject to the rule discussed in ¶ 10). Any amount of income or profits tax (subject to subsections 126(4.1) and (4.2), which concern the “no economic profit” and “short-term security acquisitions” rules, respectively) paid by a taxpayer to a foreign jurisdiction is included in the taxpayer’s “non-business-income tax” with respect to the country in which that jurisdiction is located, as long as the amount is not specifically excluded from the definition thereof in subsection 126(7). The following should be noted with regard to some of these exclusions:

(a) “Non-business-income tax” cannot include any tax (or portion of the tax) that qualifies under subsection 126(7) as “business-income tax” (see ¶ 7). On the other hand, a foreign income or profits tax (or portion of the tax) that might otherwise be considered to be business-related but that does not qualify as “business-income tax” is not excluded from the definition of “non-business-income tax”. Examples of the latter are given in ¶ 9.

(b) “Non-business-income tax” cannot include any portion of a foreign income or profits tax that is **deductible** under subsection 20(11). This exclusion, which is provided for in paragraph (*b*) of that definition, applies regardless of whether or not the amount qualifying for deduction under subsection 20(11) is actually deducted under that provision. It should be noted that only foreign income or profits tax paid by an individual (including a trust) in respect of foreign-source income from a property other than real property—and furthermore only such portion of the tax that is in excess of 15% of the gross amount of such income—is deductible under subsection 20(11). This means that “non-business-income tax” **can** include (subject to the other applicable rules in section 126) the following:

- in the case of an individual (including a trust):
  - foreign income or profits tax in respect of foreign-source income from a property that is not real property, up to—but not exceeding—15% of the gross amount of such income (subsection 20(11) in conjunction with the exclusion from “non-business-income tax” provided for in paragraph (*b*) of its definition being the means to impose this 15% limitation when claiming a subsection 126(1) foreign tax credit with respect to this type of a property); and
  - all foreign income or profits tax (i.e., not subject to the above-mentioned 15% limitation) in respect of foreign-source income from a property that is real property; and
- in the case of any other taxpayer, all foreign income or profits tax (i.e., not subject to the above-mentioned 15% limitation) in respect of foreign-source income from any property.

For further comments regarding subsection 20(11), see (c) below, ¶ 30 and the current version of IT-506, *Foreign Income Taxes as a Deduction From Income*.

(c) For purposes of claiming a subsection 126(1) foreign tax credit, “non-business-income tax” cannot include any amount that is **deducted** under subsection 20(12). This exclusion from “non-business-income tax”, which

is provided for in paragraph (*c*) of its definition, reflects the fact that an amount that qualifies as "non-business-income tax" can be used either for purposes of a subsection 126(1) foreign tax credit or for purposes of claiming a deduction under subsection 20(12) in determining income (for further particulars on the latter, see the current version of IT-506, *Foreign Income Taxes as a Deduction From Income*). The following should be noted:

- The taxpayer must first calculate income, taking into account the amounts, if any, **deducted** under subsection 20(11) (see (b) above) and subsection 20(12). These deductions may in fact result in nil income.
- If an amount of income does exist, the taxpayer then determines whether there is any taxable income. (See also the comments in ¶ 38 regarding the addition of an amount in computing taxable income as permitted by section 110.5.)
- If there is an amount of taxable income, the taxpayer then determines CTOP(1), which will be used in the calculation of CTOP(FNBI) (see ¶ 1).
- Finally, the taxpayer determines the amount of foreign tax credits to be claimed. For this purpose, the exclusion from "non-business-income tax" provided for in paragraph (*c*) of its definition requires that the amount, if any, deducted under subsection 20(12) be excluded from "non-business-income tax" for purposes of claiming a subsection 126(1) foreign tax credit. Thus, the amount deducted under subsection 20(12) is excluded from FTP(NBIT) in ¶ 1. Also, the amounts, if any, deducted under subsections 20(11) and (12):

– reduce the amount calculated for FNBI (the numerator) in ¶ 1 (for further particulars, see ¶ 30); and

– have an effect on other variables in ¶ 1 and ¶ 2.

It is not possible to claim the full amount of FTP(NBIT) in ¶ 1 (which is based on "non-business-income tax") as a subsection 126(1) foreign tax credit if CTOP(FNBI) is less than FTP(NBIT). This could occur because either CTOP(1) or FNBI (the numerator in ¶ 1) is too low. (A situation where FNBI could be nil—even though foreign tax has been paid—is described in ¶ 21.) Furthermore, any portion of FTP(NBIT) for a particular year that cannot be, or is not, claimed as a subsection 126(1) foreign tax credit for the year, cannot be carried over and claimed as a foreign tax credit for another year. If an amount of what would otherwise qualify as "non-business-income tax" for purposes of a subsection 126(1) foreign tax credit cannot be claimed as such in order to obtain dollar-for-dollar tax relief by means of a direct reduction to Canadian tax otherwise payable, claiming the amount as "non-business-income tax" under subsection 20(12), (i.e., as a deduction in computing income), provides tax relief at the effective tax rates. (As indicated above, for purposes of claiming foreign tax credits, the amount claimed under subsection 20(12) is excluded from "non-business-income tax" and FTP(NBIT) in ¶ 1, and it also affects other variables in ¶ 1 and ¶ 2.)

