The Joint Committee on Taxation of
The Canadian Bar Association and
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June 19, 2003

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Dear Mr. Farber

Re: October 11, 2002 Notice of Ways and Means Motion Relating to Non-Resident Trusts and Foreign Investment Entities

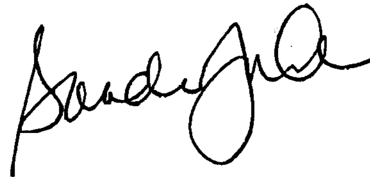
We are pleased to provide you with our comments on the October 11, 2002 Notice of Ways and Means Motion (the "Motion") relating to non-resident trusts ("NRT") and foreign investment entities ("FIE"). While our submission on the FIE provisions contained in the Motion is fairly comprehensive, we have been able to include only selected comments which have been raised by our members in respect of the NRT provisions.

We appreciate the opportunity of being able to participate in the consultative process and are pleased to see that the government has adopted the prescribed rate method as the default method of calculating the annual income inclusion from a particular FIE investment. This will provide a measure of simplicity for those investors who do not wish to undertake a detailed, and perhaps time consuming, analysis or valuation. Please note however, that we continue to support an alternative that will allow small investors (i.e. those owning less than a 10% interest) to pick up their share of the income, capital gains and underlying foreign tax of the non-resident entity should they desire to do so.

The submission contains a detailed discussion of some of the problems inherent in the FIE rules as they relate to financial statement presentation and the look-through rule. We hope this discussion will be of assistance in amending the legislation to correct some of these problems, as this is a critical aspect in the practical application of the new regime.

We trust that you will find our comments and recommendations helpful and, as always, we would be pleased to meet with you at a convenient time to elaborate on any of the issues discussed in this submission.

Yours truly,



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Encl.

Joint Taxation Committee Submission on Non-Resident Trusts and Foreign Investment Entities – October 11, 2002 Notice of Ways and Means Motion

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Foreign Investment Entities (FIEs)

A. Capital Loss Arising on the Disposition of a FIE

If a taxpayer has a participating interest in a FIE and does not elect (or is otherwise not entitled) to use the mark-to-market regime, the prescribed rate regime will result in an income inclusion each year. The calculation of this income inclusion will necessarily result in either an overaccrual or underaccrual of income, as it bears no relation to income (or loss) that is actually earned by the non-resident entity.

When the participating interest in the FIE is disposed of, regular capital gain (or loss) treatment will result. A capital loss will arise if the economic value of the investment has declined over the time that it is held. Throughout that time, however, the taxpayer has continued to pay tax on the required income inclusion each year.

Currently, there is no provision that allows the capital loss that ultimately arises on the disposition of the FIE to offset previous income inclusions. Therefore even though the investment suffered a loss in economic value, the application of the prescribed rate regime required that the taxpayer pay tax on phantom income that never in fact materialized.

The same result applies in cases where the mark-to-market regime has applied in a prior year and ceases to apply in a subsequent year. When the participating interest is disposed of in a subsequent year, it is a capital property, and any capital loss arising on the disposition cannot be applied to offset the prior years' income inclusions, which would have been calculated based on fluctuations in value that never in fact materialized.

Recommendation

Where either the prescribed rate method or the mark-to-market method has been used to calculate annual income inclusions and a true economic loss arises on the disposition of a FIE, we recommend that a mechanism be introduced to allow for an offset of the loss against previous income inclusions.

B. Prescribed Rate Regime -- Use of Fair Market Values in the Definition of "Designated Cost"

The "designated cost" of a taxpayer's participating interest in a FIE (assuming that the participating interest is acquired prior to 2003 and was not previously subject to the rules in old section 94.1) is determined as the total of its cost amount plus the difference, if any, between its fair market value at the end of 2002 and its cost amount at that time.

Therefore if the fair market value of the participating interest at the end of 2002 is greater than its cost, this fair market value becomes the designated cost.

If the fair market value is less than the cost of the participating interest at the end of 2002, no downward adjustment is made to the cost amount, and the cost amount is the designated cost.

One of the reasons for introducing the prescribed rate regime as the default method for calculating the required income inclusion was to solve the problem of having to obtain fair market value information for a taxpayer's participating interest in a FIE. It appears

inconsistent with this rationale to require a taxpayer to determine the fair market value of an investment at December 31, 2002 in order to calculate its designated cost.

Additionally, the use of this arbitrary value seems unfair, given that it is to be used only if it is greater than cost, and not if it is less.

Recommendation

The use of fair market value at December 31, 2002 as the basis for the designated cost of a participating interest should be eliminated. The definition should simply use the cost amount of the investment, with no adjustment to fair market value.

Alternatively, if fair market value will continue to apply for purposes of calculating designated cost in cases where an investment has increased in value, then this same principal should also apply to investments that have declined in value.

C. Prevention of Double Taxation in Section 94.3

The purpose of the rules in section 94.3 is to prevent the double taxation of income in situations where a FIE makes distributions to its investors that must otherwise be included in income under Canadian rules. Where the mark-to-market method is used, the rules appear to operate as intended where an investment's value increases year over year. However, where that value of the investment decreases, this does not appear to be the case. This is illustrated in the following example.

Assume that the fair market value of a participating interest in a FIE is $1,500 at the beginning of the year (which equates to the original cost of the investment) and $1,000 at the end of the year. The non-resident entity pays a dividend of $50 in the year.

Under the mark-to-market formula in subsection 94.2(4), the taxpayer is entitled to deduct $450 in computing income for the particular year as follows:

Fair market value at end of year	$ 1,000
Plus amount received from investment in year	50
Less fair market value at beginning of year	(1,500)
Net deduction under mark-to-market rules	$ (450)

Pursuant to section 90, the taxpayer would also include in its income the $50 dividend received. Theoretically, section 94.3 should apply to allow a deduction of $50 in the year to reflect the fact that the investment has actually decreased in value by $500, not just $450. However, the formula in subsection 94.3(2) does not work in this case because no income has been included under subsection 94.2(4). Under the formula, no deduction will be allowed as follows:

Deduction is equal to the lesser of:

(i)	amount otherwise included in income	50
(ii)	amount included in income under s.94.2(4) less amount deducted under s.94.2(4)	nil

The taxpayer's net loss for the year is therefore $400, not $450, made up of the $450 deduction allowed under subsection 94.2(4) and the dividend income inclusion of $50 under section 90.

Assume the taxpayer disposes of the participating interest in the subsequent year (after the non-resident entity's year-end) for $1,000. The mark-to-market income inclusion/deduction for the year of disposition would be calculated as follows:

Proceeds of disposition received in year	$ 1,000
Less fair market value at beginning of year	(1,000)
Net deduction under mark-to-market rules	$ nil

The disposition will not produce a loss under the regular rules in the Act, as the cost of the participating interest is deemed to equal to its fair market value at the beginning of the year (i.e. $1,000) due to paragraph 94.2(13)(a). So in the year of disposition there will be no effect on the income of the taxpayer as a result of these rules.

Economically, the taxpayer has received a total of $1,050 for its original investment of $1,500. Therefore the taxpayer has an overall economic loss of $450. However, the taxpayer has only been allowed to deduct $400. It would appear from this example that the taxpayer paid tax on $50 of income which should, in fact, not have been included in income.

Recommendation

The formula in subsection 94.3(2) needs to be reworked in order to ensure that double taxation is in fact prevented in cases where a taxpayer uses the mark-to-market method and suffers an overall economic loss from the participating interest.

D. Tax Avoidance Motive

D.1 Wording in paragraph catches many investments

Paragraph 94.1(2)(k) deems a taxpayer to have a tax avoidance motive in respect of a particular participating interest if it is reasonable to conclude that the main reasons for the acquisition of the interest include the derivation of a benefit the value of which can reasonably be attributed to income and gains from the investment property, and the deferral or reduction of tax that would have been payable by the taxpayer under Part I had the taxpayer earned such income or gains.

The main reason for the acquisition of a particular participating interest may simply be that it represents a sound investment decision based on the taxpayer's assessment of its risks and rewards. However, at the same time, the investment may also meet the two conditions contained in paragraph 94.1(2)(k).

It would appear that a taxpayer investing in a non-flow through entity such as a corporation would always satisfy both parts of this test. The taxpayer will derive a benefit from the investment in the form of a dividend, and will have a deferral of tax until such time as a dividend is paid.

