

# International Financial Centre British Columbia: A Tax Incentive for International Business

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<sup>1</sup> Bruce Flexman, FCA, is President of the International Financial Centre British Columbia and greatly acknowledges the contribution of Alice Harder, Director, Research and Communications, International Financial Centre British Columbia in preparing this paper and to Marco Cavasin of PricewaterhouseCoopers LLP, and Tony Martin and Joseph Petrie of KPMG LLP for their comments on an earlier draft. Any errors, omissions or inaccuracies are the sole responsibility of the author.

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## A. The International Financial Activity Program

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The International Financial Centre British Columbia (IFC BC) is in the business of marketing British Columbia's many advantages as a location for investment. One of the key tools used to promote British Columbia is a unique tax incentive program, known as the International Financial Activity (IFA) program. The legislative framework for this program is the *International Financial Activity Act* (IFAA) of 2004. Under the IFAA, companies registering an international financial business (IFB) with the province of BC receive a refund of up to 100% 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% effective January 1, 2010 and is scheduled to drop to 10% 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% will be reduced to 15% in 2012. At 15%, the corporate tax rate on qualifying IFB income will become competitive with other international finance centres such as Singapore and Hong Kong<sup>3</sup>.

Personal tax benefits are also available to employees of registered companies. Certain employees who are attracted to work for these companies and who were previously non-

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<sup>2</sup> For patent activities, 75% of the BC Corporate income tax paid on international financial business (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% of the BC corporate tax attributed to its IFB income.

<sup>3</sup> The current corporate income tax rate in Hong Kong is 16.5% and in Singapore, it is 18.0%.

residents of Canada can receive a refund of up to 75% 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% (instead of the normal top BC marginal rate of 43.7%)

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.

## 1. Background

In 1986, the federal government established the International Banking Centre (IBC) by amending section 33.1 of the *Income Tax Act (Canada)* 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 commonly known as offshore banking centres.

British Columbia was dissatisfied with the limited activities permitted under the IBC federal provisions. In 1988, British Columbia implemented its own legislation, the *International Financial Business (Tax Refund) Act*, 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 the legislation was believed by many to be too restrictive. In 2004, the *International Financial Activity Act (IFAA)* replaced the *International Financial Business (Tax Refund) Act*.

## 2. The *International Financial Activity Act* (IFAA)

The IFAA broadened the scope of the *International Financial Business (Tax Refund) Act* to all corporations by basing eligibility on the entity's activities, rather than on the type of corporation. Now any organization—not only financial institutions—can take advantage of this tax incentive by locating their international financial business in British Columbia. In addition:

- An IFB can be established in any location in British Columbia—not only 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 back-up 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.

## 3. 2008 and 2009 Changes to the IFAA

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

**a. Wastewater Treatment and Fuel Cell Technology Patents (2009)**

The list of allowed patents was expanded to include patents related to wastewater treatment and fuel cell technology.

**b. 90-Day Amalgamation Notice (2009)**

The requirement that companies notify the province within 90 days of an amalgamation was relaxed to give the commissioner discretion to accept late notifications when there is an amalgamation between a registered and a non-registered company.

**c. Head Office Activities (2008)**

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.

**d. Short-term Financial Instruments for Non-Securities Corporations (2008)**

Non-securities corporations can now trade in money market investments with a non-resident.

**e. Hedging Activities (2008)**

Non-securities corporations can now include income or loss from certain currency hedging transactions that is incident to a qualifying activity in determining IFB income.

## **f. Green-related Patents (2008)**

The list of eligible patents that can be exploited under the IFAA now 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.

## **B. Qualifying Entities**

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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 in British Columbia a permanent establishment, as defined in section 400 (2) of the Income Tax Regulations (Canada);*

*(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.*

## **Notes**

- 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 the corporation's IFB income, as determined under Subdivision b of Division B of Part 1 of the federal *Act*."<sup>4</sup> Therefore, in order for all

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<sup>4</sup> See Technical Interpretation IFA 2005 – 0008, International Financial Activity, BC Ministry of Small Business and Revenue ([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))

of the IFB income of a partnership to qualify, each of the partners must be corporations separately registered under the IFAA.

- A permanent establishment in British Columbia is required.
- The company must become a member of the International Financial Centre British Columbia (IFC BC) Society, 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 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. The IFC BC’s current annual membership fees are \$1,000 plus a 0.45% participation assessment on IFB income. The maximum assessment is \$80,000. For organizations whose benefits under certain patent provision are limited to 75% of the normal refund, the participation assessment fee is pro-rated at 75% of the above amount with an upper limit of \$60,000.

## C. International Financial Business (IFB) Defined

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An “international financial business” (IFB) is defined in Section 1 of the IFAA:

*"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.*

A “qualifying business” is further defined in subsection 1.1(1) of the *International Financial Activity Regulation* (“*IFA Regulation*”):

*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>5</sup> in British Columbia in an amount equal to or greater than \$10,000,000 and*

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<sup>5</sup> Subsection 1.1(2) of the *IFA Regulation* provides:

*(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 a proportion of \$300,000 that the number of days in the taxation year bears to 365.*

## **Notes**

- The definition of international financial business implies that the business must be wholly comprised of activities that qualify as international financial activities. The Ministry of Finance interprets this requirement as defining the international financial business as only comprising the activities which are international financial activities<sup>6</sup>. In other words, if a corporation carries on a business, which 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 comprised of only the portion of the business that comprises the qualifying international financial activities. This will require

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*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:  
amount = total capital × (BC taxable income/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 [BC]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.*

<sup>6</sup> See IFA Technical Interpretations IFA 2006-0001 and IFA 2004-0001; and, IFA Ruling 2005-0004, International Financial Activity BC Ministry of Small Business and Revenue ([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))

apportionment of expenses that may be applicable to both the qualifying and non-qualifying activities.

- In paragraph (a), the IFB will be a “qualifying business” if it is an “active business” as defined in subsection 248 (1) of the *Income Tax Act (Canada)*. If the business is an active business, there is no requirement for a minimum number of employees or is it necessary to meet the “substantial presence” test outlined in paragraph (c)
- Paragraph (b) of the definition of qualifying business deals with the situation where 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 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 form 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 this revenue source to rise to the level of being 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 as such, its income is normally presumed to be from a business.<sup>7</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 to be a business, and therefore, be a qualifying business.