From all of the above, the following general conclusions can be made with respect to non-business income from a particular foreign country and the income or profits taxes paid to that country on that income:

- Where the Canadian tax rate is greater than the foreign tax rate, there will likely be a subsection 126(1) foreign tax credit but not a subsection 20(12) deduction.
- Where the Canadian tax rate is less than the foreign tax rate and the foreign tax is less than the non-business income (for Canadian tax purposes) from the foreign country (before any deduction for that tax), the maximum amount of tax that any combination of subsection 126(1) foreign tax credit and subsection 20(12) deduction can eliminate is the Canadian tax otherwise payable on that income.
- Where the amount deducted under subsection 20(12) creates or increases a loss (for Canadian tax purposes) for the non-business income sources for the foreign country, there cannot be any subsection 126(1) foreign tax credit.

For further comments regarding subsection 20(12), see (d) below, ¶ 30 and the current version of IT-506, *Foreign Income Taxes as a Deduction From Income*.

(d) "Non-business-income tax" for foreign tax credit purposes cannot include any foreign income or profits tax (or portion of the tax) paid by the taxpayer that may reasonably be regarded as relating to an amount received or receivable by any other person or partnership from the foreign jurisdiction to which the tax is paid. For example, if a foreign country's tax is withheld on income from property paid to a taxpayer resident in Canada but a portion of the tax is refunded or refundable to the foreign payer of the income, such portion of the tax is excluded from the taxpayer's "non-business-income tax" for subsection 126(1) foreign tax credit purposes. Such portion of the tax may, however, qualify for inclusion in the taxpayer's "non-business-income tax" for the purpose of a subsection 20(12) deduction. For further comments, see the current version of IT-506, *Foreign Income Taxes as a Deduction From Income*.

(e) If an individual claims an overseas employment tax credit under subsection 122.3(1), the individual's "non-business-income tax" cannot include any foreign income tax (or portion of the tax) that may reasonably be regarded as attributable to the taxpayer's income from employment to the extent of the lesser of the amounts determined in respect of that income under paragraphs 122.3(1)(*c*) and (*d*) for the year. If the individual is entitled to, but does not, claim the overseas

employment tax credit, the full amount of foreign income tax on the relevant overseas employment income can be included in the calculation of the individual's "non-business-income tax" (subject, of course, to the other exclusion rules in the definition of "non-business-income tax"). This means, for example, that the individual typically can choose to include foreign income tax on this type of income in the calculation of "non-business-income tax" where the overseas employment tax credit would be rendered ineffective because of the application of the minimum tax under section 127.5 (a special foreign tax credit can be claimed against the minimum tax—see ¶ 37).

¶ 9. The following are examples of foreign taxes that cannot qualify as "business-income tax"—because they are not taxes paid by the taxpayer on income from the taxpayer's carrying on a business in a country other than Canada (as discussed in ¶ 7)—but can qualify as "non-business-income tax" (see ¶ 8(a)):

- foreign tax withheld on dividends received from a foreign corporation by a Canadian trader in securities who did not carry on any trading business in a foreign country;
- United States tax on income from a business carried on by a U.S. "subchapter S corporation" but paid by its principal shareholder, a U.S. citizen resident in Canada, because the business was not carried on by the person who paid the tax;
- foreign tax paid in respect of a capital gain on the sale of a property used by the taxpayer in carrying on a business in a foreign country, because a capital gain is not income from carrying on a business; and
- foreign tax paid to the extent that it is in respect of a business (or a part of a business) that is carried on in Canada (see, however, ¶ 21).

¶ 10. A foreign income or profits tax which meets the subsection 126(7) definition of "non-business-income tax" will nevertheless not qualify for purposes of a subsection 126(1) foreign tax credit to the extent that the tax may reasonably be regarded as having been paid by a corporation in respect of its income from a share of the capital stock of a foreign affiliate of the corporation, as indicated in the description of FTP(NBIT) in ¶ 1. (See, however, the relief from double taxation provided for in section 113, subsection 91(4) and subsection 91(5).) If an amount representing a return of capital on a Canadian corporation's shares in the capital stock of a foreign affiliate is considered to be a dividend under the United States *Internal Revenue Code* earnings and profits rules, U.S. taxes paid by the Canadian corporation on that amount are considered to be in respect of its income from such shares and thus these taxes do not qualify for inclusion in FTP(NBIT).

Amount Paid by the Taxpayer for the Year

¶ 11. Before an amount of foreign tax can be used in the calculation of a foreign tax credit (i.e., as FTP(NBIT) in ¶ 1 or FTP(BIT) in ¶ 2), it must be "paid...for the year," whether paid before, during or after the year in question. Once paid, the Canadian dollar equivalent of the foreign tax (converted into Canadian currency in accordance with whichever method and rate of exchange described in ¶ 16 to ¶ 18 may be appropriate in the circumstances) may be taken into account in computing a foreign tax credit for the year to which the foreign tax relates. Any portion of a taxpayer's foreign tax which is paid but which subsequently is, or will be, refunded to the taxpayer is not considered to be tax "paid for the year". In other words, the foreign tax "paid for the year" for purposes of claiming a foreign tax credit cannot be more than the applicable finally-determined foreign tax liability (i.e., the Canadian dollar equivalent of that amount).

