

# International Financial Centre British Columbia

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## Abstract

British Columbia offers a tax incentive to companies that do international business. Under the International Financial Activity Act (IFAA), the legislation governing the tax incentive, a registered company can receive a refund of up to 100 percent of BC corporate taxes paid on income earned from qualifying activities, thus reducing its effective tax rate by 10.5 percent in 2010. Qualifying employees of registered companies are also eligible for personal tax benefits.

The author discusses qualifying activities, applicable rulings and interpretations, and registration and compliance requirements. British Columbia's 2010 budget, tabled on March 2, 2010, expanded the IFAA to include digital media and publishing, certification and trading of carbon credits, and clean technology, as well as fund investment management and administration. Changes to the IFAA resulting from the 2010 budget are noted in the paper and summarized in the addendum.

**Keywords** International; financial; British Columbia; international finance; international banking; international financial centre.

## The International Financial Activity Program

The International Financial Centre British Columbia (IFC BC) is in the business of marketing British Columbia as a location for investment. One of the key promotional tools is a unique tax incentive known as the International Financial Activity (IFA) program. The legislative framework for the IFA program is the

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International Financial Activity Act (IFAA) of 2004.<sup>1</sup> Under the IFAA, companies registering an international financial business (IFB) with British Columbia receive a refund of up to 100 percent of provincial corporate income taxes paid on income earned from a qualifying international business.

The BC provincial corporate tax rate was reduced to 10.5 percent effective January 1, 2010 and is scheduled to drop to 10 percent in 2011. A corporation registered in the IFA program generally will pay only the federal corporate income tax rate on its qualifying IFB income.<sup>2</sup> The current (2010) federal rate of 18 percent will be reduced to 15 percent in 2012. At 15 percent, the corporate tax rate on qualifying IFB income will be competitive with rates in effect in other international financial centres such as Singapore and Hong Kong.<sup>3</sup>

Personal tax benefits are also available to employees of registered companies: certain employees who were previously non-residents of Canada can receive a refund of up to 75 percent of provincial taxes paid on employment income earned in the qualifying business for up to five years. For such income over approximately \$127,000, the marginal tax rate (federal and BC combined) is 32.675 percent (instead of the normal top BC marginal rate of 43.7 percent). (The 2010 budget proposed to change the refund amount to 100 percent in years 1 and 2; to 75 percent in year 3; to 50 percent in year 4; and to 25 percent in year 5. Therefore, the top marginal tax rate for specialists would be 29.0 percent in years 1 and 2; 32.675 percent in year 3; 36.35 percent in year 4; and 40.025 percent in year 5. See paragraph no. 4 of the addendum to this paper.)

Through the IFA program, British Columbia offers the global corporate community an opportunity to increase profitability by carrying out functions in an onshore location with a competitive tax structure but without the associated costs and risks of doing business in an offshore economy.

## **Background**

In 1986, the federal government established International Banking Centres (IBCs) by amending section 33.1 of the Income Tax Act<sup>4</sup> to encourage the repatriation of non-resident loans booked in low-tax jurisdictions. While the amendment was limited in both application and interpretation, at the time it seemed to make sense, given the growth of what were then commonly known as offshore banking centres.

British Columbia was dissatisfied with the limited activities permitted under the federal IBC provisions. In 1988, the province implemented its own legislation, the International Financial Business (Tax Refund) Act,<sup>5</sup> which established a range of financial activities that, if transacted internationally, would be free of provincial corporate income tax. All financial institutions, including securities firms and asset management firms, were encouraged to apply, but many believed the legislation to be too restrictive. In 2004, the IFAA replaced the International Financial Business (Tax Refund) Act.

## The IFAA

The IFAA broadened the scope of the International Financial Business (Tax Refund) Act by basing eligibility on a corporation's activities rather than on its type. Now any organization—not only financial institutions—can take advantage of the tax incentive by locating its IFB in British Columbia. In addition:

- An IFB can be established in any location in British Columbia, not only in Vancouver.
- Most non-arm's-length, as well as arm's-length, transactions are allowed.
- Financial activities carried out for, with, or on behalf of a non-resident include loans and deposits, dealing in securities, providing financial advice, managing foreign exchange, managing investments, preparing financial research, factoring, leasing, and insurance.
- The IFAA extends beyond financial activities to include distributing film and television outside Canada; providing administrative support services related to an international financial activity; providing backup services; and selling, assigning, or licensing to a non-resident a life science or green-related patent, or selling to a non-resident a good or service whose sales revenue is principally derived from an invention for which a life science or green-related patent has been issued. (The 2010 budget proposed to add new activities of distribution and publishing of digital media, clean technology, and certification and trading of carbon credits. See paragraph no. 1 of the addendum to this paper.)

## 2008 and 2009 Changes to the IFAA

In 2008 and 2009, the IFAA was amended as follows:

- 1) The list of allowed patents was expanded to include patents related to wastewater treatment and fuel cell technology (2009).
- 2) The requirement that companies notify the province within 90 days of an amalgamation was relaxed to give the Commissioner of Income Tax discretion to accept late notifications when there is an amalgamation between a registered company and a non-registered company (2009).
- 3) Prescribed management services directly related to the business operations of a non-resident were added. These include strategic management and human resource services provided by the head office of the corporation (2008). (The 2010 budget proposed to repeal management services as a qualifying activity and to add executive specialists earning \$250,000 or more. See paragraph no. 5 of the addendum to this paper.)
- 4) Non-securities corporations can trade in money market investments with a non-resident (2008).

- 5) Non-securities corporations can include income or loss from certain currency-hedging transactions that is incident to a qualifying activity in determining IFB income (2008).
- 6) The list of eligible patents that can be exploited under the IFAA includes patents with classifications under the International Patent Classification System related to power generation using forces of nature such as wind, solar, and tidal energy (2008).

## Qualifying Entities

Section 9 of the IFAA lists the requirements for eligibility:

(1) A corporation that meets all of the following requirements may apply to the commissioner for registration:

(a) the corporation was incorporated in Canada and, since that incorporation, has not been continued, amalgamated or otherwise transferred by a similar process into a foreign jurisdiction;

(b) the corporation must have a permanent establishment in British Columbia;

(c) the corporation must not be exempt under section 27 [exemptions] of the Income Tax Act from paying tax under that Act;

(d) any other prescribed requirements [to date no other requirements have been prescribed].

(2) The corporation must submit to the commissioner

(a) an application for registration in the form and containing the information required by the commissioner,

(b) with the application, any other information or records required by the commissioner, and

(c) with the application, the prescribed fee [the prescribed fee is currently set at \$5,000].

The conditions of maintaining registration are listed in section 11 of the IFAA:

(1) A registered corporation must do all of the following:

(a) continue to meet the requirements of section 9(1)

(b) subject to subsection (2), continue to carry on an international financial business;

(c) subject to subsection (3), remain a member of the Society.

(2) If the corporation does not carry on an international financial business on the date the corporation is registered, the corporation must establish an international financial business within 90 days after the date the notice of registration is served on the corporation.

(3) If the corporation is not a member of the Society on the date the corporation is registered, the corporation must become a member of the Society within 90 days after the date the notice of registration is served on the corporation.

Eligibility is limited to corporations; partnerships do not qualify. Nevertheless,

a registered corporation that carries on an IFB through a partnership may be eligible for a tax refund under the IFA Act. The income or loss from the IFB that is carried on through a partnership would be included in calculating that corporation's IFB income, as determined under Subdivision b of Division B of Part I of the federal Act.<sup>6</sup>

Therefore, in order for all of the IFB income of a partnership to qualify, each of the partners must be a corporation separately registered under the IFAA.

A permanent establishment in British Columbia is required. The company must become a member of the IFC BC, referred to in the legislation as "the Society." The mandate of the IFC BC is to promote British Columbia as a location for investment and to encourage corporations and individuals to take advantage of the favourable tax treatment available under the IFAA. The IFC BC is primarily funded by members that access benefits under the IFA program. At present, IFC BC's annual membership fees are \$1,000 plus a 0.45 percent participation assessment on IFB income. The maximum assessment is \$80,000. For organizations whose benefits under certain patent provisions are limited to 75 percent of the normal refund, the participation assessment fee is prorated at 75 percent of the above amount, with an upper limit of \$60,000.

### **IFB Defined**

"International financial business" is defined in section 1 of the IFAA:

"[I]nternational financial business," in relation to a corporation, means a business

- (a) that is a qualifying business carried on by the corporation through a fixed place of business in British Columbia, and
- (b) all the activities of which are international financial activities.

"Qualifying business" is defined in section 1.1(1) of the International Financial Activity Regulation:<sup>7</sup>

1.1(1) In the Act, qualifying business, in relation to a corporation, means

- (a) an active business carried on by the corporation,
- (b) a business carried on by the corporation
  - (i) that is separate from another business that is an active business carried on by the corporation,
  - (ii) for which the income or loss of the business is principally income or loss from a source that is property, and
  - (iii) for which the income or loss of the business does not include the income or loss from any source that is property that
    - (A) is incident to the active business carried on by the corporation, or
    - (B) is used or held principally for the purpose of gaining or producing income from the active business carried on by the corporation, or

- (c) a business carried on by the corporation if that corporation
  - (i) is affiliated with or not dealing at arm's length with another corporation that carried on an active business,
  - (ii) at the particular time for the purposes of this Act, has capital employed<sup>[8]</sup> in British Columbia in an amount equal to or greater than \$10,000,000 and
  - (iii) for the particular taxation year, paid salary and wages to employees of the corporation employed in the active conduct of the business in British Columbia in an amount equal to or greater than
    - (A) \$300,000, or
    - (B) if the taxation year is less than 365 days, the amount that is that proportion of \$300,000 that the number of days in the taxation year bears to 365.