Recommendation

If the particular investment satisfies the two conditions of paragraph 94.1(2)(k), it may be difficult for the taxpayer to prove that the main reason for its acquisition was not tax driven. The wording in this paragraph seems much too broad as it could catch almost all types of investments in non-resident entities. We recommend that the wording be changed to ensure that the paragraph applies only to actual tax-motivated transactions.

D.2 Timing of application of test

Paragraphs 94.1(2)(m) and (n) deem a taxpayer not to have a tax avoidance motive in certain circumstances. These rules are drafted as if the tax avoidance motive test were an ongoing test. It is not clear how they are intended to fit with paragraph (e) of the definition of "exempt interest", which requires that there be no tax avoidance motive for the *acquisition* of an interest.

Recommendation

The time at which the tax avoidance motive is determined should be clarified and applied consistently in all applicable parts of the rules.

D.3 Income distribution requirement

Subparagraph 94.1(2)(m)(i) deems a taxpayer not to have a tax avoidance motive if all or substantially all of the income, profits and gains of the particular non-resident entity become payable to its interest holders and are included in computing the taxpayer's income in the applicable year. It is unclear what rules will apply in making the determination of whether "all or substantially all of the income, profits and gains" have in fact become payable. Is this determination based on accounting principles or tax principles? If it is based on tax principles, will domestic or foreign rules apply?

Subparagraph 94.1(2)(m)(ii) requires that each FIE in which the non-resident entity has a direct or indirect interest must also meet this all or substantially all distribution test, and the non-resident entity must include its share of the distributed income, profits and gains in computing its income. It is unclear, from a tax policy perspective, why there is a need for the underlying FIEs to have actually distributed their income to the particular non-resident entity. So long as the top tier entity has distributed an amount that includes all or substantially all of the income, profits and gains of its underlying FIEs, there appears to be no reason for the underlying FIEs to have to actually distribute those amounts.

Recommendation

We recommend that this distribution test be amended in order to clarify how the determination of whether all or substantially all of the income, profits and gains have become payable is to be made. We also feel that the requirement that all underlying FIEs actually distribute their income up to the top tier entity should be eliminated, provided that the top tier entity has distributed an amount that includes all or substantially all of the income, profits and gains of its underlying FIEs.

E. Application of the FIE Rules to Non-resident Testamentary Trusts

A non-resident trust that is deemed to be resident in Canada as a result of the draft rules in new section 94 is deemed not to be a non-resident entity for purposes of the FIE rules, due to the charging provision in subsection 94(3). Therefore, a Canadian resident beneficiary of such a trust will not be caught by the FIE rules.

However, a Canadian resident beneficiary of a non-resident trust that is not deemed to be resident in Canada under proposed section 94 may potentially be caught by the FIE rules.

Both the June 22, 2000 and the August 2, 2001 versions of the FIE draft legislation specifically included interests in non-resident testamentary trusts that have never been acquired for consideration in the definition of "exempt interest" in section 94.1. As a result, these interests were previously excluded from the FIE rules. This category of exempt interest has now been deleted from the October 11, 2002 version of the draft legislation.

As a result of this change, certain trusts set up outside of Canada that have never had any connection to Canada other than having a Canadian beneficiary could now be subject to the FIE rules. Once a testamentary trust is established on the death of a non-resident individual and the Canadian beneficiary has an indefeasibly vested interest in the trust, the FIE rules will apply to the beneficiary if the trust owns primarily investment property. This result seems to be a major shift in policy from previous versions of the legislation, and could be patently unfair to Canadian resident beneficiaries.

A beneficiary could potentially be required to include a large amount in income each year based on the fair market value of the interest in the trust, under either the prescribed rate regime or the mark-to-market regime. This would be the case even if the beneficiary is only a capital beneficiary of the trust and will never receive any income therefrom. This result would require the beneficiary to pay current income tax while receiving no actual cash with which to make such a payment.

A non-resident testamentary trust that has never had any connection to Canada, even if it has a Canadian resident beneficiary, is not caught under the proposed rules in section 94 as there is presumably no "connected contributor" to the trust. To now subject the beneficiary to taxation in Canada seems to be a dramatic change in tax policy that has never before been raised or discussed with tax practitioners.

Recommendation

The application of the FIE rules to non-resident testamentary trusts should be eliminated. There seems to be no policy reason for having the rules apply to non-resident trusts that are in no way connected to Canada.

F. Financial Statement Presentation Concerns and the Look-through Rule

See attachment at end of Non-resident Trust submission (page 21)

G. Timing of Controlled Foreign Affiliate Election

The wording of paragraph 94.1(2)(h) is difficult to read and has raised a number of questions from tax practitioners. In the preamble, it states that the non-resident entity is deemed to be a controlled foreign affiliate (CFA) throughout the period that begins at the earliest time in a taxation year at which the entity is a foreign affiliate (FA) of the taxpayer. We assume that the taxation year referred to is the first year in which the CFA election is made for that particular FA, although this interpretation is not readily apparent to some practitioners.

As well, subparagraph (v) requires that the taxpayer has not made an election for any year other than the first CFA year. However, subparagraph (iv) requires that the election be made in the first CFA year. It is unclear when subparagraph (v) will ever apply.

Recommendation

The wording in paragraph 94.1(2)(h) needs some clarification, as it seems to be confusing to many practitioners.

H. Mark-to-market Regime and the Definition of "Readily Obtainable Fair Market Value" in Subsection 94.2(1)

In order to qualify for mark-to-market treatment, a participating interest in a non-resident entity must have a "readily obtainable fair market value" (ROFMV). Paragraph (a) of this definition requires that the participating interest must be widely held and actively traded and listed on a prescribed stock exchange. It is interesting to note that most interests that would meet these requirements would not be subject to the FIE rules in the first place as they would meet the definition of an "exempt interest", assuming that no tax avoidance motive exists.

Nonetheless, we believe that this requirement seems to be too narrow in scope. The participating interest should have an objectively measured fair market value, however this can be determined if the security is listed on a stock exchange, whether or not a prescribed stock exchange, or if it trades in an over the counter market.

Under paragraph (b) of the ROFMV definition, it is required that the amount that is the "price that is payable at that time" at the demand of the holders be determined by reference to the fair market value at that time of the property of the non-resident entity. There is a concern that this rule is not flexible enough to deal with, for example, funds that have monthly or quarterly redemptions and the price is determined based on the fair market value at the time of the redemption. Since CCRA generally accepts that monthly or quarterly redemptions can meet the "at the demand" requirement, it should be sufficient to determine the fair market value at, or around, the time of the redemption.

Recommendation

The definition of ROFMV should be amended such that any objectively measured determination of fair market value can be used in order to meet the test. As well, the time of any redemption should be the time at which the fair market value determination is made under paragraph (b).

I. Tracking Interest Rule

I.1 Application of the rule to FIEs

In policy terms, the tracking interest rule appears to be aimed at certain participating interests of a taxpayer in a controlled foreign affiliate of the taxpayer, and certain non-resident entities (other than controlled foreign affiliates) which are not FIEs, where the participating interest is similar in economic terms to a participating interest in a FIE.

If the tracking interest rule applies to a participating interest, the Canadian owner is required to use the mark-to-market method to calculate the annual income inclusion applicable to that interest. However, with the introduction of the prescribed rate regime in the October 11, 2002 draft legislation, there appears to be no reason to require mark-to-market valuation to

be used. In many cases, the fair market value information needed in order to comply with the mark-to-market rules will not be available to an investor.

Consider the following illustrative examples of difficulties that arise with the application of the tracking entity rules to FIEs.

Example 1

There are two classes of units in a non-resident entity which meets the definition of a FIE, each of which is tracked to different parts of the entity's portfolio of passive assets. It is assumed that the units do not represent an "exempt interest". There is no "readily obtainable fair market value" for the units.

Where this is the case, units in each class held by a Canadian investor would be subject to the prescribed rate regime as the investor holds a participating interest in a FIE. There does not appear to be any reason why the mark-to-market rules should apply. As well, the ability to apply the mark-to-market rules will be difficult if no fair market value information is available.

Only certain "exempt interests" are excluded from the tracking interest rule, including mark-to-market property and certain widely held and actively traded public interests. It would seem that most, if not all, of the property listed in the definition of "exempt interest" should be excluded from the rule.

Recommendations

The tracking interest rules should not apply to a participating interest of a taxpayer in a FIE, since the FIE regime will already apply to that interest. As is the case under the FIE regime, the mark-to-market rules should only apply to "tracking interests" at the election of the taxpayer, given that investors would often have difficulty in obtaining the information needed to apply the mark-to-market rules.