If, for example, a resident of Canada receives income from sources in another country which has been subject to withholding tax at a rate in excess of that specified in a treaty between Canada and that country, such excess is not considered to be foreign tax "paid for the year" for purposes of the foreign tax credit. The maximum credit allowed will be determined on the basis of the treaty rate and the taxpayer must seek a refund of the excess withholding tax from the foreign revenue authorities.

If a resident of Canada voluntarily pays to a jurisdiction in a foreign country an amount that, according to the domestic law of that country can be levied as tax but according to the terms of a treaty between Canada and that country cannot be so levied, the amount voluntarily paid cannot be considered to be foreign tax paid for the year for purposes of a foreign tax credit. (Any refund of such voluntary payment in a subsequent year would not reduce any amount of foreign tax paid for that subsequent year.)

The expression "for the year" in subsections 126(1), (2) and (7) means for the year for which the foreign tax is exigible in the foreign country.

¶ 12. An initial allowance of, or an adjustment to, a foreign tax credit in respect of foreign taxes "paid for the year" may be included in an assessment, reassessment or additional assessment of tax for the year or a notification that no tax is payable for the year. For the time frames and conditions under which an assessment, reassessment or additional assessment of tax or a notification that no tax is payable (as the case may be) can be issued, see section 152.

¶ 13. A taxpayer's foreign tax credit calculation can include only a foreign income or profits tax that is paid "by the taxpayer". In this connection, but subject to ¶ 11, the recipient of foreign-source income is considered to have paid any amount withheld and remitted by the payer of the income on account of, or in settlement of, the recipient's foreign tax liability. Payment is considered to have been made at the time the amount was withheld.

A tax is not considered to be paid "by the taxpayer" for foreign tax credit purposes if the actual liability for the tax lies with another person. For example, a unitary tax of a state of the United States does not qualify as being paid by a Canadian corporation, for purposes of that corporation's

claiming a foreign tax credit, if the actual liability for the tax lies with one or more of its U.S. affiliates (see also the comments regarding a unitary tax in ¶ 5 and ¶ 7).

¶ 14. The payment of an amount of foreign tax by an agent on behalf of a Canadian resident taxpayer is equivalent to payment by the taxpayer. Whether or not a principal/agency relationship exists is a question of fact based on Canadian law and is not affected by the treatment of the relationship by foreign tax authorities. Thus, foreign tax paid by an agent of a resident of Canada can qualify for the foreign tax credit of the principal even though the agent was assessed the foreign tax on the basis that the activities were for the agent's own account, provided that the tax can in fact be considered to be that of the principal. The following are examples of situations where the tax typically can be considered to be that of the principal:

- The agent can recover the tax paid from the principal.
- The tax is paid by the agent from sales made by the agent on behalf of the principal and the amount of the tax paid is included in the gross amount of the sales income of the principal.

¶ 15. If spouses resident in Canada have paid a foreign income tax on a community income basis (e.g., by filing a joint return in the United States), an appropriate share of the foreign tax paid generally may be included in the foreign tax credit calculation of each spouse. The amount paid is generally apportioned based on the relationship of their respective foreign incomes that gave rise to the foreign tax, rather than the amount actually paid by each spouse.

¶ 16. For the purpose of claiming a foreign tax credit, an amount in respect of income taxes which is payable to a foreign government in a foreign currency should be converted to Canadian dollars at the rate at which the income itself (other than capital gains) was converted. For business income, this could be done monthly, quarterly, semi-annually or annually, using the average rate for the period, depending on the taxpayer's normal method of reporting income. For investment income which was subject only to a tax similar to that imposed by Part XIII of the Act, the conversion rate should be the rate applicable on the date of receipt of the income, although use of the average rate for the month or the mid-month rate would usually be acceptable. For other types of income, such as salaries and wages, the average rate for the months in which they are earned is the most appropriate rate. For capital gains, the rate should approximate the rate applicable at the time the gain was realized.

¶ 17. Fluctuations in the exchange rate may cause a difference between the following two amounts:

- the Canadian dollar equivalent of the amount of the foreign tax liability used for purposes of the foreign tax credit, as determined in accordance with ¶ 16; and
- the Canadian dollar equivalent of the amount (or amounts) paid, determined as of the date (or dates) of payment, in settlement of such foreign tax liability.

Any such difference will be a gain or loss on exchange to which (as in the case of a foreign exchange gain or loss on the payment of any other debt denominated in a foreign currency) the rules in subsection 39(2) apply.

¶ 18. If the taxpayer has overpaid the tax, the overpayment is not allowable as a foreign tax credit (see ¶ 11). The overpayment should be converted to Canadian dollars under the rules discussed in ¶ 16, and any difference between this figure and the Canadian dollar value of a refund of the overpayment, computed as of the day of its receipt, will be a gain or loss on exchange to which the rules in subsection 39(2) apply.

¶ 19. Evidence of payment of foreign tax is to accompany each return in which a foreign tax credit is claimed. If a taxpayer's foreign tax liability is settled by an amount withheld by the payer of the related income (i.e., analogous to tax under Part XIII of the Act), a copy of the foreign tax information slip is usually satisfactory. In most other cases, a copy of the tax return filed with the foreign government is required together with copies of receipts or documents establishing payment. The Canada Revenue Agency should be notified of any increase or decrease in the amount of foreign tax paid as a result of a subsequent assessment or reassessment thereof, and the rules discussed in ¶s 11, 16, 17 and 18 should be followed to the extent they are applicable). If the foreign assessment or reassessment results in additional foreign tax paid, proof of payment should be provided.