- Paragraph (c) of the definition of qualifying business contains the “substantial presence” test. This provision allows a business which 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 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 BC by having share capital of \$10,000,000 or greater employed in BC and by paying salary and wages of \$300,000 or greater to employees in BC.
- 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 interpretation by the Ministry of Finance of the “substantial presence” test still raises considerable uncertainty concerning whether certain income from property can qualify as IFB income. Many practitioners believed that if the capital and salary requirements were met, the income from property would be considered to be a qualifying business. This may not

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<sup>7</sup> See *Anderson Logging Co.* 52 DTC 1209 and *Canadian Marconi* 86 DTC 6526

necessarily be the case since paragraph (c) requires that the activity of earning income from property meet their requirements for a business carried on by the corporation.

- The IFAA defines “business” by reference to the *Income Tax Act (Canada)* (ITA) as “a profession, calling, trade, manufacture or undertaking of any kind whatever” (but the IFAA does exclude an undertaking which is an adventure or concern in the nature of trade). It is understood 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 only introduced in 2008, it may be advisable to seek a ruling or technical interpretation on any specific proposed set of facts.

## D. Qualifying International Financial Activities

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### 1. Loans and Deposits

Paragraphs 2(2)(a) to (d) of the IFAA includes as a qualifying international financial activity, the following:

*(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 subsection 4(1) of the *IFA Regulation* as:

*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).*

## **Notes**

- Loans can be made to and deposits accepted from individuals, corporations, financial institutions, governments, trusts, and estates, provided the party on one side of the transaction is a non-resident. While loans to a non-resident are considered to be a financial activity, see the discussion on qualifying business under Section C International Financial Business (IFB) Defined and Section H Examples 5. Financing Foreign Affiliates.

- Funds lent from or deposited by non-residents and booked in an IFB are also eligible. In addition to booking non-resident loans and deposits in a registered IFB, also permitted are any loans and deposits with other registered IFBs, federally designated International Banking Centres (IBCs), or registered IFCs (Montreal). There is a requirement for symmetry in respect of other IFBs. If a registered corporation makes a deposit with another IFB member, such as a bank, the income from the deposit will qualify while the bank will have to reflect the amount as an expense in its IFB income. This provision has created some audit difficulties in that it may be very difficult for a registrant to demonstrate that any deposits have been made with another registrant under the IFAA or registrant under the Montreal IFC program. Moreover, even if the party receiving the deposit were to be cooperative, it may be difficult to determine whether the deposit is “in respect of its international financial business.” This is due to the fact that an international financial business will normally be defined in respect of its qualifying activities. The expenses applicable to the IFB will often be an apportionment of an aggregation of expenses. For example, a financial institution which has loans to non-residents as part of its IFB, would normally deduct against this interest income a representative “cost of capital.” The “cost of capital” would be determined based on the bank paying interest on its deposits and other loans.

If the deposit made by an IFAA registrant is part of the deposits used by the financial institution in determining its cost of capital, would this be considered to be “in respect of” its IFB? This particular issue creates problems for registrants in providing an adequate audit trail and may create similar issues for the Province in attempting to audit this provision.

- International financial transactions often involve the movement of funds internationally through such means as SWIFT (Society for Worldwide Interbank Financial Telecommunication) or other services that facilitate automatic payments of foreign accounts; or lock-box and other services, which facilitate the collection of foreign payments from foreign accounts. In a yet-to-be published Technical Interpretation the issue was addressed as to whether services provided to a Canadian company of effecting payment to its foreign suppliers by depositing amounts directly into its suppliers' non-resident accounts qualified under paragraph 2(2)(b). Furthermore, the Technical Interpretation also requested whether services provided to a Canadian resident that facilitated the receipt of funds from non-residents and deposited these funds into a Canadian bank account would be a qualifying activity under paragraph 2(2)(a). In the view of the Ministry of Finance, such services would not be qualifying financial activities as the provision of paragraphs 2(2)(a) and 2(2)(b) are applicable only to services provided to non-residents.

## 2. Loan Guarantees

Paragraph 2(2)(e) of the IFAA includes in qualifying financial activities:

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

### **Notes**

- “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>8</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 would appear 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 clause 2(2)(g)(i)(A) of making an agreement to acquire the letter of credit security from a non-resident.

### 3. Letter of Credit (L/C) and Documentary Collections

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

*(f) if 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.*

#### ***Limitations***

For this international financial activity, there is an arm’s-length requirement

Subsection 2(3) of the IFAA provides that:

*“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*

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<sup>8</sup> See IFA Technical Interpretation 2005-0007, International Financial Activity, BC Ministry of Small Business and Revenue.

*person who is dealing at arm's length with and who is not affiliated with the corporation.”*

### ***Definitions***

A “savings institution” is defined in the *Interpretation Act* and means:

- banks,
- credit unions,
- trust companies, extra-provincial trust corporations authorized to carry on deposit business under the *Financial Institutions Act*, and
- Corporations that are subsidiaries of banks and are loan companies to which the *Trust and Loan Companies Act* (Canada) applies<sup>9</sup>.

## **4. Securities Dealing**

Paragraph 2(2)(g) of the IFAA includes the following activities as 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*

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<sup>9</sup> See Bulletin IFA 001 issued by the Ministry of Small Business and Revenue

*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” in subparagraph 2(2)(g)(ii) are defined in the *IFA Regulation* as short-term debt instruments other than derivatives.<sup>10</sup>

### ***Limitations***

A company’s own securities or those of its affiliates do not qualify, pursuant to subsection 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 substitute for a non-resident person, pursuant to subsection 2(6) of the IFAA:

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<sup>10</sup> See subsection 4(2.1) of the *IFA Regulation*.

*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.*

### **Definitions**

Subsection 2(1) of the IFAA sets out the following definitions:

1. “Non-resident broker”

*“non-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.*

2. “Securities Corporation” is defined as follows:

*“securities corporation” means*

*a) a savings institution<sup>9</sup>, or*

*b) a corporation registered under the Securities Act as a dealer or underwriter.*

### **Notes**

- When the dealer is a securities corporation:

- a.* Subparagraph 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 subparagraph *g(iii)*.
- b.* When a securities corporation, which is registered, acts as principal, the IFB includes securities transactions with non-residents. It can, therefore, acquire, dispose of, subscribe to, or underwrite securities with a non-resident. The only restriction to transactions of this nature is that it cannot trade its own stock or the stock of an affiliate.
- c.* When the securities corporation, which is registered, acts as agent or broker for a Canadian resident, the IFB will again include securities transactions with non-residents. The IFB can acquire, dispose of, subscribe to or underwrite securities with a non-resident on behalf of a Canadian resident; but only with 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>11</sup>

- d.* A non-resident broker can be substituted for a non-resident person and thus fulfill the requirement that one side of the transaction be with a non-resident.<sup>12</sup>

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<sup>11</sup> See Section 3200 of the Income Tax Regulations (Canada) and Technical Interpretation IFA 2005-0008.