The definition of “international financial business” implies that the business must be wholly composed of activities that qualify as international financial activities. The Ministry of Finance interprets this requirement as defining the IFB as comprising only the activities that are international financial activities.<sup>9</sup> In other words, if a corporation carries on a business that has both qualifying international financial activities and activities that do not qualify as international financial activities, the IFB is considered to be a separate business and will be composed of only the portion of the business that comprises the qualifying international financial activities. This will require the apportionment of expenses that may be applicable to both the qualifying and the non-qualifying activities.

The IFB will be a “qualifying business” under paragraph (a) of the definition if it is an “active business” as defined in subsection 248(1) of the federal Income Tax Act. If the business is an active business, there is no requirement for a minimum number of employees, nor is it necessary to meet the “substantial presence” test outlined in paragraph (c).

Paragraph (b) of the definition deals with the situation in which the IFB generates property income. The property income must be from a business separate from the active business. It must not be incident to the active business, and it must not be used or held principally for the purpose of earning income from the active business. Therefore, the IFB income cannot be from the temporary investment of surplus funds earned in the active business, and it cannot be used to finance the active business.

On the other hand, the investment of excess funds from an active business, which are clearly surplus to the needs of an active business, may be a qualifying business. However, the requirement under paragraph (b) requires that the property income be a separate “business.” Therefore, the income from property must have sufficient activity associated with the revenue source to rise to the level of being from a specified investment business, separate from the active business.

The case law, which determines whether an activity carried on by a corporation is considered to be a business, has generally concluded that a corporation is incorporated to carry on a business, and thus its income is normally presumed

to be from a business.<sup>10</sup> Nevertheless, the Ministry of Finance is generally of the view that the investment of surplus cash from an active business must have a significant degree of activity in order to be considered a business and therefore a qualifying business. (The 2010 budget proposed that lending activities must be arm's-length to qualify. See paragraph no. 9 of the addendum to this paper.)

Paragraph (c) of the definition contains the "substantial presence" test. This provision allows a business that is not, in and by itself, an active business to be a qualifying business if the corporation that carries on the business is affiliated with or is not dealing at arm's length with another corporation carrying on an active business. In this situation, the corporation must have a "substantial presence" in British Columbia by virtue of having share capital of \$10 million or more employed in British Columbia and by paying salary and wages of \$300,000 or more to employees in British Columbia.

The introduction of the "substantial presence" test was intended to broaden the IFB definition of "qualifying business" to clarify that certain types of income from property involving qualifying activities could qualify as IFB income. Nevertheless, the Ministry of Finance's interpretation of the "substantial presence" test still gives rise to considerable uncertainty about whether certain income from property can qualify as IFB income. Many practitioners believe that if the capital and salary requirements are met, the income from property will be considered to be income from a qualifying business. This may not necessarily be the case, since paragraph (c) requires that the activity of earning income from property meet the requirements for a business carried on by the corporation.

Section 1 of the IFAA defines "business" by reference to section 248 of the federal Income Tax Act as "a profession, calling, trade, manufacture or undertaking of any kind whatever" (but the IFAA excludes an undertaking that is an adventure or concern in the nature of trade). It is understood that the Ministry of Finance believes that many passive investment activities would not have sufficient activity to qualify as a business despite meeting the salary and capital requirements of the "substantial presence" test. Since the "substantial presence" test was introduced only in 2008, it may be advisable to seek a ruling or technical interpretation on any specific proposed set of facts.

## **Qualifying International Financial Activities**

### **Loans and Deposits**

Sections 2(2)(a) to (d) of the IFAA set out the following as qualifying international financial activities:

- (a) accepting deposits in any currency
  - (i) from a non-resident person, or
  - (ii) in respect of a prescribed business from a person carrying on the business;
- (b) making deposits in any currency
  - (i) with a non-resident person, or

- (ii) in respect of a prescribed business with a person carrying on the business;
- (c) making loans in any currency
  - (i) to a non-resident person, or
  - (ii) in respect of a prescribed business to a person carrying on the business;
- (d) borrowing in any currency
  - (i) from a non-resident person, or
  - (ii) in respect of a prescribed business, from a person carrying on the business.

The prescribed businesses are defined in section 4(1) of the IFA regulation as follows:

For the purposes of section 2 (2) (a) to (d) of the Act, the following are prescribed businesses:

- (a) an international financial business of any other registered corporation;
- (b) an international banking centre business designated under section 33.1(3) of the federal Act;
- (c) an international financial centre as defined in *An Act Respecting International Financial Centres* (Quebec).

Loans can be made to and deposits accepted from individuals, corporations, financial institutions, governments, trusts, and estates, provided that one party to the transaction is a non-resident. Loans to a non-resident are considered to be a financial activity. (The 2010 budget proposed that lending activities must be arm's-length to qualify. See paragraph no. 9 of the addendum to this paper.)

International financial transactions often involve the movement of funds by such means as the Society for Worldwide Interbank Financial Telecommunication (SWIFT) and other services that facilitate automatic payments of, or the collection of foreign payments from, foreign accounts. A technical interpretation (not yet published) addressed the question of whether effecting payment to a Canadian company's foreign suppliers by depositing amounts directly into the suppliers' non-resident accounts qualified under section 2(2)(b). The technical interpretation also addressed the question of whether services provided to a Canadian resident that facilitated the receipt of funds from non-residents and deposited those funds into a Canadian bank account was a qualifying activity under section 2(2)(a). In the view of the Ministry of Finance, such services would not be qualifying financial activities because sections 2(2)(a) and 2(2)(b) are applicable only to services provided to non-residents.

## **Loan Guarantees**

Section 2(2)(e) of the IFAA includes the following as a qualifying financial activity:

(e) guaranteeing the payment of a debt if all of the debtors or creditors are non-resident persons.

“Guaranteeing the payment of a debt will qualify as an international financial activity only if either all of the debtors or all of the creditors of each debt are non-residents.”<sup>11</sup> These activities are often part of a business of providing trade financing in respect of imports or exports and can also be a key part of an intra-group treasury function. It appears that the practice of discounting letters of credit issued by non-resident banks by banks or brokerage firms should be a qualifying financial activity under section 2(2)(g)(i)(A) (making an agreement to acquire the letter of credit security from a non-resident).

### **Letters of Credit and Documentary Collections**

Section 2(2)(f) of the IFAA includes the following as a qualifying financial activity:

- (f) [I]f the corporation is a savings institution,
- (i) issuing and accepting letters of credit, or
  - (ii) handling documentary collections,
- in respect of a transaction of which not more than one party is resident in Canada.

For this international financial activity, there is an arm’s-length requirement. Section 2(3) of the IFAA provides as follows:

An activity referred to in subsection (2)(f) . . . is not an international financial activity unless the corporation carries on the activity for, with or on behalf of a person who is dealing at arm’s length with and who is not affiliated with the corporation.

“Savings institution” is defined in the BC Interpretation Act<sup>12</sup> and means

- a bank,
- a credit union,
- an extraprovincial trust corporation authorized to carry on deposit business under the Financial Institutions Act, and
- a corporation that is a subsidiary of a bank and is a loan company to which the Trust and Loan Companies Act (Canada) applies.<sup>13</sup>

### **Securities Dealing**

Section 2(2)(g) of the IFAA includes the following as qualifying international financial activities of a corporation:

- (g) acting
  - (i) if the corporation is a securities corporation,
    - (A) as principal in making or offering to make with a non-resident person an agreement for acquiring, disposing of, subscribing for or underwriting securities, or
    - (B) as agent for a person resident in Canada in making or offering to make with a non-resident person an agreement for acquiring, disposing of, subscribing for or underwriting securities, except securities that are listed on a stock exchange prescribed in section 3200 of the Income Tax Regulations (Canada),
  - (ii) if the corporation is not a securities corporation, as principal in making or offering to make with a non-resident person an agreement for acquiring or disposing of prescribed securities, or
  - (iii) as agent for a non-resident person in making or offering to make with a person resident in Canada or another non-resident person an agreement for acquiring, disposing of, subscribing for or underwriting securities.

“Prescribed securities” are defined in the IFA regulation as short-term debt instruments other than derivatives.<sup>14</sup>

Activities in respect of a company’s own securities or those of its affiliates do not qualify, pursuant to section 2(5) of the IFAA:

An activity referred to in subsection (2)(g) is not an international financial activity if the corporation is acting in respect of securities of the capital stock of

- (a) the corporation, or
- (b) a person affiliated with the corporation.

A non-resident broker can be substituted for a non-resident person, pursuant to section 2(6) of the IFAA:

For the purposes of subsection (2)(g)(i) and (ii), if a corporation is acting as principal or agent in making or offering to make an agreement referred to in that subsection with a non-resident broker acting as agent for another person, the non-resident broker is deemed to be the non-resident person.