Foreign Business Income

¶ 20. The total amount of a taxpayer's income from businesses carried on by the taxpayer in a particular foreign country is included in the calculation of the numerator, FBI, in ¶ 2 with respect to that country. Amounts that could also be regarded as income from property are included in FBI as business income if such amounts arise in the course of the taxpayer's carrying on a business or businesses in the foreign business country. FBI cannot include income from carrying on a business in Canada (see the comments in ¶ 7, ¶ 23 and ¶ 24 with regard to the question of whether a business is carried on in Canada or in a foreign country).

"Tax-exempt income" cannot qualify for inclusion in the numerator, FBI, in ¶ 2. The comments in ¶ 21 regarding "tax-exempt income" for purposes of determining FNBI in ¶ 1 apply equally for purposes of determining FBI.

Foreign Non-Business Income

¶ 21. The numerator, FNBI, in ¶ 1 represents the taxpayer's income from sources in a particular foreign country, as calculated in accordance with subparagraph 126(1)(*b*)(i). The calculation made in subparagraph 126(1)(*b*)(i) is subject to certain assumptions and adjustments. One of these assumptions is that "**no businesses** were carried on by the taxpayer **in that country**." Although income from carrying on a business in Canada is not explicitly excluded from FNBI by that assumption, such income generally cannot be

included in FNBI because such income is not income from a source in a foreign country as required by subparagraph 126(1)(*b*)(i). Sections 3 and 4 reflect, among other things, that a business is a source of income for purposes of Part I of the Act. It follows that, for purposes of subparagraph 126(1)(*b*)(i), the location or locations where a business exists as a source of income is the location or locations where the business is carried on. Therefore, to the extent that income is derived from carrying on a business in Canada, it is considered to be income from a source in Canada, not income from a source in a foreign country, and thus it cannot be included in FNBI in ¶ 1.

Note: *Where income derived from carrying on a business in Canada is **interest** paid to the business by a person resident in a country other than Canada, and the business has paid a NBIT to that other country on the income, proposed paragraph 126(6)(d) will, if enacted as proposed, deem the income to be income from a source in that other country such that the income can be included in FNBI.*

Also, for purposes of granting a credit for foreign income taxes paid as referred to in an "elimination of double tax" article of an income tax treaty between Canada and a foreign country, what would otherwise be income from a source in Canada is deemed to be income from a source in that foreign country (see, for example, paragraph 3(a) of Article XXIV of the *Canada-United States Income Tax Convention (1980)*), that income is included in FNBI when calculating a foreign tax credit with respect to that country. For example, the net income derived from a loan made to a non-resident by a lending institution that is resident in Canada in the course of its business carried on in Canada can be included in FNBI if:

- such income is subject to income tax in the foreign country in which that non-resident resides; and
- such income is deemed, in the manner and for the purposes described above, by the income tax treaty between Canada and that country to be income from a source in that country.

"Tax-exempt income" cannot qualify for inclusion in the numerator, FNBI, in ¶ 1. According to its definition in subsection 126(7), "tax-exempt income" means income from a source in a country if two conditions are fulfilled in respect of that income:

(a) the taxpayer is entitled to an exemption, because of a tax treaty into which that country has entered, from all income or profits taxes, imposed in that country, to which the treaty applies; and

(b) no income or profits tax to which the treaty does not apply is imposed in any country other than Canada.

If, for example, a taxpayer resident in Canada is exempt from income or profits taxes levied by a foreign country because of a tax treaty but pays an income or profits tax to a political subdivision of that country (income tax treaties typically do not cover taxes levied by a political subdivision of a country), condition (b) above would not be fulfilled. As a result, the income on which the political subdivision's tax is paid would not be "tax-exempt income" and such income would qualify for inclusion in the numerator, FNBI in ¶ 1.

¶ 22. By virtue of subparagraph 126(1)(*b*)(i), a **corporation's** foreign non-business income (i.e., the corporation's numerator, FNBI, in ¶ 1) does not include income of the corporation from shares of the capital stock of a foreign affiliate of the corporation. (This is consistent with the fact that a corporation's foreign non-business-income tax in respect of such income does not qualify for purposes of a subsection 126(1) foreign tax credit—see FTP(NBIT) in ¶ 1, and also see ¶ 10.)

Unlike a corporation, an **individual's** foreign non-business income (i.e., the individual's numerator, FNBI, in ¶ 1) does include the individual's income from a share of the capital stock of a foreign affiliate (and the individual's "non-business-income tax" in respect of that income is not excluded from FTP(NBIT) in ¶ 1). Note that subparagraph 126(1)(*b*)(i) provides that a subsection 91(5) deduction will not be taken into account when calculating the foreign non-business income, i.e., will not have to reduce FNBI in ¶ 1.