- When the dealer is not a securities corporation:
  - a.* Subparagraph 2(2)(g)(ii) qualifies a non-securities corporation acting as principal and dealing in prescribed securities with a non-resident. Securities are prescribed by Regulation as “short-term debt securities other than derivatives.”<sup>10</sup>
  - b.* Again, a non-resident broker can be a substitute for a non-resident person and thus fulfill the requirement that one side of the transaction be with a non-resident.<sup>12</sup>
  
- When the corporation acts as agent for a non-resident:
  - a.* Sub-paragraph 2(2)(g)(iii) applies to all corporations—securities and non-securities corporations. In this case, the IFB includes transactions in securities whether with a resident or a non-resident.

Paragraph 2(2)(g) deals with all of the permutations and combinations of securities transactions. Subject to some limitations, as long as a non-resident or non-resident broker is involved in some aspect of the transaction, the securities transaction will be an international financial activity.
  
- Therefore, under subparagraph 2(2)(g)(ii), a corporation, which is not a Securities corporation, can acquire short-term debt securities such as a Treasury Bill, from a non-resident broker and to the extent this is part of a qualifying business, it would be a qualifying activity – see H Examples 6. Investment of Surplus Funds.

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<sup>12</sup> See subsection 2(6) of IFAA

## 5. Insurance

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

*(h) 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.*

Risks are prescribed by subsection 4(3) of the *IFA Regulation*:

*4(3) 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.*

### ***Limitations***

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.*

The arm's-length restriction does not apply to captives<sup>13</sup> registered under the *Insurance (Captive Company) Act*.

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<sup>13</sup> See subsection 2(4) of IFAA.

## Notes

- Insurance premiums earned by a captive insurance company may be eligible as a qualifying financial activity under the IFAA. The Province of BC is the only province in Canada to have captive insurance legislation (see 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 H Examples 7. Captive Insurance.

## 6. Financial Advice

Paragraph 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 as it is prescribed by subsection 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.*

## Notes

- Assuming a registrant is not in the business of providing legal, accounting, or tax advice, financial advice qualifies, including advice provided by a company's legal, accounting, and tax departments—as long one side of the transaction is with 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>14</sup>
- Providing ‘financial advice’ generally includes recommendations or opinions offered regarding a course of action. According to the Ministry of Finance (formerly Ministry of Small Business and Revenue):

It is our view that financial advice includes a recommendation or an opinion offered regarding a course of action. For other activities that are not inherently financial, such as providing legal advice, [and presumably tax advice] whether the activity qualifies under *the IFA Act* will depend on whether the activity provides financial advice.<sup>14</sup>

## 7. Foreign Exchange

Paragraph 2(2)(j) of the IFAA provides 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.]

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<sup>14</sup> See Ruling IFA 2006-0001, International Financial Activity, BC Ministry of Small Business and Revenue

*(k) managing, for a fee or commission, foreign exchange activities for non-resident persons...*

### ***Limitations***

An arm's-length requirement applies to sub-paragraph 2(2)(j)(ii) (a corporation whose primary business is dealing in foreign exchange).<sup>15</sup> There is no arm's length requirement for managing foreign exchange activities.

If the IFA registrant is a bank, credit union, 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 where the counterparty of the transaction can be a Canadian resident and qualify. For other types of registrants, only foreign exchange transactions with non-residents will qualify.

## **8. Investment Management**

Paragraph 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)...*

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<sup>15</sup> See subsection 2(3) of the IFAA

## *Notes*

Fund management or administration for foreign-based funds may qualify as an international financial activity. Therefore managers of private equity, venture capital, hedge funds, mutual funds and other types of investment funds will be able to have their fee or commission income 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 subsection 2(1) of the IFAA for 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.

In managing 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, namely: 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>11</sup>

- According to the Ministry of Finance (formerly the Ministry of Small Business and Revenue), “Where a stock is listed on more than one stock exchange that includes a prescribed exchange, it will not qualify”<sup>16</sup>

This restriction has created compliance challenges for IFC BC members as most accounting systems do not identify trades carried out in respect of foreign securities that are dual listed on both a Canadian exchange and a foreign exchange.

- When the business has a mixed portfolio, the government requires a reasonable allocation method must 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, 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>17</sup>

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<sup>16</sup> See Technical Interpretation IFA 2005-0008, International Financial Activity Ministry of Small Business and Revenue.

<sup>17</sup> See Technical Interpretation IFA 2004-0001, International Financial Activity Ministry of Small Business and Revenue.

## 9. Financial Research

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

*(n) 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 prescribed in subsection 4(5) of the *IFA Regulation*:

*(5) for 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.*

### Notes

- Assuming 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>18</sup>

## 10. Factoring

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

*(o) collecting trade accounts that*  
*(i) are receivable from a non-resident person, and*

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<sup>18</sup> See Advanced Ruling IFA 2006-0001, International Financial Activity, BC Ministry of Small Business and Revenue.

*(ii) have been bought outright from the seller and without recourse to the seller.*

## Notes

- According to the Ministry of Finance, 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>19</sup>
- Ministry of Finance (MoF) has also stated, “For 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 ultimate obligation to pay the debts which have been purchased rests with the non-resident person.”<sup>19</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>20</sup>

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<sup>19</sup> See IFA Rulings 2005-0006 and 2006-0003, International Financial Activity Ministry of Small Business and Revenue.

<sup>20</sup> See Technical Interpretation IFA 2006-0003, International Financial Activity (IFA), BC Ministry of Small Business and Revenue (MSBR)

## 11. Leasing

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

*(p) 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.*

## 12. Film Distribution

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

*(q) 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.*

## 13. Patents

Paragraph 2(2)(q.1) and (q.2) of the IFAA provides 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*

## Notes

- International Patent Codes (IPC) are prescribed by subsection 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 apply to those related to power generation using forces of nature such as wind, solar and tidal forces as well as fuel cell technology and waste water treatment.
- In any taxation year, a registered corporation may choose to claim a refund either on its life science or green technology patent activities or on its other eligible international financial activities, but not both.<sup>21</sup>
- A corporation must directly license a patent to qualify as an IFA activity. According to the Ministry of Finance, “It is our view that 2 (2) (q.1) of the *IFA Act* requires that a corporation must directly license a patent to qualify as an international financial activity. Licensing distribution rights will not fulfill this requirement.”<sup>22</sup>
- A corporation must own at least one qualifying patent used to produce the invention. Again, the Ministry of Finance states, “It is our 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>22</sup>

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<sup>21</sup> See paragraph 17.1(1)(c) of the IFAA.