Section 2(1) of the IFAA defines a “non-resident broker” as follows:

“[N]on-resident broker” means a non-resident person who

- (a) is authorized under the laws of a foreign jurisdiction to trade in securities as principal or agent,
- (b) is not registered under the *Securities Act* and is not authorized under a similar law of another province to trade in securities as principal or agent, and
- (c) is not related to a corporation that is registered under the *Securities Act* or authorized under a similar law of another province to trade in securities as principal or agent.

Section 1 of the IFAA defines a “securities corporation” as follows:

“[S]ecurities corporation” means

- (a) a savings institution,<sup>[15]</sup> or
- (b) a corporation registered under the *Securities Act* as a dealer or underwriter.

When the dealer is a securities corporation, section 2(2)(g)(i) deals with two cases: (1) the securities corporation acting as principal, and (2) the securities corporation acting as agent for a resident of Canada. Acting as agent for a non-resident of Canada is covered in section 2(2)(g)(iii).

When a securities corporation, which is registered, acts as principal, the IFB includes securities transactions with non-residents. The corporation can therefore acquire, dispose of, subscribe to, or underwrite securities with a non-resident. The only restriction on transactions of this nature is that it cannot trade its own stock or the stock of an affiliate.

When the securities corporation, which is registered, acts as agent or broker for a Canadian resident, the IFB will include securities transactions with non-residents. The corporation can acquire, dispose of, subscribe to, or underwrite securities with a non-resident on behalf of a Canadian resident, but only securities that are not listed on a prescribed Canadian stock exchange will qualify. The prescribed stock exchanges are tiers 1 and 2 of the TSX Venture Exchange (also known as tiers 1 and 2 of the Canadian Venture Exchange), the Montreal Stock Exchange, and the Toronto Stock Exchange.<sup>16</sup> A non-resident broker can be substituted for a non-resident person and thus fulfill the requirement that one party to the transaction be a non-resident.<sup>17</sup>

When the dealer is not a securities corporation:

- 1) Section 2(2)(g)(ii) qualifies a non-securities corporation acting as principal and dealing in prescribed securities with a non-resident. Securities are defined by the IFA regulation as “short-term debt securities other than derivatives.”<sup>18</sup>
- 2) A non-resident broker can be substituted for a non-resident person and thus fulfill the requirement that one party to the transaction be a non-resident.<sup>19</sup>

When the corporation acts as agent for a non-resident:

- 1) Section 2(2)(g)(iii) applies to all securities and non-securities corporations. In this case, the IFB includes transactions in securities with a resident or a non-resident.
- 2) Section 2(2)(g) deals with all of the combinations of securities transactions. Subject to some limitations, as long as a non-resident or a non-resident broker is involved in some aspect of the transaction, the securities transaction will be an international financial activity.

Therefore, under section 2(2)(g)(ii), a corporation that is not a securities corporation can acquire short-term debt securities such as treasury bills from a non-resident broker. To the extent that this transaction is part of a qualifying business, it is a qualifying activity. (See the discussion below under the heading, “Examples—Investment of Surplus Funds.”)

## Insurance

Section 2(2)(h) of the IFAA provides that the following is an international financial activity of a corporation:

- insuring or reinsuring prescribed risks
  - (i) of, or relating to, non-resident persons, and
  - (ii) relating to property situated or events occurring outside of Canada.

“Prescribed risks” are defined by section 4(3) of the IFA regulation:

For the purposes of section 2(2)(h) of the Act, prescribed risks are any risks that fall within any class of insurance defined under the *Insurance Act*, except life, sickness or accident insurance.

For this international financial activity, an arm’s-length requirement applies:

An activity referred to in subsection (2)(f), (h) . . . is not an international financial activity unless the corporation carries on the activity for, with or on behalf of a person who is dealing at arm’s length with and who is not affiliated with the corporation.<sup>20</sup>

The arm’s-length restriction does not apply to captives<sup>21</sup> registered under the Insurance (Captive Company) Act.<sup>22</sup> The earning of insurance premiums by a captive insurance company may be eligible as a qualifying financial activity under the IFAA. British Columbia is the only province in Canada that has captive insurance legislation (the Insurance (Captive Company) Act). Therefore, an organization can set up a captive insurance company under BC regulatory requirements and may obtain the benefits of the IFAA on insuring offshore risks of, or relating to, non-resident persons. (See the discussion below under the heading “Examples—Captive Insurance.”)

## Financial Advice

Section 2(2)(i) of the IFAA provides that the following is an international financial activity of a corporation:

- (i) providing financial advice, other than prescribed financial advice, to non-resident persons.

Certain financial advice does not qualify because it is prescribed by section 4(4) of the IFA regulation:

For the purposes of section 2(2)(i) of the Act, prescribed financial advice is legal, accounting or tax advice provided by a corporation in the business of providing that advice.

Assuming that a registrant is not in the business of providing legal, accounting, or tax advice, the provision of financial advice qualifies, including advice provided by a company's legal, accounting, and tax departments, as long as one party to the transaction is a non-resident.

The term "financial" implies a relationship to the management of money and other assets of a business system, including the "acquisition and allocation of those resources."<sup>23</sup>

According to the Ministry of Finance, financial advice includes a recommendation or an opinion offered regarding a course of action. Whether other activities that are not inherently financial, such as providing legal advice (and presumably tax advice), qualify under the IFAA will depend on whether the activity provides financial advice.<sup>24</sup>

## Foreign Exchange

Sections 2(2)(j) and (k) of the IFAA provide that the following is an international financial activity of a corporation:

- (j) dealing in foreign exchange other than on the corporation's own account, if the corporation is
  - (i) a savings institution,
  - (ii) a corporation whose primary business is dealing in foreign exchange, or
  - (iii) a prescribed corporation [to date, no corporations have been prescribed];
- (k) managing, for a fee or commission, foreign exchange activities for non-resident persons.

An arm's-length requirement applies to section 2(2)(j)(ii) (a corporation whose primary business is dealing in foreign exchange).<sup>25</sup> There is no arm's-length requirement for the managing of foreign exchange activities.

If the IFA registrant is a bank, a credit union, a trust company, or a corporation whose primary business is dealing in foreign exchange, dealing in foreign exchange transactions with Canadian residents is a qualifying activity. This is one of the few qualifying activities in which the counterparty to the transaction can be a Canadian resident. For other types of registrants, only foreign exchange transactions with non-residents will qualify.

## Investment Management

Sections 2(2)(l) and (m) of the IFAA provide that the following are international financial activities of a corporation:

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

Fund management or administration of foreign-based funds may qualify as an international financial activity. Therefore, the fees or commissions of managers of private equity funds, venture capital funds, hedge funds, mutual funds, and other types of investment funds will qualify as long as the investment fund is considered to be a non-resident person. Many international funds for international investors are structured as a form of partnership in order to allow any tax consequences to flow directly through to the investor. Under section 2(1) of the IFAA, for the purposes of determining qualifying activities, a non-resident person does not include a partnership unless all of the partners are non-resident persons. Therefore, if an international limited partnership fund has one Canadian-resident partner, all of the fees or commissions will be considered to be from a Canadian resident.

With respect to the managing of investments for residents of Canada, only fees or commissions earned in respect of managing foreign securities can qualify.

Foreign securities must be issued by a non-resident and not listed on a prescribed exchange (tiers 1 and 2 of the TSX Venture Exchange, also known as tiers 1 and 2 of the Canadian Venture Exchange; the Montreal Stock Exchange; or the Toronto Stock Exchange).<sup>26</sup> According to the Ministry of Finance, “Where a stock is listed on more than one stock exchange that includes a prescribed exchange, it will not qualify.”<sup>27</sup> This restriction has created compliance challenges for IFC BC members because most accounting systems do not identify trades carried out in respect of foreign securities that are listed on both a Canadian exchange and a foreign exchange.

When the business has a mixed portfolio, the government requires that a reasonable allocation method be used to determine income:

Where a portfolio includes securities that are issued by a resident person or securities that are listed on a prescribed stock exchange, the portfolio is a mixed portfolio, and this portion of the activities [is] not an international financial activity. The total fee for managing a mixed portfolio must be allocated, and only the fee that can reasonably be attributed to activities that are international financial activities will qualify as international financial business (IFB) income. The allocation method chosen should be reasonable in the circumstances and should substantiate the amount claimed.<sup>28</sup>

## Financial Research

Section 2(2)(n) of the IFAA provides that the following is an international financial activity of a corporation:

preparing stock market or other financial research, other than prescribed financial research, for the exclusive use of non-resident persons.

Prescribed financial research is not a qualifying financial activity, as set out in section 4(5) of the IFA regulation:

[F]or the purposes of section (2)(2)(n) of the Act, prescribed financial research is legal, accounting or tax research provided by a corporation in the business of providing that research.