As well, except where there are compelling reasons to the contrary, the "exempt interest" rules in subsection 94.1(1) should apply to both FIEs and non-FIEs for the purposes of subsection 94.2(9).

Example 2

A FIE has issued one class of common shares. The FIE has a portfolio of passive investments and (say) a 100% interest in its wholly-owned subsidiary (the assets of which represent about 20% of the consolidated assets of the group). A Canadian investor owns a number of shares in the FIE. Without reference to the tracking interest rule, the prescribed rate regime would apply to the Canadian investor's shares in the FIE.

Analysis:

- Based on the liquidation entitlement of the common shares, there could arguably be "tracked property" associated with those shares.
  If there is "tracked property", it presumably would be all of the assets of the FIE (determined without reference to the look-through or consolidation rules in paragraphs 94.1(2)(a), (b) and (j)). If the "tracked property" does represent all of the FIEs property,

the exception in paragraph (a) of the definition of "tracking entity" in subsection 94.2(1) would apply and the FIE should not be a "tracking entity".

However, while the "tracked property" described above would be all of the FIE's actual property (i.e., determined without reference to paragraph 94.1(2)(a), (b) and (j)), it would appear that the property that the FIE is deemed to own as a consequence of paragraph 94.1(2)(a) or (j) would "taint" the FIE by causing the FIE to be a "tracking entity" as the exception in paragraph (a) of that definition would not apply.

- The requirement that the entitlement to payments be "determined primarily by reference to . . . " the criteria set out in paragraph 94.2(9)(d) causes some confusion. It is unclear how this determination is to be made.
  The entitlement to payments in respect of a particular form of participating interest is determined based on the documentation for that form of interest. So for example, share attributes outlined in the incorporation documents will determine entitlements to dividends and returns on liquidation, and the allocation of partnership income to a particular interest will be based on the partnership agreement. In most cases it is not the underlying property of the entity that will determine the entitlement to receive payments. The amount of the payment may be determined based on the income, profits etc. earned by the entity's property, but the entitlement to receive the payment is not.

Recommendations

The changes recommended earlier in respect of the use of consolidated financial statements and the application of the look-through rule must also be incorporated into the tracking interest rules in order to ensure that appropriate carrying values are being picked up.

The entitlement referred to in paragraph 94.2(9)(d) should not include a liquidation or similar entitlement with regard to assets of a non-resident entity. As well, clarification is needed as to how the entitlement to payments is to be "determined" for purposes of these rules, as it is currently unclear how legal entitlements tie into this determination.

There does not appear to be any sound policy rationale to have the tracking interest rules apply to partnerships (which are included in the definition "non-resident entity"), given that the FIE definition excludes interests in partnerships.

I.2 Application of the tracking interest rule in unintended circumstances

There appear to be serious problems that arise when attempting to apply the tracking interest rule, even with regard to fairly simple examples. Complicated share and organizational structures will undoubtedly reveal additional problems. The present problems and lack of clarity with regard to these rules are illustrated in the two examples below.

Example 3

A non-resident entity that is not a FIE owns 20% portfolio assets, but 80% of its assets are shares of a wholly-owned subsidiary which carries on an active business. The non-resident entity has two classes of shares: a large class of common shares (Class A) and "tracked shares" (Class B) that relate to 95% of the portfolio assets held by the entity.

Analysis:

One could arguably take the position that there is "tracked property" with regard to the Class A shares – namely, the shares of the subsidiary and the portfolio assets **not** covered by the Class B shares.

If this were the case, the entity would appear to be a "tracking entity" with regards to the Class A shares under paragraph (a) of that definition. This would be because:

- all of that "tracked property" would be owned by the entity,
- that "tracked property" would not represent 90% or more of the carrying value of the entity's property, and
- while most of that "tracked property" represents "active" assets in conceptual terms, the carrying value of such "active" assets is nil (because of the application of paragraph 94.1(2)(a) or (j)) and, consequently, the 50% "investment property" test in subparagraph (a)(ii) of the definition "tracking entity" would be satisfied merely because of the minor portfolio assets not covered by the Class B shares. It is not appropriate in policy terms for this minor interest in portfolio assets to taint the status of the non-resident entity with regard to the Class A shares.

Recommendation

It would appear reasonable to provide that the tracking interest rule should not apply to participating interests in an entity unless it is reasonable to consider that the terms of the participating interest have been designed so that the return on the participating interest

- does not have any significant correlation to the return on "active" assets of the entity, and
- does have a significant correlation to the return on assets of the entity that are not "active" assets of the entity.

For this purpose, "active" assets should be defined as assets owned by the entity that are not "investment property" (as defined in subsection 94.1(1), without reference to the "tracking entity" exception) owned by the entity on a consolidated accounting basis (or that would be owned by the entity if paragraph 94.1(2)(j) applied).

Example 4

A Canadian individual has an option to acquire shares of a non-resident entity. The option can be settled with the issue of shares of the entity or with cash. In most cases, the options are settled with cash.

Analysis:

- The individual has a "participating interest" in the non-resident entity due to paragraph (d) of the definition in subsection 94.1(1).
- There appears to be no relevant exemption in subsection 94.2(9).
- The "tracked property" appears to be the shares of the entity.
- The "tracked property" is not owned by the entity, so paragraphs (a) and (b) of the definition "tracking entity" in subsection 94.2(1) are not relevant.

- However, unless a restrictive meaning is given to paragraph (c) of the definition "tracking entity", it would appear that the non-resident entity would be a "tracking entity" assuming that it owns "investment property" (e.g., cash reserves) that are meant to satisfy the options.

Recommendation

The tracking interest rule should not apply to participating interests in a non-resident entity that are rights to acquire participating interests in the entity.

J. Administrative Overrides

New administrative overrides (the most significant of which are contained in paragraphs 94.1(2)(p) to (r)) have the effect of creating a parallel set of substantive rules for the FIE regime that would apply on an *ad hoc* basis to particular taxpayers who have received an information demand from the CCRA and failed to answer the demand to the satisfaction of the CCRA within 60 days (or a longer period acceptable to the CCRA). The breadth of these overrides seems unduly harsh. For example, pursuant to paragraph 94.1(2)(q), a non-resident entity carrying on the most active of businesses could be treated as a FIE in the event that a Canadian investor in the entity is unable to provide satisfactory information to the CCRA on a timely basis.

It is unclear why these new administrative overrides have been introduced. If the CCRA objects to a position taken by a taxpayer, it can reassess the taxpayer. It is well established under case law that a taxpayer would have the onus of disproving assumptions made in such a reassessment by the CCRA. The reassessment process has the advantage that, ultimately, review by an independent third party is possible.

Recommendation

The administrative override provisions should be eliminated or substantially limited.

K. Convertible Interests

Paragraph 94.1(2)(d) provides that convertible interests are deemed to have been converted for purposes of applying the FIE rules. However, where an offshore fund has several classes of interests and interests of one class can be converted into interests of another class, the application of this paragraph produces an anomalous result.

Recommendation

The wording in the paragraph needs to be redrafted in order to ensure that such interests are not converted into other interests.

L. Exempt Life Insurance Policies

Subparagraph 94.2(11)(c)(iii) excludes a life insurance policy from the mark-to-market rules if the taxpayer can establish that the amount required by section 12.2 is included in income. Section 12.2 does not apply to policies that are exempt policies. Therefore, it is unclear whether an exempt policy is excluded from the mark-to-market rules. It can be argued that if the taxpayer can establish that the amount required to be included in income is nil, because the policy is an exempt policy, the condition is met.

Recommendation

Uncertainty on this point would be avoided if the subparagraph explicitly referred to the taxpayer establishing that the policy is an exempt policy.

M. Treatment of FIE Income in a Trust

Paragraph 94.2(2)(g) provides that where a trust is required to include an amount in income under the mark-to-market regime in respect of an interest in a non-resident entity, the income is treated as non-Canadian source if more than 90% of the net accounting income of the non-resident entity is derived from non-Canadian sources. There should be a similar rule available to trusts which are required to include amounts in income in respect of a participating interest in a non-resident entity under the prescribed rate regime. There is no apparent policy reason for restricting the application of this principle to interests that can be marked to market, which, due to the requirement for a readily obtainable fair market value, may have limited applicability.

Recommendation

An equivalent rule to that contained in paragraph 94.2(2)(g) should also apply to trusts in respect of the prescribed rate regime in section 94.1.

