APPLICATION OF FAD EXCEPTIONS FOR A COMMON SR & ED STRUCTURE

The foreign affiliate dumping (FAD) rules in section 212.3 of the ITA are a potential concern whenever a corporation resident in Canada (CRIC) that is controlled by a non-resident is investing in a foreign affiliate (FA). There are, however, commercially sensible structures that can fit into exceptions within the FAD rules. This is particularly the case in the technology sector, where accessing scientific research and experimental development (SR & ED) tax credits is a key consideration.

A common form of such commercially sensible structures involves a non-resident parent establishing a CRIC that is primarily dedicated as a research and development (R & D) cost centre, the activities of which qualify for SR & ED tax credits. A key qualifying condition for SR & ED tax credits is that the activities carried on must meet certain requirements—see, for instance, *Northwest Hydraulic Consultants* (1998 CanLII 553 (TCC)), which elaborates on the definition of SR & ED in subsection 248(1). A carefully managed CRIC will distinguish between activities that likely qualify for SR & ED tax credits and activities that likely do not (for example, design or routine development work that is not incidental to the performance of SR & ED). For commercial reasons, such as cost control, management may prefer that non-SR & ED qualifying activities be performed outside Canada by an FA of the CRIC, under the CRIC's direction and in support of the CRIC's primary research in Canada.

The funding of the FA may involve the CRIC lending or contributing capital to the FA. The question whether such capital injection by the CRIC will be subject to the FAD rules needs to be considered. Provisions granting relief from the FAD rules are available if exceptions under paragraph 212.3(10)(c) are met. In addition, as explained below, the CRIC and the FA may meet the "more closely connected" test under subsection 212.3(16). These rules are highly fact-specific and restrictive, and they add complexity—see CRA document no. 2013-0483751C6 (May 23, 2013). Nonetheless, in our experience, a CRIC with the fact pattern described above can often satisfy the subsection 212.3(16) conditions.

At the time of the investment in the FA, the CRIC can meet the "more closely connected" exception provided that all three of the following fact-specific conditions in paragraphs 212.3(16)(a), (b), and (c) are satisfied:

a. The business activities of the CRIC and the FA are closely related, and there exists no other non-resident corporation (or other non-resident persons not dealing at arm's length with the CRIC) with which the FA's business activity is more closely related. Note that conducting R & D should be considered "business activities." In the simplest example, the CRIC is the primary centre of the multinational group's R & D, and the FA's sole activities would be those that support the R & D work of the CRIC. In that situation, the FA's business activities would indeed be more closely related to the CRIC's activities than to those carried out by any other entities of the multinational group.
   Ideally, it can be shown that the CRIC would have made the same investment in the FA even if it was not controlled by a non-resident parent.
b. The officers of the CRIC must have, and must exercise, the principal decision-making authority with respect to the investment in the FA, and the majority of those officers must be resident in and working principally in Canada or where the FA is resident. This is often the case when the research work is principally managed in Canada.
c. It is reasonable to expect that those officers will have and will exercise the ongoing principal decision-making authority in respect of the investment, and that the performance evaluation and compensation of the officers who are resident in and working principally in Canada will be based on the results of the FA's operations to a greater extent than will be the performance evaluation and compensation of any officer of a non-resident corporation (other than the FA) that does not deal at arm's length with the CRIC. In the context under consideration, this test can often be met because the FA supports and reports to the CRIC, and thus it is typically the case that the evaluation and remuneration of the CRIC's officers will be based on the FA's results more than will be the evaluation and remuneration of the officers of other entities in the multinational group.

Alternatively, if the FA cannot meet the closely connected business exception in subsection 212.3(16), or if there is any risk that the exception may not be met, the CRIC can consider structuring the injection into the FA as a pertinent loan or indebtedness (PLOI) by electing under subsection 212.3(11), so that the loan, by virtue of subparagraph 212.3(10)(c)(ii), is not considered an investment for the purposes of the FAD rules. According to subsection 17.1(1), the CRIC will be subject to an interest income inclusion, with the interest rate determined under regulation 4301(b.1). Recent increases to the prescribed rate mean that this approach can represent a material tax cost; however, depending on the strength of the group's position with respect to subsection 212.3(16), it may be a prudent precautionary measure.

Although a technology business has been used to illustrate the FAD exceptions, businesses in other sectors could benefit from these exceptions in a similar manner—for example, in circumstances where the CRIC is the manufacturing centre of the multinational group, and its FA supplies parts to the CRIC's Canadian manufacturing operations.

Balaji (Bal) Katlai
Baker Tilly WM LLP, Toronto

Kenneth Keung
Moodys Tax, Calgary

International Tax Highlights
Volume 2, Number 1, February 2023
©2023, Canadian Tax Foundation and IFA Canada

Copyright © Advanced Solutions International.