Assuming that a registrant is not in the business of providing legal, accounting, or tax advice, financial research for the benefit of a non-resident is a qualifying activity. “Activities such as corporate and operations accounting by their nature provide financial research.”<sup>29</sup>

## Factoring

Section 2(2)(o) of the IFAA provides that the following is an international financial activity of a corporation:

collecting trade accounts that

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

According to the Ministry of Finance, income from factoring qualifies as active business income: “For the purposes of the federal Act, ‘active business income’ has been interpreted to include income from a non-arm’s length factoring arrangement on terms comparable to those between arm’s length parties, carried out on a regular and ongoing basis.”<sup>30</sup>

The Ministry of Finance has also stated that

[f]or the purposes of section 2(2)(o) of the IFA Act, trade accounts receivable may be purchased from a resident or non-resident, on an arm’s length or non-arm’s length basis, so long as the contractual obligation to pay the debts which have been purchased rests with the non-resident person.<sup>31</sup>

A factor must purchase the debts of the exporter without recourse, thus accepting responsibility for all credit control, collection, and accounting. According to the Ministry of Finance,

It is our view that section 2(2)(o) of the IFA Act, in referring to the term “without recourse,” requires the purchaser to assume the financial risks associated with the collection of the debt, such as the insolvency of the debtor. It does not require the purchaser to also assume risks associated with defective products nor to assume risks associated with mistaken, incorrect and/or erroneous invoicing.<sup>32</sup>

## Leasing

Section 2(2)(p) of the IFAA provides that the following is an international financial activity of a corporation:

leasing property to a non-resident person by means of a direct financing lease, as defined in the Handbook of The Canadian Institute of Chartered Accountants, as amended from time to time.

## Film Distribution

Section 2(2)(q) of the IFAA provides that the following is an international financial activity of a corporation:

selling, assigning or licensing rights to a non-resident person

- (i) to distribute outside of Canada a film or television production, other than a prescribed production, or
- (ii) to exploit outside of Canada any thing related to the production.

## Patents

Sections 2(2)(q.1) and (q.2) of the IFAA provide that the following are international financial activities of a corporation:

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

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

International patent codes are prescribed by section 5(1) of the IFA regulation. In general, life science patents are those related to biological, medical, or veterinary processes or inventions. Green-related patents are those related to power generation using forces of nature such as wind, solar, and tidal forces as well as fuel cell technology and wastewater treatment.

In any taxation year, a registered corporation may choose to claim a refund either on (1) its life science or green-technology patent activities or on (2) its other eligible international financial activities, but not on both.<sup>33</sup>

According to the Ministry of Finance, a corporation must directly license a patent to qualify as an international financial activity. Licensing distribution rights will not fulfill this requirement.”<sup>34</sup>

Further,

It is [the ministry’s] view that to meet the requirements of section 2(2)(q.2) of the IFA Act, a corporation must own at least one qualifying patent that is used to produce the invention. Licensing a patent will not fulfill the ownership requirement of the patent as set out in section 2(2)(q.2) of the IFA Act.<sup>35</sup>

(The 2010 budget proposed an amendment to clarify that IFB income includes all income related to the licensing of a qualifying patent. See paragraph no. 3 of the addendum to this paper.)

### **Administrative Support Services**

Section 2(2)(r) of the IFAA provides that the following is an international financial activity of a corporation:

providing, to a non-resident person, administrative support services, other than prescribed administrative support services, that are directly related to a financial activity of the non-resident person.

Call centres, marketing, and advertising are excluded by section 4(7.1) of the IFA regulation.

According to the Ministry of Finance, providing centralized accounting services would likely constitute administrative support services where those services support a financial activity.

The determination of the specific administrative support services that qualify for the purposes of section 2(2)(r) of the IFA Act is a question of fact. For example, the cash collection and recording functions relating to the collection of trade accounts receivable supports a financial activity whereas collecting outstanding trade accounts receivable is a financial activity in and of itself.<sup>36</sup>

### **Management Services**

Section 2(2)(r.1) of the IFAA provides that the following is an international financial activity of a corporation:

providing, to a non-resident person, prescribed management services that are directly related to the business operations of the non-resident person.

This activity is further defined in section 4(7.1) of the IFA regulation:

For the purposes of section 2(2) (r.1) of the Act, the following are prescribed management services:

- (a) strategic management services provided by the head office of the corporation;
- (b) the following human resource services provided by the head office of the corporation:
  - (i) payroll;
  - (ii) benefits management;
  - (iii) recruitment and selection;
  - (iv) training and development.

The provincial budget of February 2008 added the “management services” international financial activity, effective February 20, 2008. The regulation uses the term “strategic management services.”<sup>37</sup> It is expected that the government will provide further guidance on the meaning of “strategic management services.”

The word “strategic” could be interpreted quite broadly: a head office generally provides management and control services to ensure that its foreign affiliate’s operations are aligned with the whole group’s strategy. It appears that executive management services carried out by C-level executives should qualify as strategic management services. On the other hand, by limiting management services to “strategic management services,” the legislature must have intended to exclude some management services, such as day-to-day management activities, which may not be considered strategic. In any event, this provision is likely to create some compliance issues for registered corporations absent guidance from the government. (The 2010 budget proposed to repeal management services as a qualifying activity and to add executive specialists earning \$250,000 or more. See paragraph no. 5 of the addendum to this paper.)

## **Backup Equipment and Premises**

Section 2(2)(s) of the IFAA provides that the following is an international financial activity of a corporation:

providing, to a non-resident person, services, equipment and premises for continuing the business operations of the non-resident person if primary equipment or premises used by the non-resident person becomes temporarily non-operational.

## **Other Financial Activities**

Section 2(2)(t) of the IFAA provides that the following is an international financial activity of a corporation:

any other prescribed financial activity that is conducted exclusively for non-resident persons and from which the corporation earns fee or commission income.

Qualifying activities are further defined in sections 4(8) and 4(9) of the IFA regulation:

(8) For the purposes of section 2(2)(t) of the Act, the following are prescribed financial activities of a corporation that is a savings institution:

(a) acting

(i) as trustee of a trust that, at all relevant times, is non-resident,

(ii) as an executor or administrator of the estate of a non-resident person, all the beneficiaries of which are at all relevant times non-residents,

(iii) as guardian of the estate of a minor who is non-resident, or

(iv) as committee of the estate of a mentally incompetent person who is non-resident;

(b) providing services to a non-resident person in respect of the *Immigration and Refugee Protection Act* (Canada);

(c) providing services to a non-resident person in respect of that person

(i) seeking leave to enter the United Kingdom as an investor,

(ii) seeking an extension of stay in the United Kingdom as an investor, or

(iii) seeking indefinite leave to remain in the United Kingdom as an investor.

(9) For the purposes of section 2(2)(t) of the Act, collecting trade accounts receivable from non-resident persons is a prescribed financial activity of a corporation.

The first three activities set out in the following list are limited to savings institutions,<sup>38</sup> and the fourth is not restricted.

- 1) Providing trustee or similar services for a non-resident.
- 2) Providing immigration services to a non-resident.
- 3) Providing services to a non-resident seeking leave to enter or remain in the United Kingdom.
- 4) Collecting trade accounts receivable from non-residents.

According to the Ministry of Finance,

While collecting accounts receivable is not an administrative support service, to the extent that the collection of trade accounts receivable from non-resident persons is conducted exclusively for non-resident persons for a fee or commission, that activity will qualify as an international financial activity under section 2(2)(t) of the IFA Act.<sup>39</sup>

## IFA Specialists

Registered corporations can apply to register individual employees as IFA specialists. A specialist is entitled to a refund of up to 75 percent of BC income tax

paid on net employment income earned from the eligible international financial activities for up to five years. (The 2010 budget proposed to change the refund amount to 100 percent in years 1 and 2; to 75 percent in year 3; to 50 percent in year 4; and to 25 percent in year 5. See paragraph no. 4 of the addendum to this paper.)

Section 13(1) of the IFAA provides as follows:

A registered corporation or a corporation that has applied for registration may apply to the commissioner for the registration of an individual who meets all the following requirements:

(a) the individual is a specialist in an international financial activity other than an activity referred to in section 2(2)(q.1), (q.2), (r), (r.1) and (s) [international financial activity]; [The 2010 budget proposed to change this to section 2(2)(q.1) and (q.2). See paragraph no. 6 of the addendum to this paper.]

(b) the individual has entered into a written employment contract with the corporation that requires the individual to devote at least 70% of the individual's working time to performing, for the corporation's international financial businesses, international financial activities, other than activities referred to in section 2(2)(q.1), (q.2), (r), (r.1) and (s), [The 2010 budget proposed to change this as noted above.] in which the individual is a specialist;

(c) the individual was

- (i) non-resident immediately before entering into the written employment contract with the corporation, or
- (ii) previously an IFA specialist;

(d) the individual meets any other prescribed requirements.

International financial activities related to patents, administrative support, management services, and backup support do not qualify for IFA specialist registration. (The 2010 budget proposed to change this to patents only. See paragraph no. 6 of the addendum to this paper.)

Specialists can only be registered by a corporation that has applied for or has been registered in the IFA program. The individual must be either a non-resident prior to entering into the employment contract or previously registered as an IFA specialist in an eligible activity. The terms of the written contract must provide that at least 70 percent of the individual's working time is to be spent on eligible activities. According to the Ministry of Finance, "The determination of the 70% working time is a question of fact and applies to the taxation year or part of the taxation year that the individual was an IFA specialist."<sup>40</sup> (The 2010 budget proposed to require a minimum salary of \$100,000. See paragraph no. 4 of the addendum to this paper.)