<sup>22</sup> See Technical Interpretation IFA 2006-0002, IFA, MSBR

## 14. Administrative Support Services

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

*(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.*

### Notes

- Call centres, marketing and advertising are excluded by subsection 4(7.1) of the *IFA Regulation*
- Providing centralized accounting services would likely constitute administrative support services where those services support a financial activity. According to the Ministry of Finance:

In our view, 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>23</sup>

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<sup>23</sup> See Advanced Ruling IFA 2006-0001, IFA, MSBR .

## 15. Management Services

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

*(r.1) 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 subsection 4(7.1) of the *IFA Regulation* 4(7.1):

*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 “management services” international financial activity was recently added with the February 2008 BC Budget, effective February 20, 2008. The Regulation prescribing management services, promulgated June 26, 2008, uses the term “strategic” management services. It is expected that the government will provide further guidance concerning the meaning of “strategic management services.”

The term “strategic” could be interpreted quite broadly as a head office would generally provide management and control services to ensure its foreign affiliate’s operations were aligned with the overall group’s strategy. It would appear 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 only “strategic management services,” there must have been an intent 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.

#### 16. Back-up Equipment and Premises

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

*(s) 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.*

#### 17. Other Financial Activities

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

*(t) 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 subsections 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.*

## Notes

- The first three activities of the following list are limited to savings institutions<sup>9</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 UK or remain in the UK
  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>23</sup>

## E. IFA Specialists

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Registered corporations can apply to register individual employees as IFA Specialists. A Specialist is entitled to a refund of up to 75% of BC income tax paid on net employment income earned from the eligible international financial activities for up to five years.

Subsection 13(1) of the IFAA provides that:

*(1) 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];*

*(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), 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.*

## **Notes**

- International financial activities related to patents, administrative support, management services, and back-up support do not qualify for IFA Specialist registration.
- Specialists can only be registered by a corporation that has applied for or has been registered in the IFA program.

- The individual has to 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 for at least 70% of the individual’s working time 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>24</sup>
- 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.(Canada)*”<sup>25</sup>

## F. Calculation of the Refund

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### 1. Tax Refund of an IFB

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

***Tax refund = [A/(B × C)] × D where:***

- **A** is the total adjusted IFB income, excluding foreign dividend income or assistance under paragraph 12(1)(x) of the *Income Tax Act (Canada)*.

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<sup>24</sup> See Advanced Ruling IFA 2005-0005, International Financial Activity, BC Ministry of Small Business and Revenue.

<sup>25</sup> See Frequently Asked Questions, International Financial Activity, BC Ministry of Small Business and Revenue ([www.sbr.gov.bc.ca/business/income\\_taxes/international\\_financial\\_activity/faq.htm#25](http://www.sbr.gov.bc.ca/business/income_taxes/international_financial_activity/faq.htm#25))

- “Total adjusted IFB income” is defined as “IFB income – (foreign dividends + inducements)” (*section 19 of the IFAA*).
- “IFB income” is the total of: (a) the income or loss of the IFB; and (b) any income or loss due to hedging (added in 2008).
- There is a separate refund formula for international financial activities that relate to patents; see F 2.

Subsection 19(1) of the IFAA provides that:

*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...*

- **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,

- **C** is the percentage of taxable income allocated to British Columbia for the taxation year, and
- **D** is the corporation's British Columbia income tax (after deducting all tax credits and deemed payments).

### Notes

- A tax refund is paid to a corporation only after all British Columbia and federal income taxes are paid.
- The IFA refund cannot be greater than the amount of net BC tax payable; therefore, in the above formula  $A/(B \times C)$  cannot be greater than one.
- As a result of the introduction of section 261 of the *Income Tax Act* (Canada), corporations can compute the income of their international financial business in their "functional" currency of US dollars, Euros or British Pounds, provided they meet the requirements. This will simplify the compliance burden for international financial businesses that use a foreign currency, in that they will be able to qualify to use their foreign currency for calculating their IFAA claim.
- The Canada Revenue Agency (CRA) has ruled that a refund received by a corporation under the IFA program is included in income under paragraph 12(1)(x) of the *Income Tax Act* (Canada), unless the corporation makes an election under subsection 12(2.2) of that *Act*.<sup>24</sup> Subsection 12(2.2) of the *Income Tax Act* (Canada) allows a taxpayer to elect to treat the IFAA refund as a reduction of BC income taxes paid and thereby avoid taxation on this

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 election can be made by attaching a signed letter to the T2 Corporate Income Tax Return which states the election is being made under subsection 12(2.2), the elected amount, the amount of the IFAA refund and the date it was received.<sup>26</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 is often not achieved by the formula.

A simple example can demonstrate the application of the formula.

Assume the following:

*Adjusted IFB Income = \$100 (A)*

*Other BC Income = nil*

*Canadian net and taxable Income = \$300 (B)*

*% of Wages Allocated to BC = 30%*

*% of Revenues Allocated to BC = 20%*

Therefore:

1. % of Taxable Income Allocated to BC (Regulation 400)

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<sup>26</sup> See Interpretation Bulletin, IT-273R2, Canada Revenue Agency

$$= (30\% + 20\%) / 2$$

$$= 25\% (C)$$

2. 2010 BC Income Tax Payable

$$= 25\% \times \$300 \times 10.5\%$$

$$= \$7.87 (D)$$

3. IFAA Refund

$$= [IFB \text{ Income } (A) / (\text{Taxable Income } (B) \times BC \% \text{ Allocation } (C))] \times BC \text{ Tax } (D)$$

$$= [\$100 / \$300 \times 25\%] \times \$7.87$$

$$= 1.33 \times \$7.87$$

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

In this particular example if the company had paid additional BC tax on non-IFB income, then the IFAA refund could be as much as 10.5% of the IFB Income or \$10.50.

Furthermore the determination of adjusted income pursuant to the above formula is based on a determination of the income from qualifying activities as if the IFB is a separate business. On the other hand, the determination of BC taxable income and by extension the amount of BC tax payable is determined by applying a formula under Regulation 400 of the *Income Tax Act* (Canada). BC taxable income is determined by applying a percentage to Canadian taxable income. The percentage averages the ratio of salaries and revenues paid or earned in BC

versus total Canadian salaries and revenues, respectively. Since the two calculations are computed on a different basis, anomalous results can occur.