N. Definitions in Subsection 94.1(1)

N.1 Carrying value

Purchased goodwill that is valued on an entity's balance sheet would be included in the determination of "carrying value". However internally generated goodwill does not appear on a balance sheet and therefore does not enter into this determination. This seems inequitable.

N.2 Entity

The definition of "entity" specifically excludes natural persons. However, we believe there are a number of instances where the term "entity" should encompass natural persons – e.g., the 10% test in subparagraph 94.1(2)(f)(ii), in subparagraph 94.1(2)(l)(iv), and in the definition of "exempt business" in subsection 94.1(1).

N.3 Exempt business

The preamble to the definition of "exempt business" refers to ". . . throughout the part of the period during which the business was carried on by the entity. . . ". It is not clear what period is intended. Presumably, the period is meant to be limited to the entity's taxation year.

N.4 Exempt interest

Subparagraph (e)(i) of the definition of "exempt business" requires that the FIE be resident in a country where there is a prescribed stock exchange and that its interests are widely held and actively traded (WHAT) and listed on a prescribed stock exchange. Subparagraph 94.1(2)(f)(iii) determines that in order for a FIE's interests to be WHAT, those interests must be qualified for distribution to the general public under the securities law of the country where the FIE is governed and exists. Therefore, if for example shares of a Cayman Islands

company are listed on the NYSE, they may not qualify as exempt interests if they are not qualified for distribution to the general public under the securities law of the Cayman Islands. This does not seem to be an appropriate result.

Clause (e)(ii)(B) of the definition requires that a taxpayer be resident in Canada throughout the period in a particular taxation year during which the taxpayer holds a participating interest. This requirement will not be met in the year in which a taxpayer becomes or ceases to be resident in Canada, if the interest is held at the time of immigration or emigration. This does not seem to be an appropriate result.

N.5 Investment property

The definition of "investment property" excludes exempt property of a non-resident entity, but includes property that is set out in paragraphs (a) to (l) of the definition. It is not clear whether the exclusion of exempt property takes priority over the inclusion of the specific listed properties. Presumably, it is intended that the exclusion overrides the inclusion.

If a property such as intellectual property is not specifically included in paragraphs (a) to (l) of the definition, it is unclear whether it could it still be considered to be investment property.

N.6 Participating interest

Paragraph (d) of the definition of "participating interest" includes property that is convertible into or exchangeable for other property. The wording in this paragraph would appear to include interests in a domestic Canadian corporation that are convertible into interests of a non-resident entity. As a result, shareholders of a Canadian corporation who receive exchangeable shares that are convertible into shares of a non-resident corporation, for example in a takeover transaction, would have a participating interest in a non-resident entity. We question whether the rules were intended to apply in such situations.

N.7 Qualifying entity

The definition of "qualifying entity" applies in reference to a period. However, the term is used in the definition of "investment property" without any period being specified.

Paragraph (d) refers to a particular time, but there is no indication of how this particular time fits into the period mentioned in the preamble to the definition.

Recommendation

Clarification is needed for points N.1 to N.7 as outlined above.

O. Technical Drafting Points

O.1 The definition of "carrying value" refers to *the* taxpayer in subparagraph (a)(i) without indicating what taxpayer is intended.

O.2 The definition of "readily obtainable fair market value" in subsection 94.2(1) provides a specific method for calculating an average price. However, that average price is never used. It is unclear why the term is defined to be an average price.

O.3 Subparagraph 94.1(2)(m)(ii) refers to "the other entity's taxation year that ends at any time". The period in which the time must occur is not specified.

O.4 The word "of" is missing before "the country" at the end of the fourth line of subparagraph (a)(iii) in the definition of "exempt business".

O.5 In the second line of subparagraph 94.1(2)(j)(iii), the word “that” should be deleted.

O.6 The prescribed rate to be used in subsection 94.1(4) is based on the amount paid by the "Receiver General". We believe that payments of interest are made by the Minister (see for example Regulation 4301(b)).

Non-resident trusts (NRTs)

A. Application of Section 94 to Tax-exempt Organizations

The new rules in proposed section 94 will potentially apply to Canadian tax exempt organizations who are generally not taxable on their incomes and who should not, in tax policy terms, pay or be exposed to Canadian tax. As a result Canadian tax-exempt organizations, such as pension funds and registered charities, could unexpectedly find themselves indirectly subject to a Canadian tax liability (not their own but the tax liability of a non-resident trust which becomes subject to the new rules) under the proposed new regime in Section 94.

For example, a Canadian tax exempt organization which invests in an otherwise prudent investment under its normal investment guidelines, such as a foreign commercial trust, a foreign mutual fund trust or a foreign pooled trust, could quite unexpectedly and unknowingly become jointly liable for the Canadian tax liability of the non-resident trust. This could occur, for example, where the Canadian tax exempt organization invests in an investment which qualifies as an exempt foreign trust at the time the investment is acquired (as defined in paragraphs 94(1)(h) and (i) of the Act) but which subsequently, as a result of actions of others and in circumstances totally beyond its control, loses its status as an exempt foreign trust investment.

It is not clear in tax policy terms why a Canadian tax-exempt organization, which would not otherwise be subject to Canadian tax on its investment, should now be indirectly exposed to the Canadian tax liability of a non-resident trust. This Canadian tax exposure presents an issue for investments that the Canadian tax exempt acquired before the new section 94 regime takes effect and may effectively prohibit their ability to make future investments in foreign mutual fund trusts, foreign pooled trusts or foreign commercial trusts, because of the risk that the non resident trust could lose its exempt foreign trust status. The Canadian tax exempt organization would be forced to continually monitor the status of these types of investments for all kinds of external factors for which it may not be able to obtain the appropriate information to be able to satisfy itself that its investment has not run afoul of the exempt foreign trust definition.

Under the FIE rules in section 94.1, tax-exempt organizations are included in the definition of "exempt taxpayer", ensuring that the rules do not apply to such organizations. Accordingly, there seems to be some inconsistency between the non-resident trust rules and the FIE rules.

Recommendation

We recommend that the draft legislation be amended such that Canadian tax-exempt organizations are excluded from the definitions of "resident contributor" and "resident beneficiaries" in respect of a non-resident trust. This could be achieved by having a definition of "exempt taxpayer" in the non-resident trust rules as is the case under the FIE rules. In this way, an "exempt taxpayer" (and any one else who is a "resident beneficiary" or a "resident contributor" in respect of a non-resident trust by reason of their interest in any exempt taxpayer), would not be subject to these rules.

B. Application of Section 94 to US Trusts

Proposed section 94 will apply to deem a US trust to be resident in Canada if that trust has a "resident beneficiary" or a "resident contributor". So say for example a Canadian resident grandfather wants to set up a trust for his US grandchildren. He will settle the trust and will then have no on-going role in respect of the trust. His grandchildren are minors, and as such the funds cannot be held directly in their names.

There are no Canadian resident beneficiaries under the terms of the trust, but the Canadian grandfather would be a resident contributor. As a result, the trust will be deemed to be resident in Canada, and it will also be resident in the US as it is created under US law and is controlled by US trustees.

There are no residency tie-breaker rules in the treaty that apply to trusts, therefore double taxation could arise in certain circumstances. The use of competent authority to settle residency issues is a very long and expensive option, and not one that the trustees would care to use.

Assuming the trust earns only US source income and pays all of that income out to the US beneficiaries on an annual basis, that income will be deductible in computing trust income for Canadian purposes and will be taxed in the US beneficiaries' hands for US tax purposes. If, on the other hand, the income is not paid out or made payable to the US beneficiaries, the trust will be taxed on that income both in Canada and in the US, with insufficient foreign tax credit relief in either country.

It may be possible to solve the problem of double taxation by ensuring that all income is paid out to beneficiaries annually, however there may be compelling legal reasons for not wanting the income paid out to minor beneficiaries. The terms of trusts set up in the past may not allow for an annual pay-out, thus preventing this solution to the problem.

Recommendation

We recommend that some form of exception be made to the rules in section 94 for trust income that is subject to tax in another high-tax jurisdiction such as the US. There will be many cases where trusts that are subject to the proposed Canadian rules will also be subject to tax in the US. This double taxation is inappropriate.

C. Definition of "Contribution" in Subsection 94(1)

C.1 Definition of "arm's length transfer" and its application to paragraph (c) of the definition of "contribution"

One of the requirements for paragraph (c) of the definition of “contribution” to apply is that the particular entity must become obligated to make a particular transfer or loan of property (other than an arm’s length transfer). The definition of “arm’s length transfer” only applies to an *actual* transfer. Thus, where there is an obligation to make a transfer or a loan that has not actually occurred, the future transfer or loan cannot be considered to be an arm’s length transfer.

