Canadian taxpayers are required to compute foreign accrual property income (FAPI) and income deemed by paragraph 95(2)(a) of the Income Tax Act to be income from an active business in accordance with Canadian tax rules. This requirement sometimes leads to anomalies and inequitable results. In this article, the authors discuss certain problems and issues that may be encountered when the general rules in the Act are applied in computing a foreign affiliate’s income other than income from an active business carried on by the affiliate. They initially examine whether a foreign affiliate should be considered to be a taxpayer for purposes of the Act and the context in which this will occur.

One of the more common problems in computing income earned by a foreign affiliate occurs when timing differences for income or gain are created between foreign and Canadian tax law. FAPI and foreign accrual tax may arise in different taxation years as a result of the use of hybrid entities, and because of differences in the foreign and Canadian tax treatment of instalment sales, rollovers, and replacement property transactions.

In computing FAPI, certain Canadian tax deductions are proscribed if the taxpayer is not resident in Canada or does not carry on a business in Canada. In other situations, it is unclear how certain provisions of the Act should be applied when an entity is acquired and it subsequently becomes a foreign affiliate. Not surprisingly, anomalies may arise for the foreign affiliate and its Canadian taxpayer in the computation of FAPI, particularly if the income is derived from the forgiveness of debt, from foreign currency transactions, or from the use of partnerships in the taxpayer’s international structure.