The Ministry of Finance has stated,

The Canada Revenue Agency (CRA) has ruled that a refund received by an IFA specialist under the IFA program is not received by virtue of the individual's employment and does not have to be included in the individual's income under the Income Tax Act.<sup>41</sup>

## Calculation of the Refund

### Tax Refund of an IFB

Tax refund calculations are specified in sections 17, 18, and 19 of the IFAA.

$$\text{tax refund} = [A / (B \times C)] \times D$$

where

- 1) *A* is the total adjusted IFB income, excluding foreign dividend income or assistance under paragraph 12(1)(x) of the federal Income Tax Act.
  - a) “Total adjusted IFB income” is defined in section 19 of the IFAA as
 

IFB income – (foreign dividends + inducements).
  - b) “IFB income” is the total of
    - i) the income or loss of the IFB and
    - ii) any income or loss due to hedging (added in 2008).
  - c) There is a separate refund formula for international financial activities that relate to patents (discussed further under the heading “Tax Refund for an IFB Patent Activity” below).

Specifically, section 19(1) of the IFAA provides as follows:

IFB income = the total of the following:

- (a) the income or loss, as determined under Subdivision b of Division B of Part I of the federal Act, of the international financial business as if the business’s income for the taxation year was only from international financial activities, other than those activities referred to in section 2(2)(q.1) or (q.2), for that part of the taxation year that the corporation was a registered corporation;
  - (b) if the corporation is not a securities corporation, the income earned or loss incurred by the international financial business in the taxation year because of a fluctuation in the value of a currency of a country other than Canada relative to Canadian currency in respect of a prescribed foreign currency agreement that is incident to an international financial activity the income from which is included in paragraph (a) of this description.
- 2) *B* is the corporation’s net income for income tax purposes, less any net capital losses and dividends deducted in determining the corporation’s taxable income for the year.
  - 3) *C* is the percentage of taxable income allocated to British Columbia for the taxation year.
  - 4) *D* is the corporation’s BC income tax (after deducting all tax credits and deemed payments).

A tax refund is paid to a corporation only after all BC and federal income taxes are paid.

The IFA refund cannot be greater than the amount of net BC tax payable; therefore, in the formula  $A / (B \times C)$  cannot be greater than 1.

As a result of the introduction of section 261 of the federal Income Tax Act, corporations can compute the income of their IFBs in their functional currency of US dollars, euros, or British pounds, provided that they meet the requirements. This will simplify the compliance burden for IFBs that use a foreign currency, in that they will be able to qualify to use their foreign currency for calculating their IFAA claim.

The BC Ministry of Finance has said, “The Canada Revenue Agency (CRA) has ruled that a refund received by a corporation under the IFA program is included in income under Section 12(1)(x) of the Income Tax Act (Canada), unless the corporation makes an election under Section 12(2.2) of that Act.”<sup>42</sup> Subsection 12(2.2) of the federal Income Tax Act allows a taxpayer to elect to treat the IFAA refund as a reduction of BC income taxes paid and thereby avoid taxation on that amount under paragraph 12(1)(x). The election is required to be made on or before the filing date of the year in which the IFAA refund was received. The taxpayer makes the election by attaching a signed letter to its T2 corporate income tax return stating (1) that the election is being made under subsection 12(2.2), (2) the elected amount, (3) the amount of the IFAA refund, and (4) the date on which it was received.<sup>43</sup>

While the calculation of the refund is intended to provide for a refund of BC corporate income taxes paid in respect of a qualifying international financial activity, this intuitive result may not be achieved.

A simple example can demonstrate the application of the formula. Assume that a corporation’s adjusted IFB income is \$100 (*A*); other BC income is nil; Canadian net and taxable income is \$300 (*B*); 30 percent of wages are allocated to British Columbia; and 20 percent of revenues are allocated to British Columbia. Therefore,

- 1) the percentage of taxable income allocated to British Columbia (regulation 400) is

$$\begin{aligned} &= (30\% + 20\%) / 2 \\ &= 25\% (C) \end{aligned}$$

- 2) 2010 BC income tax payable

$$\begin{aligned} &= 25\% \times \$300 \times 10.5\% \\ &= \$7.87 (D) \end{aligned}$$

- 3) IFAA refund

$$\begin{aligned} &= [\text{IFB income } (A) / (\text{taxable income } (B) \times \text{BC \% allocation } (C))] \\ &\quad \times \text{BC Tax } (D) \\ &= [\$100 / \$300 \times 25\%] \times \$7.87 \\ &= 1.33 \times \$7.87 \end{aligned}$$

However, the IFAA refund cannot exceed the net BC tax payable; as a result, the IFAA refund is limited to \$7.87.

In this example, if the company had paid additional BC tax on non-IFB income, the IFAA refund could be as much as 10.5 percent of the IFB income, or \$10.50. Furthermore, the determination of adjusted income pursuant to the formula is based on a determination of the income from qualifying activities as if the IFB were a separate business. On the other hand, the amount of BC taxable income (and by extension the amount of BC tax payable) is determined by a formula in regulation 400 of the federal Income Tax Act. BC taxable income is determined by applying a percentage to Canadian taxable income. The percentage is the average of the percentage of salaries and revenues paid or earned in British Columbia of the total Canadian salaries and revenues, respectively. Because the two calculations are computed on a different basis, anomalous results can occur.

### **Tax Refund for an IFB Patent Activity**

The tax refund for patent activities is limited to 75 percent of BC corporate income tax paid, to a maximum of \$8 million. The refund calculation follows the same pattern, except that it is capped at \$8 million and the refund is only 75 percent of the BC taxes paid on the IFB patent activity income. Therefore, the following formula applies:

$$\text{tax refund} = \text{lesser of } \$8 \text{ million and } [A / (B \times C)] \times D \times 75\%$$

where  $A$ ,  $B$ ,  $C$ , and  $D$  have the values noted above, except that, as they relate to IFB income, they include only patent-related IFB income.

A corporation that claims a refund under the patent provisions will not be able to make a second claim under the general provisions in respect of another qualifying activity.

## **Administration**

### **Filing Requirements**

Registrants and specialists have 18 months after the end of the taxation year to file a refund claim.<sup>44</sup> There is discretion for the commissioner to extend the filing date.

For a corporate claimant, form FIN 578, “IFA Tax Refund of a Corporation” (for a patent-related refund claim, form FIN 546, “IFA Tax Refund of a Life Science Corporation”), is required, along with financial statements, income tax returns, and the CRA notice of assessment and statement of account showing payment of BC taxes. A trial balance and general ledger for the IFB and other supporting documents may be required.<sup>45</sup>

If a claimant is issued a notice of reassessment by the CRA under the federal Income Tax Act that changes the tax refund, the claimant is required to report the change to the commissioner within 90 days.<sup>46</sup>

A registered corporation is required to file a report in respect of each IFA specialist employed by the corporation during the calendar year. This report is due by March 31 after the calendar year-end (March 30 in a leap year).<sup>47</sup>

## **Interest**

Interest on unpaid refund applications begins to accrue 61 days after all documents are received by the BC Ministry of Finance.<sup>48</sup> When the province owes interest to a registrant, the rate is 2 percent below the prime rate of the province's principal banker; when a registrant owes interest to the province, the rate is 3 percent above the prime rate of the province's principal banker.

## **Audits**

Audits are conducted at the discretion of the Ministry of Finance. In practice, audits are normally conducted annually after a return is filed. Registered corporations must retain documentation to support the determination of IFB income, including reasonable allocation of expenses between the IFB and non-IFB activities.<sup>49</sup>

## **Transfer Pricing**

Section 20(1) of the IFAA defines "transaction price." Section 20(2) provides that the transaction price between non-arm's-length parties must be determined as if the parties were dealing at arm's length:

For the purpose of calculating a corporation's IFB income, if the corporation participates in a transaction or a series of transactions for, with or on behalf of a person who is affiliated with or who is not dealing at arm's length with the corporation, any transaction price in respect of the transaction or series of transactions must be the amount that would have been the transaction price in respect of the transaction or series of transactions if the participants in the transaction or series of transactions had been dealing at arm's length with each other.

Section 20(3) of the IFAA permits the commissioner to set the transaction price between non-arm's-length parties as if the parties were dealing at arm's length:

If the commissioner is not satisfied that the transaction price is in accordance with subsection (2), the commissioner may set the transaction price, for the purpose of calculating the corporation's IFB income, as the amount that would have been the transaction price in respect of the transaction or

series of transactions if the participants in the transaction or series of transactions had been dealing at arm's length with each other.

The Ministry of Finance generally allows documentation required by section 247 of the federal Income Tax Act to be a factor used to determine the transaction price for the purposes of section 20 of the IFAA:

It is our view that documentation prepared in accordance with section 247(4) of the federal Act will comply for the purposes of applying section 20 of the IFA Act to non-arm's length transactions between residents and non-residents of Canada where that documentation has been accepted and agreed to by the Canada Revenue Agency. In any other case, transfer pricing documentation prepared in accordance with section 247 of the federal Act will be one of several factors considered in determining the transaction price for the purposes of section 20 of the IFA Act.<sup>50</sup>

## **Administration of the IFAA**

The IFA program is administered by the BC Ministry of Finance. In 2009, the revenue responsibilities of the BC Ministry of Small Business and Revenue, Income Taxation Branch, were transferred to the Ministry of Finance.