## 2. Tax Refund of an IFB-Patent Activity

The tax refund for patent activities is limited to 75% of British Columbia corporate income tax paid to a maximum of \$8 million.

The refund calculation follows the same pattern; except it is capped at \$8 million and the refund is only 75% 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 meanings as noted above except that, as they relate to international financial business income, they would only include patent-related IFB income.

A corporation, which 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

## G. Administration

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### 1. Filing requirements

Registrants and specialists have 18 months after the end of the taxation year to file a refund claim.<sup>27</sup> There is discretion for the commissioner to extend the filing date.

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<sup>27</sup> See subsection 24(1) of the IFAA

For a corporate claimant, the form FIN 578, *IFA Tax Refund of a Corporation* (or for a patent related refund claim, use form FIN 546 *IFA Tax Refund of a Life Science Corporation*) is required, along with financial statements, income tax returns, and *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. Required forms are listed in “Appendix 3, Checklist” in *The Guide to Completing the Tax Refund Form*.

If a claimant is issued a notice of reassessment by CRA under the *Income Tax Act* (Canada) which changes the tax refund, the claimant is required to file a form advising of the change with the commissioner within 90 days.<sup>28</sup>

A registered corporation is also 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 (or March 30 in a leap year).<sup>29</sup>

## 2. Interest

Interest on unpaid refund applications begins to accrue 61 days after all documents are received by the BC Ministry of Finance.<sup>30</sup>

When interest is owed by the Province to a registrant, the rate is 2% below the prime rate of the Province’s principal banker; when interest is owed to the Province, the rate is 3% above the prime rate of the Province’s principal banker.

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<sup>28</sup> See Section 25 of the IFAA.

<sup>29</sup> See Section 26 of the IFAA.

<sup>30</sup> See Section 33 of the IFAA.

### 3. Audits

Audits are conducted at the discretion of the Ministry of Finance (formerly BC Ministry of Small Business and Revenue). In practice, audits are normally conducted annually after a return is filed. Registered corporations need to retain documentation to support the determination of IFB income, including reasonable allocation of expenses between the IFB and non-IFB activities.<sup>31</sup>

### 4. Transfer Pricing

Subsection 20(1) of the IFAA defines “transaction price.”

Subsection 20(2) of the IFAA provides that the transaction price between non-arm’s length parties must be determined as if the parties were dealing at arm’s length:

*(2) 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.*

Subsection 20(3) of the IFAA permits the Commissioner of Income Tax to set the transaction price between non-arm’s length parties as if the parties were dealing at arm’s length:

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<sup>31</sup> See subsection 25(3) of the IFAA.

*(3) 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.*

## **Notes**

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

It is our view [Ministry of Finance] that documentation required by section 247(4) of the *Income Tax Act* (Canada) (federal *Act*) will be accepted 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* would be one of the factors considered in determining the transaction price for the purpose of section 20 of the *IFA Act*.<sup>32</sup>

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<sup>32</sup> See Advanced Ruling/ Interpretation IFA 2005-0001, 2005-0003 and 2005-0006 among others. International Financial Activity, BC Ministry of Small Business and Revenue.

## 5. Administration of the IFAA

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

## 6. 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 *Income Tax Act* (Canada):

*(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.*

## H. Examples

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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 in nature, others are not, such as life sciences patent income and management and control activities. 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. Management and Control
5. Financing Foreign Affiliates

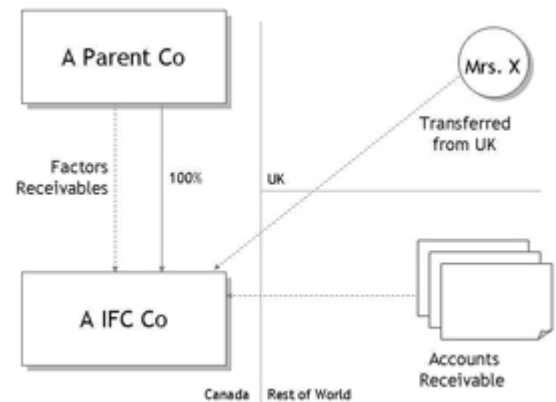
6. Investment of Surplus Funds

7. Captive Insurance

## 1. Factoring Foreign Accounts Receivable

### Facts

- A IFC Co is a corporation incorporated in BC and wholly owned by its Canadian parent, A Parent Co. It has leased office space in British Columbia.
- A Parent Co. decides to sell its worldwide receivables to A IFC Co. A IFC Co does not have recourse to A Parent Co. for receivables that are not collectible.
- A Parent Co. and A IFC Co conduct a transfer pricing study to ensure the non-arm's length sale price is comparable to arm's length transactions.
- A Parent Co. transfers an executive, Mrs X, from London, UK to oversee the operations and hires the remainder of the staff locally within British Columbia.
- Mrs X has been a resident of the U.K. and has entered into a written employment contract that requires her to spend at least 70% of her time overseeing the collection of the foreign accounts receivable.



## Analysis

A IFC Co is eligible to apply for registration since it will be carrying on an “international financial business.”<sup>33</sup> It was incorporated in Canada and has a permanent establishment in British Columbia. A IFC Co will be required to become a member of the International Financial Centre British Columbia (IFC BC) Society in order to remain registered.<sup>34</sup> A IFC Co is carrying on an active business of collecting foreign trade receivables and, as such, is carrying on a qualifying business<sup>35</sup> through a fixed place of business in British Columbia. A IFC Co’s business activities qualify as international financial business activities because A IFC Co is collecting trade accounts from non-resident persons that have been acquired on a non-recourse basis.<sup>36</sup> A IFC Co will be eligible to claim a refund of its BC corporate income taxes paid<sup>37</sup> in respect of its international financial business.