Recommendation

This problem could be fixed by including an assumption that the obligated transfer or loan has actually occurred. It may also be necessary to deem any consequential transactions to

have occurred. For example, if the entity in whose favour the obligation exists will become obligated to do something in return, that reciprocal obligation should also be deemed to exist.

C.2 Paragraphs (b) and (c) of the definition of "contribution"

In paragraphs (b) and (c) of the definition of "contribution", it is unclear what sort of linkage is intended by the requirement that a transfer or loan be *made in respect of* the particular transfer or loan or the obligation.

Recommendation

The requisite linkage should be made clearer.

D. Definition of "Beneficiary" in Subsection 94(1)

It is unclear what the intention is in clause (b)(ii)(A) of the definition of "beneficiary" where there is expanded wording added in reference to subparagraph 248(25)(b)(ii). The words "any arrangement in respect of the particular trust" in subparagraph 248(25)(b)(ii) are expanded to say "any arrangement (including the terms or conditions of a share, or any arrangement in respect of a share, of the capital stock of a corporation that is beneficially interested on the particular trust) in respect of the particular trust".

The arrangement must still be in respect of the particular trust. Thus, the terms or conditions of a share or any arrangement in respect of a share must have something to do with the particular trust.

Recommendation

If the additional words are merely for greater certainty, then it would be helpful to state this. Otherwise, it appears that the language needs to be revised so that it is consistent with what is intended.

E. Deemed Transfers

Paragraphs 94(2)(e) and (f) deem a particular entity to have transferred property to another entity when the particular entity gives a guarantee on behalf of the other entity, provides it with any other financial assistance, or renders any service to it. It is unclear how other rules apply with respect to this deemed transfer.

One area of uncertainty is the application of paragraph (b) of the definition of "arm's length transfer". For example, in order to determine if the deemed transfer is described in subparagraph (b)(iv) of that definition, one must look at the consideration the recipient has provided in exchange for the transfer. However, the rules do not deem the recipient to have provided any consideration for the transfer. In particular, there is no rule deeming the consideration given for the guarantee, financial assistance, or service to be consideration for the deemed transfer of property.

Another area of uncertainty relates to paragraph (a) of the definition of "arm's length transfer" and also subparagraph 94(2)(c)(ii). Those rules refer to the reasons for the transfer. There are no deemed reasons for a deemed transfer.

This issue is relevant, for example, if a law firm or accounting firm renders services to a non-resident trust. For the above reasons, the services may constitute a contribution to the trust, even though the firm receives fair market value consideration for the services. The definition of "exempt service" excludes certain services provided on arm's length terms, but not services provided by a law firm or accounting firm since the services are not provided as an employee or agent of the trust.

Recommendation

Further deeming rules should be added so that the deemed transfer is made for the same reasons and consideration as the actual transaction. Alternatively, arm's length transactions should be excluded from the deemed transfer rule (as is done with "exempt services").

F. Trusts that Immigrate to Canada

If a non-resident trust was not subject to section 94 prior to 2003, but becomes subject to proposed section 94 for its 2003 taxation year, and if that trust becomes factually resident in Canada in 2003, then paragraph 128.1(1) could apply twice.

For example, assume a non-resident trust, which was not subject to section 94 in 2002, immigrates to Canada on July 1, 2003 and would be subject to proposed section 94 in 2003. According to paragraph 128.1(1)(a), the trust will have a deemed year-end immediately before its immigration (ie. on June 30, 2003). The trust will be deemed by subsection 94(3) to be resident in Canada commencing on January 1, 2003 and it will therefore be deemed to have disposed of its capital properties on December 31, 2002 because of paragraph 94(3)(c) and to have reacquired those properties on January 1, 2003. The factual immigration causes the deemed disposition and reacquisition to occur again on June 30, 2003 and July 1, 2003 respectively (per 128.1(1)(b) and (c)).

Recommendation

We recommend that changes should be made to paragraph 94(3)(c) and/or the immigration rules in section 128.1 to ensure that the deemed disposition and reacquisition rules as they apply to a non-resident trust that becomes resident in Canada apply only once, at the earliest time.

G. Definition of "Exempt foreign trust" in Subsection 94(1)

G.1 Application to foreign employee benefit arrangements

Paragraph (g) of the "exempt foreign trust" definition in broad terms provides an exemption for foreign employee benefit arrangements. Among the requirements that must be met to qualify under this paragraph are:

- the trust must be resident in a country the laws of which impose an income or profits tax (subparagraph (iii)), and
- the trust must be exempt, under the laws of that country, from the payment of income tax and profits tax to the government of that country *in recognition of the purposes for which the trust is operated* (subparagraph (iv)).

We believe that the requirement that the exemption from tax be based on the purpose for which the trust is operated is too restrictive. There are employee benefit plan vehicles that are established in jurisdictions that impose tax but do not impose tax on trusts with non-resident beneficiaries. Thus, the exemption from tax does not arise from an explicit exemption for trusts established for the purposes of providing employee benefits, but simply as a consequence of the operation of the applicable law.

Further, it is possible that such a trust might not be completely exempt from tax in its country of residence, but could be liable to tax in that country depending on the type of income earned. However, in order to ensure that it is not liable for tax it does not engage in the types of activities that would result in a tax liability.

For example, under Canadian rules, certain trusts that are generally not subject to tax may be subject to special types of taxes on certain types of income and gains on or holdings of certain types of investments (for example, taxes on excess foreign property holdings, and taxes on income from carrying on business). If a foreign jurisdiction would tax a pension vehicle on certain types of income, then that vehicle might not be considered to be "exempt" as required by paragraph (g), even though the trust is operated in such a way that it does not expose itself to these taxes.

Recommendation

We suggest that the policy objectives would be served by requiring only that the trust not have been liable for income tax or profits tax in its country of residence on the income or gains it has earned.

G.2 Application to unit trusts

Paragraph (i) of the definition of "exempt foreign trust" provides an exemption for certain unitized trusts. However, the trustee must make a filing with the Minister in order for unitholders resident in Canada to take advantage of the exemption. It is submitted that this requirement is far more restrictive than necessary to serve the policy objectives.

In regard to existing trusts, this requirement should not apply, or should be capable of being satisfied by a filing by the unitholder. With respect to pre-existing investments, a unitholder has no ability to require the trustee to comply with this requirement. It is unreasonable to expect that a unitholder will be able to require the trustee to comply with a Canadian tax requirement when the investment has already been made. There is no incentive for the trustee to agree to comply.

Recommendation

We submit that, with respect to new investments, a Canadian investor may be able to require the trustee to agree to make the filing as a condition to a subscription for units. However, even in this case, we believe that the policy objectives should be served by the unitholder making the filing and providing a copy of the declaration of trust and any financial information received from the trust to the Minister.

G.3 Definition of "exempt services"

Subparagraph (iii) of paragraph (i) of the "exempt foreign trust" definition requires that no consideration be received by a contributor to the trust other than an interest in the trust. The definition of "contributor" in subsection 94(1) would include a provider of services to the trust due to this definition, the definition of "contribution" in subsection 94(1), and the rule in paragraph 94(2)(f), which provides that the rendering of any service other than an "exempt service" (as defined in subsection 94(1)) to another entity is deemed to be a transfer of property.

It is submitted that the definition of "exempt services", which excludes only services relating to the "administration of the trust", is too restrictive. For example, it is not clear that services relating to the administration of the trust would include services relating to the management of the trust assets for which a management fee is payable.

Recommendation

It is submitted that the definition of "exempt services" should be expanded to include services relating to the management or investment of the trust assets.

G.4 Technical drafting points in respect of the definition of "exempt foreign trust"

Subparagraph (c)(iii) of the definition of “exempt foreign trust” refers to the trust’s “current year”. This should be revised to specify the year, e.g., the trust’s “taxation year that includes the particular time”.

Subparagraph (d)(iii) of the definition of “exempt foreign trust” requires that there be a group of at least 20 persons who are all contributors and who all deal with each other at arm’s length. If 25 people have contributed to a trust and 10 of them have died, the condition will not be met, since there can only be arm’s length dealings between persons who are in existence. The test should be applied on the assumption that all contributors are alive.