Determination of the Location of a Source of Income

Business income

¶ 23. While a determination of the place where a particular business (or a part of the business) is carried on (i.e., the location of the **source** of the business income—see the comments in ¶ 21) necessarily depends upon all the relevant facts, such place is generally the place where the operations in substance take place. For the following particular types of business, the following factors (among others) should be given consideration:

- development and sale of real property – the place where the property is situated;
- merchandise trading – the place where the sales are habitually completed, but other factors, such as the location of the stock, the place of payment or the place of manufacture, are considered relevant in particular situations;
- trading in intangible property (e.g., stocks and bonds) – the place where the purchase or sale decisions are normally made;
- money lending – the place where the loan arrangement is in substance completed;
- personal property rentals – the place where the property available for rental is normally located;
- real property rentals – the place where the property is situated; and
- service – the place where the services are performed.

¶ 24. In the case of a single business comprising more than one of the above-mentioned activities, each activity is considered separately for purposes of determining in which

country or countries the business is carried on (this situation should not be confused with the situation in which the taxpayer has separate businesses—see the current version of IT-206, *Separate Businesses*). If, however, one activity of a business is clearly incidental to a predominant one, the incidental activity is not considered when determining in which country or countries the business is carried on. If a vendor of machinery, for example, provides to customers an engineer to supervise the installation of the machinery, this service would generally be considered to be incidental to the activity of selling the machinery; however, this type of service could in some cases be considered to be a significant activity on its own, depending on the machinery being sold, the nature of the installation service, and the terms of the contract with the customer.

If a business is carried on in more than one country, a reasonable proportion of the net income from the business must be allocated to each country. For this purpose, see the comments in ¶ 30 to ¶ 36 regarding the determination of net income from a source or sources in a particular foreign country.

Employment income

¶ 25. The location of the source of an individual's office or employment is considered to be the place where he or she normally performs the related duties. If those duties require the individual to spend a significant part of the time in a country other than Canada, the individual may be subject to tax in that foreign country on a portion of the remuneration. In such cases, an apportionment of the individual's regular salary or wages based on the number of working days spent in Canada, and in that other country, is usually considered appropriate in determining the foreign-source income from the employment for the purpose of the foreign tax credit calculation. Director's fees are generally considered to be earned where the director's meetings are held, and commission income is earned in the country in which the effort was expended for the purpose of gaining such remuneration.

Income from property

¶ 26. If interest is earned and the interest is income from property rather than income from business as in ¶ 20, the residence of the debtor ordinarily determines the location of the source of the income.

¶ 27. If a resident of Canada receives a dividend on shares of a corporation which is resident in a foreign country and not resident in Canada, the dividend will normally be recognized as being from a source in that foreign country. In determining a dividend-paying corporation's country of residence for purposes of the above, the possible impact of the following should be considered:

- the provisions, in an income tax treaty (if any) between Canada and the foreign country in question, that can determine the corporation's residence for the purposes of the treaty; and
- subsection 250(5), which (in conjunction with such a treaty) may deem the corporation to be not resident in Canada.

¶ 28. If income is derived from the rental of tangible property and the income is income from property rather than income from business as in ¶ 20 and ¶ 23, the location of the source of the income is considered to be:

- in the case of income from the rental of real property, the country where the property is located; and
- in the case of income from the rental of other tangible property, the country where the property is used.

¶ 29. The location of the source of a royalty payment is the country in which the related right is used or exploited. For example, a royalty payment received by a resident of Canada on the quantity of ore extracted from a mine situated in a foreign country is income from a source in that country. Or, for example, a royalty payment received by a resident of Canada from a resident of a foreign country, on a written work created in Canada and copyright-protected in that foreign country under its copyright laws, is income from a source in that foreign country.

Calculation of the Amount of Net Income From Sources in a Foreign Country

¶ 30. The income amounts that are used for FNBI in ¶ 1 and FBI in ¶ 2 are **net income** amounts determined in accordance with the provisions of the Act (see ¶ 31 to ¶ 34). Thus, all direct costs as well as reasonable allocations of overhead expenses must be deducted in calculating FNBI and FBI.

If an amount of foreign income or profits tax is deducted under subsection 20(11) or (12) and if income—from the same source as the source of the income to which that tax pertains—is included in FNBI (the numerator) in ¶ 1 with respect to the foreign country in question, the amount of that tax must also be deducted when calculating such FNBI. This rule—which has its basis in subsection 20(11) or (12), as the case may be, in conjunction with subsection 4(3) (see ¶ 33)—is consistent with the following rules:

- The amount deducted under subsection 20(11) or (12) is deducted when calculating WI(1) (the denominator) in ¶ 1. This is because a subsection 20(11) or (12) deduction is a deduction for purposes of calculating section 3 income.
- The amount deductible under subsection 20(11) or the amount deducted under subsection 20(12) is excluded from FTP(NBIT) in ¶ 1 (see ¶ 8(b) and ¶ 8(c)) with respect to the particular foreign country in question.

For a discussion of subsections 20(11) and (12), see the current version of IT-506, *Foreign Income Taxes as a Deduction From Income*.)

For purposes of calculating the net income amount to be used for FNBI in ¶ 1 or FBI in ¶ 2, the possible impact of an income tax treaty between Canada and the foreign country

should also be considered. In the case of a U.S. citizen who is resident in Canada, for example, see paragraphs 4, 5 and 6 of Article XXIV of the *Canada-United States Income Tax Convention (1980)*.