A IFC Co can register Mrs. X as a specialist under the IFAA.<sup>38</sup> As a specialist under the IFAA, Mrs. X will be eligible to claim a refund of 75% of BC individual income taxes paid for up to 5 years.<sup>39</sup>

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<sup>33</sup> See Section 1 definitions of the IFAA 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”

<sup>34</sup> See Paragraph 11(1)(c) of IFAA

<sup>35</sup> See paragraph 1.1(1)(a) of International Financial Activity Regulation

<sup>36</sup> See paragraph 2 (2) (o) of IFAA

<sup>37</sup> See section 17 of IFAA

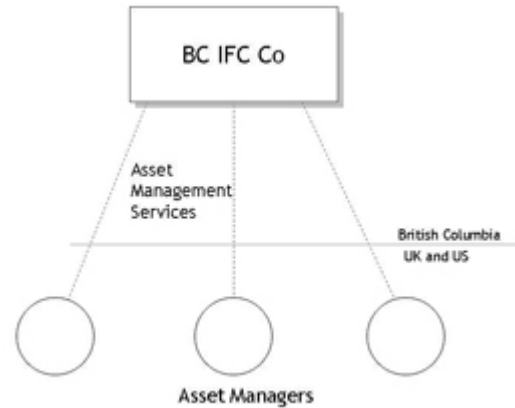
<sup>38</sup> See section 13 of IFAA

<sup>39</sup> See section 22 of IFAA

## 2. Fund Asset Management

### Facts

- B IFC Co is a corporation incorporated in Canada with a fixed place of business in British Columbia.
- B IFC Co provides third party services to global asset managers who are resident in London, UK and New York, US through its fixed place of business in British Columbia.



- B IFC Co 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.
  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.
  7. Managing cash flow balances and banking for the fund.

## **Analysis**

B IFC Co is eligible to apply for registration since it will be carrying on an “international financial business,”<sup>40</sup> was incorporated in Canada and has a permanent establishment in British Columbia. B IFC Co will be required to become a member of the IFC BC Society in order to remain registered.<sup>34</sup> B IFC Co is carrying on an active business providing management and administrative services of investments for a non-resident, and, as such, is carrying on a qualifying business<sup>35</sup> through a fixed place of business in British Columbia. B IFC Co’s fund administration services business is an active business and there would not be any requirement to meet the “substantial presence” test. B IFC Co’s activities performed for non-resident persons of managing investments and providing administrative support services will qualify as international financial activities.<sup>41</sup> B IFC Co will be eligible to claim a refund of its BC corporate income taxes paid.<sup>37</sup>

### **3. Life Science Patent Income**

#### **Facts**

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<sup>40</sup> See section 1 of IFAA. B IFC Co must be carrying on an “qualifying business” through a fixed place of business in BC and all of the activities of the international financial business must be “international financial activities.”

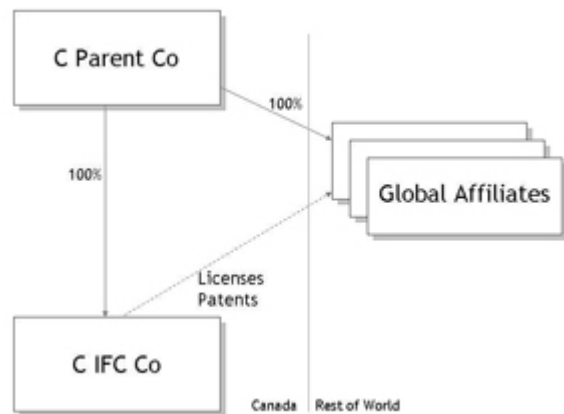
<sup>41</sup> The activities of B IFC Co can qualify as international financial activities under different provisions of the IFAA. B IFC Co’s activities would qualify under paragraph 2(2)(l) “managing, for a fee or commission, investments for non-resident persons.” Moreover, the activities may also qualify under paragraph 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 activities of the non-resident person.” B IFC Co is not carrying on any prescribed administrative support services of call centers, marketing or advertising, as outlined in the *IFA Regulations*. Some of B IFC Co’s activities may also qualify under other activities; see paragraph 2(2)(i) on providing financial advice and paragraph 2(2)(n) on preparing stock market or other financial research.

- C IFC Co is a corporation incorporated in Canada with a fixed place of business in BC.

- C IFC Co is owned by C Parent Co.

- C IFC Co has developed a patent (life sciences patent) which has a primary classification number assigned in accordance

with the International Patent Classification, 8<sup>th</sup> edition, adopted under the *Strasbourg Agreement Concerning the International Patent Classification* under Item 5, Section C, Class 07.



- C IFC Co licenses its life sciences patent to the foreign affiliates of C Parent Co.
- C IFC Co and the foreign affiliates conduct a transfer pricing study to ensure the non-arm’s length license fees are comparable to arm’s length transactions.

## Analysis

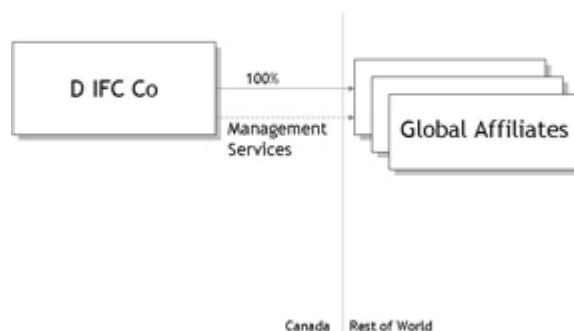
C IFC Co is eligible to apply for registration since it will be carrying on an “international financial business,”<sup>33</sup> was incorporated in Canada and has a permanent establishment in British Columbia. C IFC Co will be required to become a member of the IFC BC Society in order to remain registered.<sup>34</sup> C IFC Co is carrying on a qualifying business. If the licensing of the life sciences patent is part of the active business of C IFC Co, then it will be a qualifying business.<sup>35</sup> On the other hand, if the licensing of the life sciences patent is considered to be a

separate business whose income is principally income from property, it will also be considered to be a qualifying business.<sup>42</sup> C IFC Co's business activity qualifies as international financial activity by means of licensing to non-resident persons a patent, which has been prescribed under the *IFA Regulations*.<sup>43</sup> C IFC Co will be eligible to claim a refund of 75% of its BC corporate income taxes paid up to a maximum of \$ 8 million for each taxation year.<sup>44</sup>

#### 4. Management and Control

##### Facts

- D IFC Co is a corporation incorporated in BC with its head office located in British Columbia.



- D IFC Co has a number of wholly owned foreign affiliates, which carry on active businesses in the United States, Asia and Europe.
- D IFC Co provides management services to its foreign affiliates. The management services include executive support services, treasury functions, strategic operational decisions, human resource policies, human resource training and development, executive foreign assignment management and international tax planning.

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<sup>42</sup> See paragraph 1.1(1)(b) of *IFA Regulations*.

<sup>43</sup> See paragraph 2(2)(q.1) of the *IFAA* and section 5 of the *IFA Regulations*.