## **Anti-Avoidance**

Section 51 of the IFAA sets out an anti-avoidance rule that is similar to the general anti-avoidance rule in section 245 of the federal Income Tax Act:

- (1) In this section:
- “avoidance transaction” means a transaction
- (a) that, but for this section, would result, directly or indirectly, in an increase in a tax refund, or
  - (b) that is part of a series of transactions that, but for this section, would result, directly or indirectly, in an increase in a tax refund, but does not include a transaction that may reasonably be considered
  - (c) to have been undertaken or arranged primarily for the purpose of carrying on a bona fide international financial activity of an international financial business, or
  - (d) to be a transaction that would not result, directly or indirectly, in
    - (i) a misuse of the provisions of this Act or the regulations, or
    - (ii) an abuse having regard to those provisions, other than this section, read as a whole;
- “tax consequences to a person” means any amount that is payable or refundable to the person under this Act or that is relevant for the purposes of calculating that amount.
- (2) If a transaction is an avoidance transaction, the tax consequences to a person must be determined in a manner that is reasonable in the circumstances

in order to deny an increase in a tax refund that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) Without limiting subsection (2),

(a) any amount included in calculating a registered corporation's total adjusted IFB income may be allowed or disallowed in whole or in part,

(b) any amount included in calculating an individual's IFB income may be allowed or disallowed in whole or in part,

(c) the nature of any payment or other amount may be recharacterized, and

(d) the tax effects that would otherwise result from the application of other provisions of this Act or the regulations may be ignored, in determining the tax consequences to a person in a manner that is reasonable in the circumstances in order to deny an increase in a tax refund that, but for this section, would result, directly or indirectly, from an avoidance transaction.

(4) If a notice of determination reflecting the application of subsection (2) to a transaction has been served on a person, any other person is entitled, within 180 days after the date of the service of that notice, to request in writing that the minister make a determination applying subsection (2) with respect to the transaction.

(5) On receipt of a request under subsection (4), the commissioner must make a determination under section 28 [determination of tax refund] despite the expiry of any time limit under section 30 [determination and assessment period], except that a determination may be made under this subsection only to the extent that the determination may be reasonably regarded as relating to a transaction referred to in subsection (4).

(6) The tax consequences to a person, after the application of this section, must only be determined through a notice of determination.

## Examples

The IFAA legislation has been broadened since 2004 to include qualifying activities relevant to non-financial institutions. While many of the qualifying activities are financial, others are not—for example, life science patent income. The following hypothetical situations illustrate the breadth of the IFAA provisions and their applicability to international activities. In some cases, organizations may have to restructure their operations to qualify their income for the IFAA benefits.

This section of the paper is designed to illustrate the applicability of the IFAA legislation to the following hypothetical fact patterns:

- 1) factoring foreign accounts receivable,
- 2) fund asset management,
- 3) life science patent income,
- 4) investment of surplus funds, and
- 5) captive insurance.

## Factoring Foreign Accounts Receivable

### Facts

In the structure illustrated in figure 1, assume that IFCCo is a corporation incorporated in British Columbia and wholly owned by its Canadian parent, Parentco. It has leased office space in British Columbia. Parentco decides to sell its worldwide receivables to IFCCo. IFCCo does not have recourse to Parentco for receivables that are not collectible. Parentco and IFCCo conduct a transfer-pricing study to ensure that the non-arm's-length sale price is comparable to arm's-length transactions. Parentco transfers an executive, Ms. X, from the United Kingdom to oversee the operations and hires the remainder of the staff locally within British Columbia. Ms. X has been a resident of the United Kingdom and has entered into a written employment contract that requires her to spend at least 70 percent of her time overseeing the collection of the foreign accounts receivable.

### Analysis

IFCCo is eligible to apply for registration, since it will be carrying on an IFB.<sup>51</sup> It was incorporated in Canada and has a permanent establishment in British Columbia. IFCCo must become a member of IFC BC in order to remain registered.<sup>52</sup> IFCCo is carrying on an active business of collecting foreign trade receivables and thus is carrying on a qualifying business<sup>53</sup> through a fixed place of business in British Columbia. IFCCo's business activities qualify as IFB activities because IFCCo is collecting trade accounts from non-resident persons that have been acquired on a non-recourse basis.<sup>54</sup> IFCCo will be eligible to claim a refund of its BC corporate income taxes paid<sup>55</sup> in respect of its IFB.

IFCCo can register Ms. X as a specialist under the IFAA.<sup>56</sup> As a specialist, Ms. X will be eligible to claim a refund of 75 percent of BC individual income taxes paid for up to five years.<sup>57</sup> (The 2010 budget proposed to change the refund to a sliding scale and to require a minimum salary of \$100,000. See paragraph no. 4 of the addendum to this paper.)

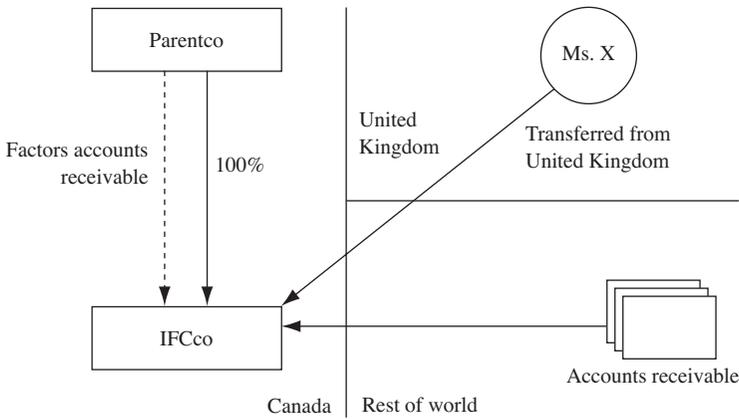
## Fund Asset Management

### Facts

In the structure shown in figure 2, assume that IFCCo is a corporation incorporated in Canada with a fixed place of business in British Columbia. IFCCo provides third-party services to global asset managers who are resident in the United Kingdom and the United States through its fixed place of business in British Columbia. IFCCo provides the following services to its global asset manager clients:

- 1) accounting for the fund, including preparation of reports and annual reports;
- 2) preparing the annual tax information package for investors in the fund;

Figure 1



- 3) holding securities of the fund as a custodian;
- 4) transacting trades of the fund as directed by the global asset manager;
- 5) accounting for investor deposits and withdrawals from the fund;
- 6) computing fees in accordance with the fund terms and conditions; and
- 7) managing cash flow balances and banking for the fund.

**Analysis**

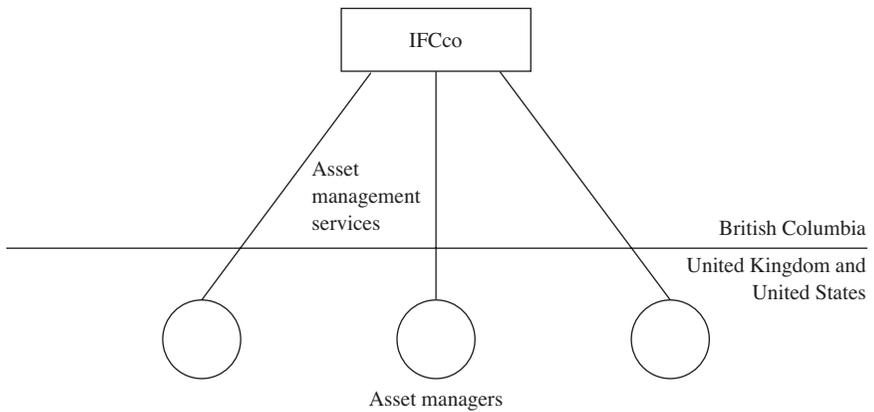
IFCco is eligible to apply for registration since it will be carrying on an IFB,<sup>58</sup> was incorporated in Canada, and has a permanent establishment in British Columbia. IFCco must become a member of IFC BC in order to remain registered.<sup>59</sup>

IFCco is carrying on an active business providing management and administrative services in respect of investments for a non-resident, and thus is carrying on a qualifying business<sup>60</sup> through a fixed place of business in British Columbia. IFCco’s fund administration services business is an active business, and there is no requirement that IFCco meet the “substantial presence” test. IFCco’s activities of managing investments and providing administrative support services for non-resident persons will qualify as international financial activities.<sup>61</sup> IFCco will be eligible to claim a refund of its BC corporate income taxes paid.<sup>62</sup>

**Life Science Patent Income**

**Facts**

In the structure shown in figure 3, assume that IFCco is a corporation incorporated in Canada with a fixed place of business in British Columbia. IFCco is owned by Parentco. IFCco has developed a life science patent that has a primary classification number assigned under item 5, section C, class 07 in accordance with

**Figure 2**

international patent classification.<sup>63</sup> IFCco licenses its life science patent to the foreign affiliates of Parentco. IFCco and the foreign affiliates conduct a transfer-pricing study to ensure that the non-arm's-length licence fees are comparable to arm's-length fees.