Paragraph (h) of the definition of “exempt foreign trust” refers to a “salary deferral arrangement”. It should refer to a “trust governed by a salary deferral arrangement”. This comment also applies with respect to paragraph (i) of the definition.

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F. Financial Statement Presentation Concerns and the Look-through Rule

Many tax practitioners have raised concerns over the proposed rules and their application when dealing with GAAP based financial statements. We have drawn up the following examples in order to illustrate a number of problems encountered with the wording that is currently in place, and to suggest possible solutions to those problems. For additional information on the Canadian GAAP treatment of intercorporate investments, see the attached Appendix, which can be used as a reference point when looking at the examples outlined below. This brief outline will serve as a general guide to the CICA Handbook accounting requirements for such investments. The examples we have included are based on Canadian GAAP requirements, and we will assume that substantially similar GAAP requirements exist in the US and the EU.

F.1 Balance sheet impact of using "consolidated" and "unconsolidated" financial statements

It is our understanding that the tax policy objective behind the "look-through rule" contained in paragraph 94.1(2)(j) is to allow a non-resident entity that holds at least 25% of the shares/interests of a particular investee to "look through" its investment and pick up its share of the carrying value of the investee's property and income. In this way, the carrying value of the non-resident entity's investments will not be considered to relate to investment property if in fact the investee is carrying on an active business.

This same rule is not needed in the case of investments that are consolidated, as the investee's assets, liabilities, revenues and expenses are already included in the non-resident entity's financial statements.

Tax policy objective of the look-through rule -- Example #1
This tax policy objective is illustrated in the following example, which is provided in the explanatory notes.

Jean owns less than 50% of the shares of ForeignCo and does not elect to treat ForeignCo as a controlled foreign affiliate. ForeignCo's financial statements are prepared in accordance with Canadian GAAP or a substantially similar GAAP. The balance sheet and adjusted balance sheet of ForeignCo (adjusted for its share of XYZ Co's assets) are as follows:

	ForeignCo's balance sheet ***(GAAP)***	ForeignCo's share of XYZ property	ForeignCo's balance sheet as adjusted ***(Tax)***
Non-active business assets:			
Cash	$ 4,000		$ 4,000
GIC	10,000	$ 6,000	16,000
Shares in ABC Co (5% interest)	5,000		5,000
Shares in XYZ Co (40% interest)	20,000	(20,000)	nil
Active business assets	nil	32,000	32,000
Total assets per GAAP/Tax f/s	$ 39,000		$ 57,000
Investment property percentage	100%		44%

From a policy perspective, this example reflects the following hypothetical facts:

- ForeignCo's financial statements are prepared in accordance with GAAP and are as shown in column 1 of the table. There are no investments held by ForeignCo that require consolidation, as all of its investments represent less than a 50% interest in the investee.
- ForeignCo's investment in ABC Co is a portfolio investment, and under GAAP would be accounted for at cost. There is no ability to use the look-through rule for tax purposes for this investment, as ForeignCo's interest is less than 25%.
- ForeignCo's investment in XYZ Co is accounted for using the equity method. As such, ForeignCo's share of XYZ Co's net income or loss each year is added to its retained earnings and to its investment account. The investment account is decreased by any dividends received from XYZ Co.
- Jean, the Canadian taxpayer, has full access to all information needed in order to make the adjustments as indicated in column 2 of the table. If Jean owns a significant interest in ForeignCo, then this assumption may hold true, but if Jean holds only say a 10% or less interest in ForeignCo, he may, as a practical metter, have great difficulty in getting any information in respect of ForeignCo's investments.

Application of proposed legislation to Example #1

Under the proposed legislation as it is currently drafted, there appears to be a number of technical problems that arise in applying the rules to this example.

- ForeignCo does not have "consolidated" financial statements (as that word is used in accounting parlance), as it has no investments that require consolidation. Therefore paragraph 94.1(2)(a) will arguably not apply.
- ForeignCo does not technically have "unconsolidated" financial statements either. Its statements are those prepared in accordance with GAAP, period. It is therefore questionable whether these statements would fall under paragraph 94.1(2)(b) as well. If the statements do not fall under paragraph (b), then the look-through rule cannot be used.

The use of the terms "consolidated" and "unconsolidated" as they are used in the draft legislation in relation to a non-resident entity's financial statements appears to cause unnecessary confusion in attempting to apply these rules. A Canadian investor, especially one with less than a 50% interest in the non-resident entity, will generally be provided with that entity's GAAP based financial statements, with all investments accounted for as required under GAAP. There will not be "consolidated" or "unconsolidated" statements issued in respect of the non-resident entity, there will simply be its financial statements prepared in accordance with GAAP. These are generally the statements that investors will have at their disposal and the ones that they must use to determine whether or not the non-resident entity is a FIE.

The Canadian investor will not have a choice as to what statements he/she should use to determine the carrying value of the non-resident entity's property. It is highly unlikely that the investor will have any information in respect of the non-resident entity in which he/she owns a direct interest other than the statements that he/she is given. We submit that there is generally no need to make an election to use specific statements as we expect that the entity will, in the

majority of cases, only be distributing one set of GAAP based statements to its investors. These are the statements that the investor must use as no others will be available.

In many cases, the investor will not have sufficient information, and will not be able to obtain sufficient information, to actually apply the look-through rule in paragraph 94.1(20(j). Any investments held by the non-resident entity will be accounted for in its financial statements as required under GAAP, but there will generally not be a breakdown of the underlying property of the investee included in the financial statements. In this example, Jean will specifically have to request the information contained in column 2 above, which he may or may not be given. If he cannot obtain this information, his participating interest in ForeignCo will be considered to be a FIE based on the carrying value of ForeignCo's property in column 1. If ForeignCo is willing to tell him, for example, that XYZ Co is an active business company and has no investment property, then Jean may have substantiation that ForeignCo is not a FIE.

Accounting for intercorporate investments on the balance sheet -- Example #2
The following illustrative example highlights some of the practical difficulties inherent in the FIE rules as they apply to various types of investments that a non-resident entity may have and their differing accounting treatment under GAAP. Assume that in this case Jean holds a 10% interest in ForeignCo, which has 5%, 40% and 60% interests in Forco A, Forco B and Forco C respectively, and he does not elect to treat ForeignCo as a controlled foreign affiliate. Also assume that:

- Forco B's balance sheet consists of $87,500 of active business assets and $12,500 of short-term investments, for a total carrying value of $100,000.
- Forco C's balance sheet consists of $75,000 of active business assets and $25,000 of short-term investments, for a total carrying value of $100,000.
- Note that for both Forco B and Forco C we have classified their short-term investments as investment property. If the company is in fact carrying on an active business, these short-term investments would arguably be exempt property as they are used or held principally in a business other than an investment business.

	ForeignCo's "legal entity" balance sheet	Forco C consolidation adjustments	ForeignCo's consolidated balance sheet ***(GAAP)***	ForeignCo's share of Forco B's property ***(Look-through)***	ForeignCo's balance sheet as adjusted ***(Tax)***
Non-active business assets:					
Cash/GIC	$ 15,000	$ 25,000	$ 40,000	$ 5,000	$ 45,000
Inv. in Forco A (5% interest)	5,000		5,000		5,000
Inv. in Forco B (40% interest)	40,000		40,000	(40,000)	
Inv. In Forco C (60% interest)	60,000	(60,000)			
Active business assets		75,000	75,000	35,000	110,000
Total assets	$ 120,000	$ 40,000	$ 160,000	nil	$ 160,000
Minority interest re Forco C (liability on b/s) (40% x $100,000)		(40,000)	(40,000)		(40,000)
Net assets	$ 120,000	nil	$ 120,000	nil	$ 120,000
Investment property %	100%		53%		31%

This example reflects the following facts:

- ForeignCo's balance sheet is prepared in accordance with GAAP and is as shown in column 3. It reflects the appropriate accounting treatment of all of ForeignCo's intercorporate investments.
- ForeignCo's investment in Forco A is a portfolio investment, and under GAAP would be accounted for at cost. For tax purposes, there is no ability to use the look-through rule for this investment, as ForeignCo's interest is less than 25%.
- ForeignCo's investment in Forco B is accounted for using the equity method. As such, ForeignCo's share of Forco B's net income or loss each year is added to its retained earnings and to its investment account. The investment account is decreased by any dividends received from Forco B.
- ForeignCo's investment in Forco C is accounted for using consolidation. As such, 100% of Forco C's assets and liabilities and income and expenses are included in ForeignCo's statements. To reflect the fact that ForeignCo only owns 60% of Forco C and not 100%, a minority interest is set up as a liability on the other side of the balance sheet (which we have not shown in the table) to reflect the 40% interest held by other investors.
- Jean, the Canadian taxpayer, has full access to all information needed in order to make the adjustments in respect of Forco B as indicated in column 4 of the table. In reality, this will probably not be the case as Jean is only a small investor in ForeignCo.
- Based on ForeignCo's GAAP based balance sheet as indicated in column 3, ForeignCo would be a FIE as more than 50% of the carrying value of its property is attributable to investment property. In order to achieve the correct results in tax policy terms, the look-

through rule must be applied to ForeignCo's investment in Forco B (as indicated in column 4), resulting in the figures in column 5. Using this adjusted tax balance sheet (column 5), ForeignCo is not a FIE as less than 50% of the carrying value of its property (31% in this example) is attributable to investment property.