<sup>44</sup> See section 17.1 of *IFAA*.

- D IFC Co and its foreign affiliates have completed a transfer pricing study to ensure the non-arm's-length management fees charged to its foreign affiliates are comparable to an arm's-length charge for these management services.

## **Analysis**

D IFC Co is eligible to apply for registration under the IFAA since it will be carrying on an “international financial business.”<sup>33</sup> D IFC Co will be required to become a member of the IFC BC Society in order to remain registered.<sup>34</sup> D IFC Co is carrying on an active business as defined in subsection 248 (1) of the *Income Tax Act* (Canada) and is therefore carrying on a qualifying business through a fixed place of business in British Columbia. Some of the management and control activities will be considered to be “prescribed management services” provided to a non-resident foreign affiliate that are directly related to the business operations of the foreign affiliate.<sup>45</sup>

Since D IFC Co has its head office in British Columbia, certain of its management activities provided to non-residents can qualify. The regulations prescribing management services have created some uncertainty relating to qualifying activities. As noted above, the reference to “strategic” management services is not clear. Strategic is defined as “relating to or concerned with strategy.” It could be interpreted very broadly as all management services should be aligned and relate to the overall business strategy of the group of companies. On the other hand, by modifying the term management services with the adjective “strategic,” there must

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<sup>45</sup> See paragraph 2(2)(r.1) of the IFAA.

have been an objective of narrowing the qualifying activities to some subset of all management services.

It would appear that executive support services and strategic operational decisions should qualify as strategic management services. Treasury functions provided to non-resident affiliates should also qualify under one or more other provisions of the IFAA.<sup>46</sup>

Certain human resource activities, such as training and development, should also qualify under the *IFA Regulation*<sup>47</sup> Managing executive foreign assignments may also qualify to the extent these activities can be characterized as “benefits management,”<sup>47</sup> such as tax equalization, costs of moving and moving allowances and support. International tax planning could be a qualifying activity under paragraph 2(2)(i) as it involves “providing financial advice, other than prescribed financial advice, to non-resident persons.”<sup>48</sup> Therefore, it is possible that most of D IFC Co’s management services will qualify as international financial activities under a number of provisions of the IFAA. D IFC Co is eligible to claim a refund of its BC corporate income taxes paid in respect of its international financial activities.<sup>37</sup>

## 5. Financing Foreign Affiliates

### **Facts**

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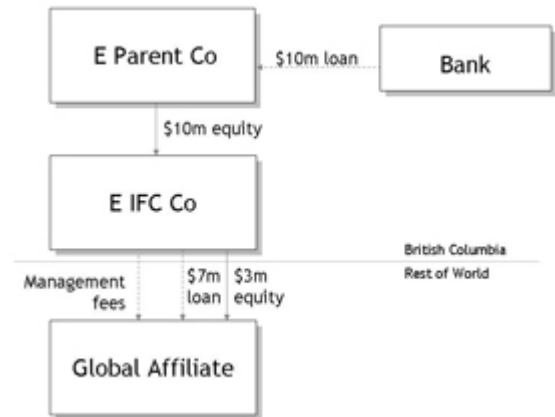
<sup>46</sup> See paragraph 2(2)(g)(ii), (h), (i), (k), (l), (m), (n) and (r).

<sup>47</sup> See paragraph 4(7.1)(b) of *IFA Regulations*—

<sup>48</sup> Under the *IFA Regulation*, prescribed financial advice is legal, accounting or tax advice provided by a corporation in the business of providing that advice. D IFC Co would not be in the business of providing tax advice.

- E IFC Co is a corporation incorporated in British Columbia which has its sole office in British Columbia.

- E IFC Co has a number of wholly owned foreign affiliates, which are resident in countries other than Canada. The foreign affiliates of E IFC Co carry on active businesses in these various countries.



- E IFC Co carries out a number of activities for its foreign affiliates including making loans to the foreign affiliates. E IFC Co also provides corporate treasury and strategic management services to its foreign affiliates.
- E IFC Co is a wholly-owned subsidiary of E Parent Co. E Parent Co has subscribed for \$10 million dollars of share capital of E IFC Co. E Parent Co has borrowed \$10 million from the banks in order to finance its share subscription in E IFC Co. E Parent Co is carrying on an active business.
- E IFC Co pays its executive employed in the conduct of its business aggregate salaries of \$300,000.

### **Analysis**

While E IFC Co may not be carrying on an “active business” in its own right, it can qualify under the “substantial presence” test. Since E IFC Co is not dealing at arm’s length with

Parent Co, which is carrying on an active business; has a share capital stock of \$10 million employed in BC; and has paid salary and wages of \$300,000 to employees employed in the conduct of its business in Canada it will meet the “substantial presence” test.<sup>49</sup> Making loans to a non-resident foreign affiliate is an international financial activity.<sup>50</sup> Nevertheless, the loan activity may not be considered to be a qualifying business by the Ministry of Finance. If the loan activity is income from property and not part of the business of E IFC Co., then the income will not be considered to be part of the international financial business. The IFC BC has been advised by the Ministry of Finance that, in their view, a long term financing arrangement with a foreign affiliate would not normally be considered to be a business, in and by itself, nor part of a qualifying business. As a result, in their view, the income from financing foreign affiliates would not normally qualify for the tax benefits under the IFAA.

The author is of the view that long-term financing arrangements can qualify for benefits under the IFAA. Provided the income from the long-term financing arrangement is considered to be part of an overall treasury business, which meets the “substantial presence” tests of \$10 million of equity and capital and \$300,000 of wages in BC. This source of income should be considered to be income from a business (income from a specified investment business). Since the definition of business is largely taken from the federal Act, the case law that has dealt with the determination of business income under the federal Act is relevant. This case law has

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<sup>49</sup> See paragraph 1.1(1)(c) of the definition of “qualifying business” in *IFA Regulations*. E IFC Co may also be carrying on an active business and be carrying on a qualifying business under paragraph 1.1(1)(a) of the *IFA Regulation*.

<sup>50</sup> See paragraph 2(2)(c) of IFAA.