¶ 31. Income from sources in a foreign country is computed under the rules given in sections 3 and 4 of the Act, subject to the additional rules contained in subparagraphs 126(1)(*b*)(i) or 126(2.1)(*a*)(i), as the case may be. Thus, for purposes of calculating FNBI in ¶ 1 or FBI in ¶ 2 for a particular foreign country, amounts of net income or net loss from each applicable source in that country are added together or netted, as the case may be. Also, certain amounts in respect of taxable capital gains and allowable capital losses from sources in that country are taken into account when calculating FNBI (see the current version of IT-395, *Foreign Tax Credit – Foreign Source Capital Gains and Losses*).

¶ 32. The rules provided by section 4 apply to the calculation of the net income (or loss) from a particular source of income, or from sources of income in a particular place, for the purpose of (among other things) calculating a foreign tax credit under section 126. Subject to the specific rules contained in subsection 4(3) (see ¶ 33), each type of allowable deduction (including an outlay or expense) in arriving at a taxpayer's total income under section 3 is, theoretically, allocable in whole or in part to a source of income in a particular country. Ordinarily such an allocation can be made on the basis of a factual relationship between the particular deduction and the gross income arising from a source in a particular country. This is not always the case, however, and some types of deductions that frequently present apportionment problems are discussed in ¶ 35 and ¶ 36.

¶ 33. For purposes of a foreign tax credit under section 126, subsection 4(3) generally provides that all deductions permitted in computing a taxpayer's income for a taxation year for the purposes of Part I of the Act shall apply either wholly or in part to a particular source of income or to sources in a particular place. The reference to a "particular place" would, of course, include a place in a foreign country. However, subsection 4(3) contains some exceptions to this general rule. Each deduction in arriving at the taxpayer's total income under section 3 that is not specifically referred to in the exceptions in subsection 4(3) must be allocated on a **reasonable** basis among the sources of income, including those in foreign countries, to which that deduction can reasonably be said to apply. The deduction amounts allocated in this manner to income from a particular source in a particular foreign country must be deducted when calculating FNBI in ¶ 1 or FBI in ¶ 2, as the case may be, for that country.

¶ 34. An allocation of expenses to a source of gross income in a particular foreign country for financial statement purposes is normally accepted for the purpose of computing a foreign tax credit for that country, provided that the rules of subsection 4(3), as discussed above, are satisfied. Once a basis for allocation has been established, future allocations are expected to be made on a consistent basis.

¶ 35. Various methods of allocating interest expense to sources of income are accepted in particular situations. For example, a specific tracing method is appropriate when funds are borrowed and used for an identifiable purpose related to the earning of income in a particular country. For interest on a general purpose borrowing, an allocation based on relative net asset values in different countries may be appropriate in some cases. An allocation of interest expense based on the relationship of gross incomes in different countries is accepted only when a less arbitrary method is not readily evident. The location of property assigned as security for a borrowing is not necessarily an indication that the funds obtained were for the purpose of earning income from a source in the country in which the property is located.

¶ 36. The total amount of capital cost allowance claimed by a taxpayer for a taxation year must be allocated among the countries to which it relates. No such allocation can exceed the allowable maximum under Part XI of the *Income Tax Regulations* in respect of property situated in a particular country. In particular, the limitation in the case of "rental properties" must be respected on a country-by-country basis. Subject to these conditions, capital cost allowance deductions may be arbitrarily allocated to income sources in various countries.

Minimum Tax

¶ 37. If an individual who is subject to minimum tax under section 127.5 pays income or profits taxes to a foreign jurisdiction during a particular taxation year, that individual may not claim a foreign tax credit under section 126 as a deduction from the federal minimum tax payable for that year. However, section 127.5 provides for the deduction of a special foreign tax credit ("SFTC") in computing the federal minimum tax payable in this situation. The SFTC can be equal to, or in certain circumstances be greater than, the foreign tax credit to which the individual would normally be entitled under section 126. The SFTC, which is defined in subsection 127.54(2), is the greater of:

(a) the total of all tax credits deductible under section 126 from the individual's tax for the year, and

(b) the lesser of:
  - the individual's "foreign taxes" (as defined in subsection 127.54(1)) for the year; and
  - 16% (changed from 17%, for the 2001 and subsequent taxation years) of the individual's "foreign income" (as defined in subsection 127.54(1)) for the year.

"Foreign taxes" for a taxation year, as defined in subsection 127.54(1), may be described as the total "business-income tax" (see ¶ 8 and ¶ 9) paid by the individual for the year in respect of businesses carried on in foreign countries and two-thirds of the total "non-business-income tax" (see ¶ 7)

paid by the individual for the year to foreign jurisdictions. This calculation takes into account the fact that the provinces provide a foreign tax credit in respect of foreign taxes on foreign non-business income.

The SFTC can be claimed on form T691, *Alternative Minimum Tax*.

Addition to Taxable Income to Prevent Reduction to Foreign Tax Credit

¶ 38. In certain situations where a corporation would not otherwise be able to fully utilize—for purposes of claiming a foreign tax credit for a particular year—the foreign income or profits taxes that it has paid, section 110.5 may make it possible for the corporation to do so. Such a situation would occur, for example, if a loss for the year reduced the corporation's total income to an amount less than its foreign source income and the resulting CTOP(FNBI) were less than FTP(NBIT) in ¶ 1 or the resulting CTOP(FBI) were less than FTP(BIT) in ¶ 2. Section 110.5 allows a corporation to add any extra amount in computing its taxable income, to the extent that this causes an increase to any amount deductible by the corporation as a foreign tax credit under subsection 126(1) or (2) but does not cause any increase to certain other amounts deductible by the corporation (as referred to in section 110.5). The amount added under section 110.5 in computing taxable income is added in the calculation of the denominator, WI(1) in ¶ 1 or WI(2) in ¶ 2, as the case may be. (This is provided for in the adjustments in subparagraph 126(1)(*b*)(ii) and 126(2.1)(*a*)(ii), respectively).