### **Analysis**

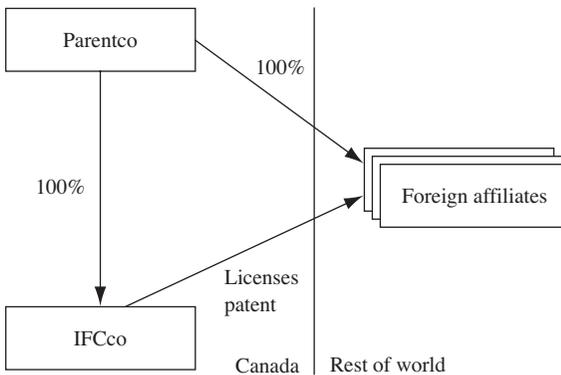
IFCco is eligible to apply for registration because it will be carrying on an IFB,<sup>64</sup> was incorporated in Canada, and has a permanent establishment in British Columbia. IFCco must become a member of IFC BC in order to remain registered.<sup>65</sup> IFCco is carrying on a qualifying business. If the licensing of the life science patent is part of the active business of IFCco, then it will be a qualifying business.<sup>66</sup> If the licensing of the life science patent is considered a separate business whose income is principally income from property, it will also be considered to be a qualifying business.<sup>67</sup> IFCco's business activity qualifies as an international financial activity by virtue of its licensing to non-resident persons a patent that has been prescribed under the IFA regulation.<sup>68</sup> IFCco will be eligible to claim a refund of 75 percent of its BC corporate income taxes paid, to a maximum of \$8 million for each taxation year.<sup>69</sup>

### **Investment of Surplus Funds**

#### **Facts**

In the structure shown in figure 4, assume that IFCco is a corporation incorporated in British Columbia. IFCco carries on an active business in British Columbia through a fixed place of business in British Columbia. IFCco has significant funds for investment that are surplus to its business needs. It invests those surplus

Figure 3



funds in short-term securities acquired from a non-resident broker (who is authorized in the United States to trade in securities and is not authorized or registered in Canada to trade in securities, or related to someone who is).

**Analysis**

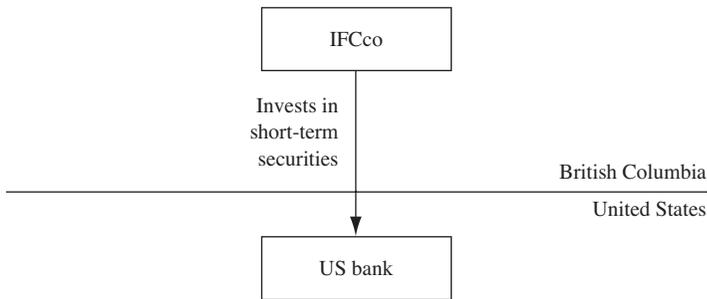
The key issue is whether IFCco is carrying on a specified investment business in relation to the investment of surplus funds. This business is separate from the active business carried on in British Columbia if the funds are clearly surplus to the needs of the active business and are not incident to the active business carried on or used principally for the purposes of gaining or producing income from the active business. The income from the investment of surplus funds is considered income from a source that is property, but this income must also be considered to be business income in order to be part of an IFB. (See the earlier discussion dealing with the financing of foreign affiliates.) The Ministry of Finance may well take the position that the activity in connection with the investment of surplus funds is not sufficient to be considered to be a business and, as such, a qualifying business.

Therefore, while the acquisition of short-term debt securities is an international financial activity,<sup>70</sup> IFCco will be eligible to claim a refund of its BC corporate taxes paid in respect of this activity only if the activity is considered to be a business.

**Captive Insurance**

**Facts**

In the structure shown in figure 5, assume that Parentco decides to cover its insurance needs with a wholly owned subsidiary and establishes a captive insurance company, IFC Captiveco, located in British Columbia. IFC Captiveco is incorporated in British Columbia and licensed under the Insurance (Captive

**Figure 4**

Company) Act.<sup>71</sup> Parentco has affiliates in Canada and elsewhere. The affiliates carry on active business in the United States, Asia, and Europe. The foreign affiliates of Parentco insure their property and casualty risks with IFC Captiveco.

### Analysis

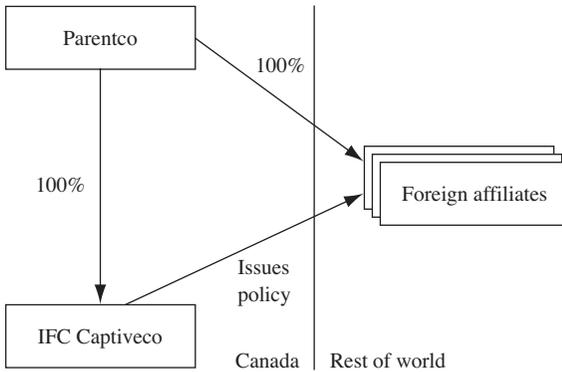
IFC Captiveco is eligible to apply for registration under the IFAA because it will be carrying on an IFB.<sup>72</sup> IFC Captiveco must become a member of the IFC BC in order to remain registered.<sup>73</sup> IFC Captiveco is carrying on an active business as defined in subsection 248(1) of the federal Income Tax Act and is therefore carrying on a qualifying business through a fixed place of business in British Columbia. Insuring risks of a non-resident relating to property outside Canada is an international financial activity.<sup>74</sup> IFC Captiveco will be eligible to claim a refund of BC corporate income tax paid as determined under the IFAA.

IFC Captiveco provides an alternative to offshore structures used for captive insurance. With an onshore structure, federal tax will be payable on the insurance earnings. However, the tax may largely be offset by the lower costs of administering an onshore structure. Many of the costs of an offshore structure relate to ensuring that tax risks associated with the residence of the captive are mitigated, and there will always be some tax risks with an offshore structure that may cause the CRA to review and/or challenge the arrangements. Moreover, senior executives must often spend time exercising mind and management in the offshore jurisdiction, incurring the associated opportunity costs. Furthermore, if the offshore captive incurs losses, it will be difficult to utilize those losses within Canada; an onshore structure, by contrast, normally facilitates the utilization of any tax losses.

### Summary

The IFAA is an important piece of legislation that can profoundly affect how British Columbia develops as a centre of international finance and commerce, an exporter of goods and services, and a recipient of direct investment in the global financial services sector.

Figure 5



IFC BC serves the government, businesses, and people of British Columbia. It is tasked with the job of reaching out to businesses and to professionals with a view to communicating the tax advantages available to companies under the IFAA. Its first and most important priority is to identify companies that might fit within the parameters of the IFAA, explain the tax refunds that might be available to them, and help them register their eligible activities under the IFAA.

As described in this paper, there are numerous situations in which companies can make use of the IFAA. The IFAA has expanded its list of qualifying financial activities significantly over the last five years. Many qualifying activities are not necessarily financial—for example, leasing, patent exploitation, film distribution, administrative support, management services, backup equipment and premises, and trustee administrative services. British Columbia has an open economy that depends largely on its ability to trade and compete internationally, and the IFAA is an important tool in allowing British Columbia to compete as an international financial centre.

Tax is only one factor in attracting and retaining international financial operations. In addition to the incentives offered by the IFAA, British Columbia possesses many other advantages as an international financial centre. Not only is it a strategic location for the emerging economies of the Asia-Pacific region, it also offers a substantial labour market with the capacity to meet the needs of investments from that region. Additionally, in 2009 the Economist Intelligence Unit, an affiliate of the *Economist* magazine, ranked Vancouver the most livable city in the world for the seventh year in a row; the Mercer Group’s 2009 quality-of-living survey ranked Vancouver fourth worldwide and first in North America.

IFC BC plans to attract many international financial activities to the province in the years to come, providing greater employment opportunities for the many highly skilled, multilingual, and productive people who call British Columbia and Canada their home.

## **Addendum**

British Columbia's 2010 budget, tabled on March 2, 2010, proposed substantial changes to several of the provisions discussed in this paper. No draft legislation on the proposed changes was released with the budget. The draft legislation is expected to be released within the next few months and will provide details on these changes, including particulars on prescribed activities and services, qualifying transactions, and required certification processes. British Columbia's Budget and Fiscal Plan: 2010/11-2012/13<sup>75</sup> provides a list of the proposed changes to the IFAA. These changes are summarized in the numbered paragraphs that follow.

**1) Qualifying international businesses added**

- a) digital media publishing and distribution,
- b) certification and trading of carbon credits, and
- c) clean technology.

**2) Investment fund management activities added**

Effective September 1, 2010, qualifying international financial activities under the IFAA are amended to include prescribed management and administrative services of prescribed investment funds.

**3) Qualifying patent activities clarified**

The IFAA is amended to clarify that international financial business income includes all income related to the licensing of a qualifying patent.

**4) Refunds for IFA specialists changed**

The requirements and benefit for IFA specialists have been changed. Effective March 3, 2010, an eligible specialist must be paid wages of at least \$100,000 annually to qualify (in addition to existing qualifications). The rate of the refund during the five years is changed to 100 percent in the specialist's first two years of eligibility, to 75 percent in the third year, to 50 percent in the fourth year, and to 25 percent in the fifth year.