Application of proposed legislation to Example #2
As is the case for the previous example, we expect that ForeignCo will only be issuing one set of financial statements to its investors. These statements will be prepared in accordance with GAAP and will reflect the appropriate accounting treatment of its various investments. No other financial statements will normally be made available to its investors. Therefore these are the statements that will have to be used by the investors to determine whether or not ForeignCo is a FIE.

As one of ForeignCo's investments is accounted for using consolidation as required under GAAP, then it seems like these statements may be classified as "consolidated" and will fit into paragraph 94.1(2)(a). However, the look-through rule in paragraph 94.1(2)(j) will now not apply as "consolidated" statements are being used. The results indicated in column 5 above, which give the correct answer from a tax policy perspective, may technically never arise based on the proposed wording of the legislation. Therefore, even if Jean is able to obtain the underlying information in respect of ForeignCo's investment in Forco B that is needed to make the appropriate adjustments, this information will be of no help and ForeignCo will be considered to be a FIE as more than 50% of the carrying value of its property (ie. 53%) is attributable to investment property as indicated in column 3.

Subparagraph 94.1(2)(a)(ii) deems the business and non-business activities, the net accounting income derived from the activities, and the assets and liabilities of the entities that are consolidated into the particular non-resident entity's financial statements to be those of the particular non-resident entity in the same proportion as the non-resident entity's interest in the investee.

It would appear that the purpose of this subparagraph is to somehow counter-balance the fact that, under GAAP, 100% of each investee's assets, liabilities, revenues and expenses are included in the non-resident entity's financial statements if the consolidation method is used to account for one or more of its investments. This is true even if the investee is not a wholly owned subsidiary of the non-resident entity. On the financial statements of the non-resident entity, a minority interest account is set up as a liability on the balance sheet and as a component of net income to reflect the percentage of net assets and net income/loss that is attributable to minority shareholders of the subsidiaries.

Although under consolidation rules 100% of the non-wholly owned subsidiaries' property is included in the non-resident entity's financial statements, we expect that this should generally not create significant differences in the overall composition of the carrying values of all of the non-resident entity's property.

As a practical matter, the information that would be needed in order for an investor to "deconsolidate" or unscramble the GAAP financial statements of a non-resident entity will seldom, if ever, be available. This is especially true if the non-resident entity has a number of investments that are accounted for using the consolidation method. There will seldom, if ever, be enough information contained in the financial statements to breakdown the appropriate

percentage of each investee's property or each investee's net income based on each proportionate interest.

Recommendations

We therefore submit that the GAAP balance sheet, as presented in the non-resident entity's financial statements, should be used for purposes of determining the entity's carrying values, with no requirement to unscramble the numbers included thereon. This is the most expedient and practical approach to follow, as any additional requirements will only serve to add unnecessary complexity to a taxpayer's ability to comply with the rules.

There should be no reference made to "consolidated" financial statements or "unconsolidated" financial statements. The vast majority of times there will only be one set of statements available to investors, and these will be the statements prepared in accordance with GAAP. The statements will present the appropriate accounting method for each type of investment held by the non-resident entity, be it cost, equity, or consolidation.

There should be no election needed to use a particular set of financial statements. As indicated above, there will normally be only one set of statements issued to investors, so there will be no choice as to what statements should be used.

If the non-resident entity holds a 25% or greater interest in an investee, we submit that the ability to use the look-through rule should always apply. Even though in some cases the information will be unavailable, the Canadian investor should still be able to apply the rule if possible. There should be no requirement that only certain financial statements can be used in order to have this rule apply.

There seems to be no need to have a deeming rule for the "proportionate interest" that a non-resident entity has in an investee that is consolidated. The non-resident entity should simply be deemed to own the property that is included on its balance sheet at the end of the year.

As a practical matter, in most cases the information needed to "deconsolidate" financial statements in order to determine this proportionate interest will not be available to the investor. It seems unreasonable to impose such a burden on the investor. As well, since 100% of all assets of the investee are being included in the non-resident entity's statements, both investment and active business assets will be bumped up to this 100% level and the overall carrying values will not be dramatically misstated.

F.2 Income statement impact of accounting for intercorporate investments

The examples outlined above only reflect the balance sheet portion of a non-resident entity's GAAP based financial statements. The income statement will also reflect the appropriate accounting methodology used for the non-resident entity's various investments.

As indicated in Example #2 above, ForeignCo's investment in Forco B is accounted for, under GAAP, using the equity method. This means that ForeignCo's 40% share of Forco B's net income will be included in ForeignCo's income statement as a one-line component of its net income. There will normally be no breakdown as to the various income and expense categories that make up this one-line item on ForeignCo's income statement.

ForeignCo's investment in Forco C is accounted for, under GAAP, using consolidation. This means that 100% of Forco C's revenues and expenses, on an item-by-item basis, will be

included in ForeignCo's income statement. The minority interest share in Forco C's net income, which in our example equals 40%, will be shown as a one-line reduction of ForeignCo's net income.

The use of the equity method and the use of consolidation for accounting for intercorporate investments result in the same net income amount on the investor's GAAP based income statement. Both methodologies end up including 100% of the investor company's own "legal entity" net income plus the investor's proportionate share of the investee's net income. The major difference lies in the presentation of the investor's share of the revenues and expenses of the investee in the GAAP based income statement of the investor.

The one-line equity pick-up that appears on the income statement of an investor when the equity method is used to account for its investment may include not only the investor's share of the investee's net income, but also adjustments related to the amortization of any fair market value increments in the underlying assets of the investee and of any purchase goodwill.

Financial statement presentation of net income -- Example #3
Let's assume that ForeignCo's GAAP based income statement, based on example #2, is as follows. It includes 100% of ForeignCo's own income and expenses, 100% of Forco C's income and expenses, an adjustment for the 40% equity pick-up related to Forco B ($10,000), and an adjustment for the 40% minority interest in Forco C ($7,000).

	ForeignCo's income statement ***(GAAP)***	Determination of "*net accounting income*" as proposed in draft legislation	Determination of "*net accounting income*" as we propose
Investment business:			
Income	$ 20,000	$ 20,000	$ 20,000
Expenses	12,000	12,000	12,000
Net income attributable to investment business	8,000	8,000	8,000
Active business:			
Income	30,000	30,000	30,000
Expenses	18,000	18,000	18,000
Net income attributable to active business	12,000	12,000	12,000
Net income before income tax, equity pick-up, minority interest	20,000	20,000	20,000
Income tax expense	(8,000)		
Plus equity in earnings of Forco B	10,000	10,000	
Less minority interest in earnings of Forco C	(7,000)	(7,000)	
Net income	$ 15,000	$ 23,000	$ 20,000

Definition of "net accounting income" in proposed legislation
The "net accounting income" of an entity, as defined in the proposed legislation, is the amount of its net income, before income taxes and extraordinary items, as included in its GAAP financial statements. Arguably, this net income amount would therefore include both the one-line equity adjustment ("equity pick-up") of an investee that is accounted for using the equity method, as well as the one-line minority interest reduction of a consolidated investee. No additional information would generally be disclosed in the financial statements as to what types of income and expenses are earned/incurred by either investee. The users of the financial statements would therefore not be able to breakdown, or look-through, these one-line items to determine whether the investees are earning investment income or active business income.

Election to use "net accounting income" to determine FIE status
Paragraph 94.1(2)(e) allows a taxpayer to elect to use a non-resident entity's net accounting income to determine whether that entity is carrying on an investment business or an active business. If making this election, the taxpayer will need to know the make up of the non-resident's entity's income and expenses, as the principal business of the entity will be deemed to be an investment business if its net accounting income attributable to investment property or businesses is greater than its net accounting income attributable to active property or businesses.