Effective use of section 110.5 occurs when:

- the additional amount added in computing taxable income causes CTOP(1) in ¶ 1 or CTOP(2) in ¶ 2 to increase;
- this in turn causes CTOP(FNBI) in ¶ 1 or CTOP(FBI) in ¶ 2 to increase; and
- this in turn allows more or all of the FTP(NBIT) in ¶ 1 or the FTP(BIT) in ¶ 2 to be deducted as a foreign tax credit under subsection 126(1) or (2).

The amount added under section 110.5 in computing taxable income is also added in calculating the corporation's non-capital loss for the year, which may be carried over to and used in other taxation years (see the current version of IT-232, *Losses – Their Deductibility in the Loss Year or in Other Years*). In other words, the additional foreign taxes that are used in the year (in the form of an increase to the foreign tax credit for the year by means of section 110.5) are effectively converted into the potential for tax savings for other years by the creation of a non-capital loss (or increase to an existing non-capital loss) for the year that can be used in those other years.

Relief from Double Tax by Taxing on a Deferred Basis

¶ 39. Double taxation may occur if Canada and another country levy tax in different taxation years with respect to a particular transaction and the taxpayer thus cannot make proper use of the foreign tax credit provisions. (A foreign tax credit under section 126 must be in respect of foreign taxes paid "for the year"—see ¶ 11.) However, relief from such double taxation may be possible in some cases by means of a provision in a reciprocal tax treaty between Canada and the other country (see, for example, paragraph 8 of Article XIII of the *Canada-United States Income Tax Convention (1980)*) in conjunction with section 115.1 of the Act. Further particulars on this topic may be found in the current version of the following:

- IT-173, *Capital Gains Derived in Canada by Residents of the United States*;
- IT-420, *Non-Residents – Income Earned in Canada*; and
- Income Tax Information Circular 71-17, *Requests for Competent Authority Consideration Under Mutual Agreement Procedures in Income Tax Conventions.*

Tax Sparing

¶ 40. A tax treaty between Canada and a foreign country typically contains a provision (referred to here as the "double tax relief provision") under which Canada is required to give a resident of Canada (the "taxpayer") relief from double taxation by allowing a deduction, from the taxpayer's Canadian tax, in respect of tax (on profits, income or gains arising in the foreign country) payable by the taxpayer to the foreign country. The double tax relief provision typically is made subject to the laws of Canada regarding such a deduction from Canadian tax, i.e., the foreign tax credit rules in the Act. Such a double tax relief provision is contained, for example, in paragraph 1(a) of Article 24 of the *Canada-Cyprus Income Tax Convention (1984)* (the "Canada-Cyprus treaty"). The treaty may also contain a provision (the "tax sparing provision") under which, for purposes of the double tax relief provision, tax (on profits, income or gains arising in the foreign country) payable to the foreign country by the taxpayer is deemed or considered to include any such taxes (the "spared taxes") that would have been so payable if it had not been for an exemption from, or reduction of, tax having been granted (as specified in the "tax sparing provision"—see, for example, paragraph 2 of Article 24 of the Canada-Cyprus treaty). Such a tax sparing provision in a treaty generally causes the spared taxes to be taken into account—as if they had been paid to the foreign country—for purposes of calculating a foreign tax credit. (It may be possible in some cases for greater tax relief to be obtained in respect of the spared taxes—see the current version of IT-506, *Foreign Income Taxes as a Deduction From Income*, for further comments.)

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised interpretations of the CCRA.

Reasons for the Revision

This bulletin is being revised as a result of the following:

- a number of legislative changes since IT-270R2 was issued;
- a change in a CCRA position; and
- additional CCRA interpretations.

A number of the paragraphs of IT-270R2 contained detailed descriptions of the provisions of the Act that determine the calculation of a foreign tax credit. Legislative changes have, to a certain extent, rendered IT-270R2 inaccurate as far as such a detailed pure description of the law is concerned. Since the bulletin's main purpose is to provide interpretations regarding certain rules and requirements contained in the foreign tax credit provisions (including comments on how to apply those provisions in certain circumstances), the descriptions of the law have been significantly reduced in those cases where there was essentially no interpretative value therein. On the other hand, the amount of interpretative discussion has been expanded in the revised bulletin.

Legislative and Other Changes

In the current Act, the definitions of "business-income tax," "non-business-income tax," "tax for the year otherwise payable" and "unused foreign tax credit" are no longer contained in paragraphs 126(7)(*a*), (*c*), (*d*) and (*e*), respectively, but rather are found in alphabetical order in subsection 126(7). This restructuring of the Act is reflected in **¶ 1** and **¶ 2** (and also subsequent paragraphs) of the revised bulletin.

¶ 5 clarifies the statement in former ¶ 8 which read:

> Notwithstanding any of the foregoing guidelines, a tax that is specifically identified as being subject to the provisions of a comprehensive income tax treaty between Canada and a particular country automatically qualifies as an income or profits tax.