**5) Management services activity repealed and replaced with executive specialist**

An executive specialist must have an annual wage of at least \$250,000; his or her wages must be included in the calculation of the program participant's international financial business income; there is no requirement for a certain percentage of time to be spent working on international financial activities; and the maximum number of executive specialists in any related group of program participants is limited. The non-resident requirement and the rates of refunds for the five years applicable to international financial activity specialists will also apply to executive specialists.

**6) IFA specialists for administrative support and backup office services introduced**

IFA specialists will be allowed in administrative support and backup office services. The IFAA is amended to allow for specialists for these international financial activities with similar requirements and limitations applicable

to an executive specialist, but with a minimum annual wage requirement of \$100,000.

**7) Section 110.5 election effect removed**

Effective for taxation years ending after March 3, 2010, the IFAA is amended to remove the effect of an election under section 110.5 of the federal Income Tax Act. This removes the anomaly that allowed for tax refunds in years when the program participant had no other income or a loss.

**8) Prescribed business provision repealed**

The resident exception for deposit and loan transactions with a prescribed business is repealed effective March 3, 2010. This change eliminates a provision that is inoperable in practice.

**9) Lending activities restricted**

Effective March 3, 2010, qualifying lending activities are restricted to arm's-length parties.

## Notes

- 1 SBC 2004, c. 49, as amended (herein referred to as "IFAA").
- 2 For patent activities, 75 percent of BC corporate income tax paid on IFB income, to a maximum of \$8 million annually, is eligible for a refund. For other qualifying activities, the registrant can receive a refund of 100 percent of BC corporate tax attributed to its IFB income.
- 3 The current corporate income tax rate in Hong Kong is 16.5 percent; in Singapore, it is 18.0 percent.
- 4 RSC 1985, c. 1 (5th Supp.), as amended.
- 5 See RSBC 1996, c. 235; repealed and replaced by IFAA section 69.
- 6 See British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation IFA 2005-0008*, January 6, 2006. (IFA technical interpretations and rulings cited in this paper can be found at [http://www.sbr.gov.bc.ca/business/Income\\_Taxes/International\\_Financial\\_Activity/rulings.htm](http://www.sbr.gov.bc.ca/business/Income_Taxes/International_Financial_Activity/rulings.htm).)
- 7 BC Reg. 327/2004, as amended (herein referred to as "the IFA regulation").
- 8 Section 1.1(2) of the IFA regulation provides as follows:

For the purposes of the definition of "qualifying business," the amount of capital employed in British Columbia is the amount calculated by the following formula:

$$\text{amount} = \text{total capital} \times \frac{\text{BC taxable income}}{\text{federal taxable income}}$$

where

total capital = the total capital stock of the corporation;

BC taxable income = the corporation's taxable income earned in the year in British Columbia, as defined in section 13.3 of the [British Columbia] *Income Tax Act*, for the taxation year;

federal taxable income = the corporation's taxable income, as defined in section 248(1) of the federal Act, for the taxation year.

- 9 See British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation IFA 2006-0001*, March 7, 2006; *Technical Interpretation 2004-0001*, November 9, 2004; and *Ruling IFA 2005-0004*, June 27, 2005.

- 10 See *Anderson Logging Co. v. The King*, 52 DTC 1209 (SCC), and *Canadian Marconi v. The Queen*, 86 DTC 6526 (SCC).
- 11 See British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation* IFA 2005-0007, December 8, 2005.
- 12 RSBC 1996, c. 238, as amended, section 29.
- 13 See British Columbia, Ministry of Small Business and Revenue, *Bulletin* IFA 001, “International Financial Activity Act Overview,” February 2006 ([http://www.sbr.gov.bc.ca/business/Income\\_Taxes/International\\_Financial\\_Activity/leg\\_bulletins.htm](http://www.sbr.gov.bc.ca/business/Income_Taxes/International_Financial_Activity/leg_bulletins.htm)).
- 14 See section 4(2.1) of the IFA regulation.
- 15 See *supra* note 13.
- 16 See regulation 3200 of the Income Tax Regulations (Canada), CRC 1978, c. 945, as amended, and *Technical Interpretation* IFA 2005-0008, *supra* note 6.
- 17 See IFAA section 2(6).
- 18 *Supra* note 14.
- 19 IFAA section 2(6).
- 20 IFAA section 2(3).
- 21 See IFAA section 2(4).
- 22 RSBC 1996, c. 227.
- 23 See *Technical Interpretation* IFA 2006-0001, *supra* note 9.
- 24 *Ibid.*
- 25 See IFAA section 2(3).
- 26 See *supra* note 16.
- 27 See *Technical Interpretation* IFA 2005-0008, *supra* note 6.
- 28 See *Technical Interpretation* IFA 2004-0001, *supra* note 9.
- 29 See *Technical Interpretation* IFA 2006-0001, *ibid.*
- 30 See British Columbia, Ministry of Small Business and Revenue, *Ruling* IFA 2005-0006, July 4, 2005. See also British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation* IFA 2006-0003, October 6, 2006.
- 31 *Technical Interpretation* IFA 2006-0003, *supra* note 30.
- 32 *Ibid.*
- 33 See IFAA section 17.1(1)(c).
- 34 See British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation* IFA 2006-0002, August 31, 2006.
- 35 *Ibid.*
- 36 See *Technical Interpretation* IFA 2006-0001, *supra* note 9.
- 37 BC Reg. 186/2008, promulgated June 26, 2008.
- 38 See *supra* note 13.
- 39 See *supra* note 36 and accompanying text.
- 40 See British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation* IFA 2005-0005, June 20, 2005.
- 41 See British Columbia, Ministry of Small Business and Revenue, “International Financial Activity: Frequently Asked Questions” ([http://www.sbr.gov.bc.ca/business/Income\\_Taxes/International\\_Financial\\_Activity/faq.htm](http://www.sbr.gov.bc.ca/business/Income_Taxes/International_Financial_Activity/faq.htm)).

- 42 Ibid.
- 43 See Canada Revenue Agency, *Interpretation Bulletin* IT-273R2, “Government Assistance—General Comments,” September 13, 2000.
- 44 See IFAA section 24(1).
- 45 Required forms are listed in appendix 3, “Checklist,” British Columbia, Ministry of Finance, “Guide to Filling Out Either the IFA Tax Refund of a Corporation or the IFA Refund of a Life Sciences Corporation.”
- 46 See IFAA section 25.
- 47 See IFAA section 26.
- 48 See IFAA section 33.
- 49 See IFAA section 19(3).
- 50 See British Columbia, Ministry of Small Business and Revenue, *Ruling* IFA 2005-0001, April 6, 2006. See also British Columbia, Ministry of Small Business and Revenue, *Technical Interpretation* IFA 2005-0003, May 17, 2005, and *Ruling* IFA 2005-0006, supra note 30, among others.
- 51 See IFAA section 1, which defines “international financial business” as follows:
- “international financial business,” in relation to a corporation means a business
- (a) that is a qualifying business carried on by the corporation through a fixed place of business in British Columbia, and
- (b) all the activities of which are international financial activities.
- 52 See IFAA section 11(1)(c).
- 53 See section 1.1(1)(a) of the IFAA regulation.
- 54 See IFAA section 2(2)(o).
- 55 See IFAA section 17.
- 56 See IFAA section 13.
- 57 See IFAA section 22.
- 58 See IFAA section 1. IFCCo must be carrying on a “qualifying business” through a fixed place of business in British Columbia and all of the activities of the IFB must be “international financial activities.”
- 59 See IFAA section 11(1)(c).
- 60 See section 1.1(1)(a) of the IFAA regulation.
- 61 The activities of IFCCo can qualify as international financial activities under different provisions of the IFAA. IFCCo’s activities will qualify under section 2(2)(l), “managing, for a fee or commission, investments for non-resident persons.” Moreover, the activities may also qualify under section 2(2)(r), “providing to a non-resident person, administrative support services, other than prescribed administrative support services that are directly related to a financial activity of the non-resident person.” IFCCo is not carrying on any prescribed administrative support services of call centres, marketing, or advertising, as outlined in the IFA regulation. Some of IFCCo’s activities may also qualify under other categories; see section 2(2)(i) on providing financial advice and section 2(2)(n) on preparing stock market or other financial research.
- 62 See IFAA section 17.
- 63 World Intellectual Property Association, *International Patent Classification*, 8th ed. (Geneva: WIPO, 2005), adopted under the Strasbourg Agreement Concerning the International Patent Classification, March 24, 1971.
- 64 IFAA section 1.
- 65 IFAA section 11(1)(c).

- 66 See section 1.1(1)(a) of the IFA regulation.
- 67 See section 1.1(1)(b) of the IFA regulation.
- 68 See IFAA section 2(2)(q.1) and section 5 of the IFA regulation.
- 69 See IFAA section 17.1.
- 70 See IFAA section 2(2)(g)(ii) and section 4(2.1) of the IFA regulation.
- 71 Supra note 22.
- 72 IFAA section 1.
- 73 IFAA section 11(1)(c).
- 74 See IFAA section 2(2)(h).
- 75 British Columbia, Ministry of Finance, Budget and Fiscal Plan 2010/11-2012/13, March 2, 2010.