In Example #3, and based on the current wording in the draft legislation, ForeignCo's "net accounting income" would be $23,000, which is its net income before taxes and extraordinary items. The adjustments made for the equity pick-up of Forco B and the minority interest in Forco C are not considered to be extraordinary items under GAAP. It is easy to determine that $8,000 of net income relates to investment property/business, while $12,000 relates to active property/business. However, what is not clear is how the equity pick-up of $10,000 that relates to Forco B and the minority interest reduction of $7,000 that relates to Forco C, should be classified.

As is the case for the balance sheet, although under consolidation rules 100% of the non-wholly owned subsidiaries' income and expenses are included in the non-resident entity's financial statements, we expect that this should generally not create significant differences in the overall composition of the non-resident entity's net accounting income.

As a practical matter, the information that would be needed in order for an investor to determine the breakdown of such income statement adjustments will seldom, if ever, be available. This is especially true if the non-resident entity has a number of investments that are accounted for using either the equity method or consolidation.

Application of the look-through rule to "net accounting income"
Clause (B) of subparagraph (i) of the look-through rule in paragraph 94.1(2)(j) currently deems the net accounting income of a non-resident entity that is derived from a participating interest in another entity to be nil. It would appear that, as the look-through rule only applies to investees that are accounted for using the equity method, the purpose of this clause is to eliminate the net income of the investee, which would be included in the one-line adjustment on the income statement of the non-resident entity. If the definition of net accounting income specifically excluded this equity pick-up adjustment, there would be no need to deem this

amount to be nil. The non-resident entity's net accounting income would already exclude this amount, as is indicated in column 3 of Example #3 above.

Subparagraph (iii) of paragraph 94.1(2)(j) then deems the non-resident entity to have the net accounting income of the investee based on its proportionate interest in the investee. This net accounting income can then be used if the taxpayer elects under 94.1(2)(e) as indicated above. The change in the definition of net accounting income as we propose should not affect the application of this rule. The $10,000 of net income that is attributable to ForeignCo's investment in Forco B is deemed to be included in computing ForeignCo's net income.

As we indicated previously, the Canadian investor that holds an interest in ForeignCo will not, in almost all cases, have sufficient information to actually apply the look-through rule. ForeignCo's GAAP income statement will include an adjustment for the equity pick-up of investees that are accounted for using the equity method, but there will generally not be a breakdown of the underlying income and expenses of the investee included in the financial statements. The investor would specifically have to request the information needed to determine if the investee's net income relates to investment or active business activities. If the investor is not able to obtain this information, then he/she will only be able to determine the net accounting income as indicated on the income statement that is available.

Recommendations

In most cases, the investor will not have sufficient information, and will not be able to obtain sufficient information, to actually determine, or look through to the make up of both the equity pick-up adjustment and the minority interest adjustment that are included on the GAAP income statement. We therefore submit that they should be excluded from the definition of net accounting income. Net accounting income should be defined as net income per the GAAP income statement, which will generally be the only income statement available to investors, before income taxes and adjustments for equity and consolidation accounting methodologies. There should be no requirement to unscramble these adjustments, as the investor will generally not have the ability to do so. This is the most expedient and practical approach to follow, as any additional requirements will only serve to add unnecessary complexity to a taxpayer's ability to comply with the rules, and may in fact make the rules impossible to apply.

APPENDIX
ACCOUNTING FOR INTERCORPORATE INVESTMENTS
CANADIAN GAAP RULES

An intercorporate investment is any purchase by one corporation of the securities of another corporation. For accounting purposes, such investments are differentiated by the level of control or influence that the investor is able to exert over the affairs of the investee. Investors may purchase only a limited number of shares, which give them virtually no control or influence over the operations of the investee. Alternatively, investors may purchase a substantial number of shares that give them the ability to control or significantly influence the affairs of the investee. The accounting methodology used for each of these types of investments is outlined below.

Accounting methodologies

When an investor corporation presents its financial statements, there are three basic ways in which investments in the voting shares of other corporations can be reported:

1. the cost method;
2. the equity method; and
3. consolidation

Portfolio investments – cost method (less than 20% ownership)

The cost method is the methodology that is used for portfolio investments, where the investor does not have significant influence over the operations of the investee. This is presumed to be the case when the investment makes up less than 20% of the voting shares of the investee. The investment is reported on the balance sheet of the investor at cost, and dividends are only reported in the investor's income when declared by the investee.

Significant influence – equity method (greater than 20% but less than 50% ownership)

The equity method is used for reporting investments in the voting shares of significantly influenced investee corporations. Significant influence is presumed to exist if the investor corporation owns between 20% and 50% of the voting shares of the investee. The percentage of ownership is only a guideline; it is the substance of the relationship between the two companies that must be determined. A number of factors must be examined in order to determine whether significant influence exists, including items such as the composition of the board of directors, the extent of intercorporate transactions, the degree of debt financing provided by the investor, and the investor's ownership of intangible assets, such as patents, trademarks or processes upon which the investee's business depends.

When using the equity method of accounting for significantly influenced investee corporations, the investment account is initially recorded at cost. The investment account is then adjusted for the investor's share of the investee's net income, less dividends received. In situations where the investor has paid more for its investment than the net book value of the net assets acquired, a

purchase price discrepancy is created. This discrepancy is then notionally allocated amongst the tangible and identifiable intangible assets acquired, in order to reflect their values at fair value to the investor. Any remaining amount of purchase price discrepancy is allocated to goodwill. The investor's share of net income reported by the investee would be adjusted for the amortization of the fair value increment of the tangible and intangible assets acquired and of the goodwill.

The net result is that, at any point in time, the investment account reflects the historical cost of the shares to the investor, plus the investor's proportionate share of the increase in the investee's net asset value since the date of the initial investment.

Accounting for an investment using the equity method generally results in the net income of the investor being the same as what it would have been had the investee been consolidated into the statements of the investor.

Control – consolidation (greater than 50% ownership)

Consolidation is the process of reporting the full amount of assets and liabilities under the control of a parent corporation. Control is considered to exist when the parent's interest in the voting shares of the investee exceeds 50%. The investee is then referred to as a subsidiary. Consolidation is accomplished by combining the financial statements of subsidiaries with those of the parent corporation. On the balance sheet, there will be no investment account for the consolidated subsidiaries. Instead, the assets and liabilities of the subsidiaries will be added to those of the parent in order to show the economic resources of the entire economic entity comprising the parent and its controlled subsidiaries. On the income statement, the revenues and expenses will be the totals for each item for the parent and the subsidiaries.

When the parent owns more than 50% of the subsidiary but less than 100%, a minority interest in the subsidiary exists. This minority interest is reflected in both the balance sheet and the income statement of the parent. The minority interest share of the subsidiary's net assets is shown as a separate item on the liability side of the balance sheet. The minority interest share of the subsidiary's net income is shown as a separate item at the bottom of the income statement.

When the parent acquires the shares of the subsidiary, the purchase price may be greater than the fair market value of the subsidiary's net assets. This "excess" purchase price is set up as goodwill on the parent's consolidated balance sheet and is amortized through its income statement each year. The parent's share of the difference between the fair market value and the book value of the subsidiary's net assets, if any, is added to the net assets of the parent on its consolidated balance sheet. This therefore results in the parent's consolidated balance sheet reflecting 100% of the book value of its own net assets, 100% of the book value of the subsidiary's net assets, plus its share of any fair market value increment inherent in the subsidiary's net assets.

Other Situations

50% Ownership of an Investee Corporation

In cases where there is exactly 50% ownership of an investee corporation a determination would have to be made as to whether a "control" relationship exists. For example, if an investor corporation owns 50% of an investee corporation and the other shareholdings are widely held control may exist and the investment would be consolidated. If on the other hand an investor corporation and another unrelated shareholder both own 50% of an investee corporation and neither party can exert operational control of the investee on their own, each shareholder would use proportionate consolidation to account for the joint venture. Under proportionate consolidation each shareholder would pick up their proportionate interest in each line item on the investee's balance sheet and income statement. Under the proportionate consolidation method there would be no minority interest reflected in the investor corporation's financial statements.

Investments in Partnerships

For Canadian GAAP purposes, an initial interest in a partnership is accounted for at cost. Each year, the partner's share of the net income/loss of the partnership is included in the partner's income statement and is added to (or subtracted from) the partner's investment. Any distributions from the partnership reduce the investment account.