That statement was misunderstood as including capital taxes or estate taxes covered by a tax treaty.

¶ 5 (formerly ¶s 7 and 8), **¶ 7** (formerly ¶ 10) and **¶ 13** (formerly ¶ 15) contain new comments regarding a unitary tax of a state of the United States.

The last part of **¶ 6** makes reference to a provision that was added to the foreign tax credit rules to deem certain foreign oil and gas levies to be paid as an income and profits tax to a foreign jurisdiction.

In **¶ 7** (formerly ¶ 10), the discussion of section 253 has been discontinued as this provision of the Act has no application to the foreign tax credit rules.

¶ 8(b) and **¶ 8(c)** replace portions of former ¶ 11. The expanded comments in ¶ 8(b) and ¶ 8(c) are for purposes of clarification rather than because of any amendment to the legislation.

¶ 10 is a new paragraph which has been added to the bulletin to discuss a situation where U.S. taxes do not qualify for a non-business foreign tax credit because they are considered to be in respect of a corporation's income from shares of the capital stock of a foreign affiliate of the corporation.

¶ 11 (formerly ¶ 13) contains new comments regarding the following:

- the voluntary payment to a foreign jurisdiction of an amount that, according to the terms of an income tax treaty, cannot be levied as tax; and
- the meaning of the expression "for the year" in the foreign tax credit provisions.

¶ 20 replaces former ¶ 25. The final sentence in former ¶ 25 stated:

> In addition, income from a foreign source outside the particular foreign country is included so long as it is derived from the carrying on of a business in that country.

That sentence is not continued in ¶ 20 of the revised bulletin in view of the new position in ¶ 21.

¶ 21 replaces former ¶ 24 which read:

> As with the definition of non-business-income tax (see 11 above), non-business income from a foreign country is defined by exclusion in subparagraph 126(1)(*b*)(i). Thus, all foreign source income that is not excluded by clause 126(1)(*b*)(i)(C), D or (E) is considered to be foreign non-business income. Since foreign-source income resulting from a business carried on in Canada is not excluded, such income can be included in the numerator of the fraction described in paragraph 126(1)(*b*) (see 23 above). For example, the net income derived from a loan made to a non-resident by a lending institution in the course of its business carried on in Canada is included in the numerator.

¶ 21 contains a new position whereby the location of the source of income from carrying on a business is considered to be the location where the business is carried on. Therefore, to the extent that income is from carrying on a business in Canada, it cannot be included in foreign non-business income because it is income from a source in Canada, not income from a source in a foreign country. Proposed paragraph 126(6)(d) provides an exception to this rule for interest payments that are included in a taxpayer's income as income from a business carried on in Canada.

Such payments are deemed to be sourced in the country where the payer is resident for Canadian foreign tax credit purposes. Another exception occurs, as explained in ¶ 21, if the income is deemed by a treaty provision to have its source in a foreign country, in which case it can qualify for inclusion in foreign non-business income. The new position in ¶ 21 will apply to all agreements entered into, loans made or indebtedness arising after December 31, 2005.

¶s 20 and **21** contain comments regarding "tax-exempt income". This term was added to the foreign tax credit rules for purposes of determining amounts that do not qualify for inclusion in the numerators, FNBI and FBI (referred to in ¶s 1 and 2, respectively).

We have clarified **¶ 22** (formerly ¶ 3), by indicating that a subsection 91(5) deduction will not be taken into account when calculating foreign non-business income.

In **¶ 24** (formerly ¶ 27), we have modified our position that providing engineering services for the installation of machinery, in a business in which that machinery is sold, is an incidental activity. We have added a comment to the effect that providing such a service could in some cases be a significant activity on its own, depending on certain factors.

¶ 26 replaces former ¶ 29. The change to the first sentence as well as the discontinuance of the remainder of former ¶ 29 are the result of the new position in ¶ 21.

¶ 27 replaces former ¶ 30. The last two sentences of former ¶ 30 are not continued in ¶ 27 because the situation they deal with would rarely occur. Also, we have added a comment in ¶ 27 regarding the possible impact of:

- an applicable income tax treaty provision; or
- subsection 250(5).

¶ 28 replaces former ¶ 31. The change to the first sentence is the result of the new position in ¶ 21.

In **¶ 29** (formerly ¶ 32), the examples have been clarified.

In **¶ 30** (formerly ¶ 33), we have added a discussion regarding the effect of a deduction under subsection 20(11) or (12) on the calculation of the numerator (FNBI) in a non-business foreign tax credit calculation. In the case of subsection 20(12), an amendment thereto made this rule possible.

In **¶ 30**, we have also added comments regarding the possible impact of an income tax treaty.

¶ 33 (formerly ¶ 36) reflects an amendment to subsection 4(3) whereby it can allocate a deduction wholly to a particular source of income.

¶ 37 (formerly ¶ 41) reflects the rate revision from 17% to 16% in subparagraph 127.54(2)(*b*)(ii).

¶ 40 is a new paragraph which has been added to the bulletin to discuss the topic of "tax sparing".

Former ¶ 42 is not continued in the new bulletin because of the repeal of the Part I.1 individual surtax.

A number of other changes have been made in the revised bulletin for purposes of clarification and readability.