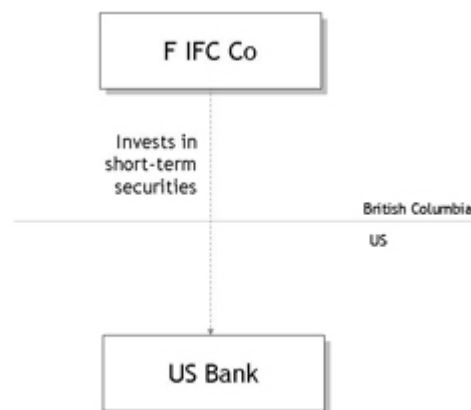
developed a *prima facie* presumption that a corporation is carrying on a business.<sup>51</sup> Therefore financing foreign affiliates as part of other treasury and management services would normally be considered to be part of a business.

The provision of treasury services to non-residents<sup>52</sup> and of strategic management, services to non-residents<sup>53</sup> may also be international financial activities. Treasury services involving cash management for foreign affiliates would normally constitute financial advice, which is an international financial activity.<sup>52</sup> Therefore, some of E IFC Co's activities should be international financial activities. E IFC Co is eligible to apply for registration since it will be carrying on an "international financial business."<sup>33</sup> E IFC Co is required to become a member of the IFC BC Society in order to remain registered.<sup>34</sup> E IFC Co is eligible to claim a refund of its BC corporate income taxes paid<sup>37</sup> in respect of its international financial business.

## 6. Investment of Surplus Funds

### Facts

- F IFC Co is a corporation incorporated in British Columbia. F IFC Co carries on an active business in British Columbia through a fixed place of business in British



<sup>51</sup> See *Anderson Logging* 52 DTC 1209 and *Canadian Marconi* 86 DTC 6526

<sup>52</sup> See paragraph 2(2)(i) of IFAA. If E IFC Co is providing legal, accounting or tax advice and is considered to be in the business of providing that advice, the financial advice will not be an international financial activity.

<sup>53</sup> See paragraph 2(2)(r.1) of IFAA and subsection 4(7.1) of *IFA Regulation*.

Columbia.

- F IFC Co has significant funds for investment that are surplus to its business needs.
- F IFC Co invests its surplus funds in short-term securities acquired from a non-resident broker (who is authorized in the US to trade in securities and is not authorized or registered in Canada to trade in securities (or related to someone who is)). .

### **Analysis**

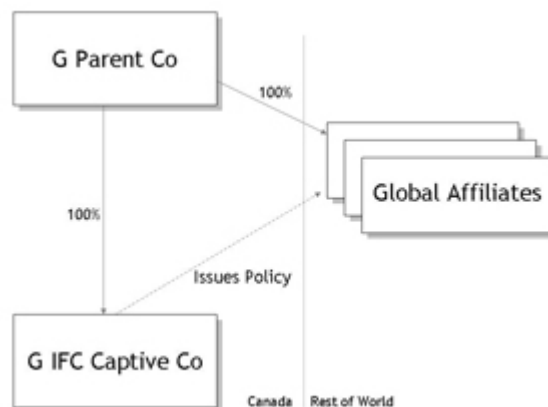
The key issue is whether F IFC Co is carrying on a specified investment business in relation to the investment of surplus funds. This business is separate from the active business carried on in BC if the funds are clearly surplus to the needs of the active business and are not incident to the active business carried on or used principally for purposes of gaining or producing income from the active business. The income from the investment of surplus funds is considered to be 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 a similar 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>54</sup> F IFC Co will only be eligible to claim a refund of its BC corporate taxes paid in respect of this activity if the activity is considered to be a business.

## 7. Captive Insurance

### Facts

- G Parent Co decides to cover its insurance needs with a wholly owned subsidiary and establishes a captive insurance company located in B.C., G IFC Captive Co.
- G IFC Captive Co is incorporated in B.C. and licensed under the *Insurance (Captive Company) Act*.
- G Parent Co has affiliates in Canada, as well as globally, which carry on active business in the US, Asia, and Europe.
- The global affiliates of G Parent Co insure their property and casualty risks with G IFC Captive Co.



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<sup>54</sup> See sub-paragraph 2(2)(g)(ii) of IFAA and subsection 4(2.1) of IFA Regulation

## **Analysis**

G IFC Captive Co is eligible to apply for registration under the IFAA since it will be carrying on an “international financial business.”<sup>33</sup> G IFC Co will be required to become a member of the IFC BC Society in order to remain registered.<sup>34</sup> G IFC Captive Co is carrying on an active business as defined in subsection 248(1) of the *Income Tax Act* (Canada) 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 of Canada is an international financial activity.<sup>55</sup> G IFC Captive Co will be eligible to claim a refund of BC corporate income tax paid as determined under the IFAA.

G IFC Captive Co provides an alternative arrangement to many offshore structures utilized for captive insurance. With an onshore structure, federal tax will be payable on the insurance earnings. However, the tax payable with an onshore captive structure may largely be offset with the savings of administering the structure onshore versus the extra costs of compliance of being offshore. Many of the costs of an offshore structure relate to ensuring that tax risks associated with residency of the captive are mitigated. Nevertheless, there will always be some level of tax risk with an offshore structure that may cause the Canada Revenue Agency (CRA) to review and/or challenge the arrangements. Moreover, there is often senior executive time required to exercise mind and management in the offshore jurisdiction with the associated opportunity costs. Furthermore, if the offshore captive were to incur losses, it would be

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<sup>55</sup> See paragraph 2(2)(h) of the IFAA

difficult to utilize those losses within Canada; whereas an onshore structure would normally facilitate utilization of any tax losses.

## I. Summary

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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.

The IFC BC serves the government, businesses and the people of British Columbia. It is tasked with the job of reaching out to professionals in the business community and businesses with a view to communicating the tax advantages available to companies under the IFAA. It's first—and most important—priority is to identify companies who 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 where companies can make use of the IFAA. The IFAA has expanded its qualifying financial activities significantly over the last five years. While of interest to financial institutions, the program has developed a much broader appeal. Moreover, many qualifying activities are not necessarily financial, such as leasing, patent exploitation, film distribution, administrative support, management services, back-up equipment and premises, and trustee administrative services. As British Columbia has an open economy that depends largely on its ability to trade and compete internationally, the IFAA is an important tool in allowing British Columbia to compete globally 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 a location for an international financial center. Not only is British Columbia a strategic location for the emerging economies of the Asia Pacific, it also offers a substantial labour market with capacity to meet the needs of an investment from this region. Additionally, the “Economist Intelligence Unit”, an affiliate of the Economist magazine, ranked Vancouver the most liveable city in the world for the seventh year in a row and the Mercer Group’s 2009 *Quality of Living Survey* ranked Vancouver fourth worldwide, first in North America.

The IFC BC plans to attract many companies to locate their international financial activities in 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.